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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE COURT OF AUDITORS

Synthesis of the Commission's management achievements in 2011

1. INTRODUCTION

Article 317 of the Treaty on the Functioning of the European Union (TFEU) gives the European Commission responsibility for implementing the EU budget, within the limits of the appropriations available and having regard to the principles of sound financial management. It provides for Member States to cooperate with the Commission to ensure that the appropriations are used in accordance with these principles.

By adopting this Synthesis Report, on the basis of the assurances and reservations made by its Directors-General and Heads of Service in their AARs, the Commission takes overall political responsibility for management of the EU budget.

In the Synthesis Report, the Commission also identifies the key management issues to be addressed as a matter of priority and the action to be taken to address identified weaknesses.

In 2011, for the fourth successive year, the Court gave an unqualified positive opinion on the EU consolidated accounts for 2010. With regard to the legality and regularity of payments, the Court estimated the error rate[1] for payments as a whole between 2% and 5%, which compares well with the situation as late as 2006, when the most likely error rate was still above 7%. This demonstrates that the measures taken over time to remedy identified weaknesses are working, and bears witness to the continuous efforts made by the Commission.

The Commission understands that the Court has decided to introduce methodological changes. These changes concern a redefinition of the underlying transactions in its audit sample (excluding pre-financing and including clearing) and the method for quantifying serious irregularities in public tendering in all policy areas. The financial year 2011 will serve as a dry-run exercise for the Court's new methodology. **The new approach which will be applied as of 2012 is likely to increase mechanically the reported error rates** as of 2012.

The Commission understands that these changes will be clearly explained and the error rates will be presented in the annual reports in such a way that the comparability with the previous years is preserved. The Commission is however concerned by the impact that the increase in the published error rates may have on the cost of control as this could lead stakeholders to request supplementary controls putting additional administrative burden on the beneficiaries and on the Commission services.

2. STRENGTHENING THE BASIS OF ASSURANCE

2.1. Chain of accountability

The College delegates the operational implementation of political and management objectives to the Directors-General and Heads of Service, who, as 'Authorising Officers by Delegation' (AOD's) receive the means to act. This decentralised management organisation is characterised by a clear definition of the responsibilities of the different actors. The AOD's are fully empowered to define the most appropriate and effective control system for ensuring sound and efficient management of the resources for which they are responsible. The AAR is the main mean by which the AOD account for their stewardship of the human and financial

[1] The most likely error estimated by the Court, for payments as a whole was 3.7% in 2010. (OJ C326 of 10 November 2011, paragraph 1.16).

resources for which they are responsible. The AOD's report on the performance of their duties in the AARs,[2] which include a signed declaration of assurance covering inter alia the legality and regularity of financial transactions. The AAR is the report in which they document any issues arising from their management which need to be brought to the attention of the College for recognition at the political level. Each AAR explicitly confirms that the responsible Commissioner(s) has (ve) been informed of the main aspects of the AAR, including any reservations the AOD intended to make, before the final signature of the declaration of assurance.

This Synthesis Report is adopted collegially after discussion at one of the Commission's weekly meetings.

2.2. Quality of the Annual Activity Reports

AARs constitute a major source of information for the Court and for the Discharge Authority. In its 2010 Annual Report, the Court assessed the quality of twenty-one 2010 AARs out of forty-nine in total. In the Court's opinion, twelve audited 2010 AARs give a 'fair assessment of financial management in relation to regularity' and nine audited 2010 AARs give a 'partially fair assessment'. For seven of those nine AARs, the Court was of the opinion that the scope or scale of a reservation should have been wider. The 2011 AARs explain how the relevant services have worked to address the issues highlighted by the Court.

The Standing Instructions for the 2011 AARs have been fine-tuned to further improve the quality of the evidence presented to support assurances made, and to improve the readability of the reports. **The Commission's analysis shows that, on the whole, the revised instructions have been adequately implemented throughout the Commission.** All services have reported regularity indicators covering all significant budget areas and management modes and those reporting subsequent event have done so in compliance with the revised guidelines.

The Commission notes major improvements towards a more objective and accurate determination of the scope of the reservations and the resulting financial exposure. These improvements include better consistency in the use of terminology, in the presentation of error rates, in the calculation of the amount at risk and the application of materiality criteria as well as the use of the best reliable information available in the shared management area.

In a constant quest for improvement, the Commission central services continue to be involved at an early stage by supporting DGs in drafting the AARs, discussing key issues with Directorates-General and Services and providing the guidance needed to improve the quality of the final texts. Again, (pre-)peer-reviews have proven to be an effective platform for the different services, as peers, to share opinions on how to formulate a number of cross-cutting issues in their AARs, how to ensure a coherent approach and how to adequately tackle identified weaknesses.

The AARs are the main vehicle through which the AOD's document their accountability to the College and are a source of evidence for the Statement of Assurance (DAS). The Commission is committed to continuously improving the readability and comparability of the AARs. The Commission instructs the Secretariat-General and the Directorate-General for Budget to continuously provide guidance to Directorates-General and Services, through a regular review of Standing Instructions, guidance notes, training measures, a quality review of draft AARs and (pre-)peer-review meetings.

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2 Article 60 of the Financial Regulation.

2.3. Reporting on error rates

Directors-General include reservations in their declarations of assurance based upon their assessment of the materiality of weaknesses and/or observations regarding the building blocks of their AARs. A key element used to determine whether a reservation is necessary is an evaluation of the detected or reported error rates and the related financial exposure.

Commission departments have different approaches to considering and calculating residual error rates, which take into account the specificities of the policy areas for which they are responsible. Wherever possible, the Secretary-General and the Director-General for Budget have encouraged the harmonisation of different aspects, in particular the use of the residual error rate. The Standing Instructions have thus been enhanced to ensure the consistent use of terminology and criteria by all the services, as regards the residual error rate, the use of a multiannual approach, and the notion of 'subsequent events' (events occurring between year-end and the signature of the report by the AOD at the end of March).

A large number of DGs have already embraced the multiannual approach to error reporting. The Commission instructs the other Services operating multiannual programmes to disclose in their AAR a cumulative financial risk under a multiannual control strategy, so that this will be the only approach from 2012 onwards.

During the reporting year, the **Structural Fund DG's worked on a new and common approach for determining materiality**. The decision on whether to make a reservation is now based on a three-step approach:

- assessing the national management and control systems;
- taking full account of the projected error rates as detected by the national authorities and reported in Annual Control Reports, when these could be validated, instead of using predefined estimated error levels;[3] and
- applying a cumulative residual risk for each programme, to monitor the corrective capacity of multi-annual management and control systems.

This approach also means that the AARs disclose the results of the **Commission's assessment of all operational programmes control systems,** taking into account the various levels of assurance and national audit opinions. This is in line with the Single Audit principle and also underlines the fact that Member States are responsible for their own control environment.

The Commission considers these efforts to harmonise the materiality criteria to be an important improvement contributing to the coherence, readability and transparency of the AARs. It instructs the Directorates-General for Regional Policy, for Employment, Social Affairs and Inclusion, for Agriculture and Rural Development, for Maritime Affairs and Fisheries to continue this harmonisation and to agree on a single set of criteria and presentation for the 2012 AAR. The Directorate-General for Home Affairs should, although having different legal bases, be associated as much as possible to this harmonisation process.

[3] The so-called 'flat-rates for financial corrections'

2.4. Internal Audit

The Audit Progress Committee (APC) continued to inform the College on audit issues, including issues with a corporate dimension. The APC also informed the College on the progress achieved in implementing accepted audit recommendations by the end of 2011. 80% of all recommendations accepted in the period 2007-2011 had been implemented. Out of 118 very important recommendations outstanding at the end of 2011, only 24 were overdue by more than 6 months compared to the initially planned target date.

In May 2012, the Commission's Internal Audit Service submitted the 2011 Annual Internal Audit Report for the year 2011 as stipulated under Article 86(3) of the Financial Regulation. It accompanied the Commission's Internal Audit Service's second Overall Opinion. The opinion is based on work carried out by the Internal Audit Capabilities and the Internal Audit Service during the period 2009 to 2011 as part of the coordinated strategic audit plan. It focuses on financial management.

The Overall Opinion provides a positive opinion on financial management in the Commission with the exception of those areas over which reservations have been expressed by Directors General in their Annual Activity Reports. The estimated potential financial impact of these reservations is less than 2% of the budget as a whole but not all reservations are quantifiable but represent potential reputational risks.

The Commission also notes that in the *Emphasis of Matter* attached to the Overall Opinion, the Internal Audit Service highlights a number of issues that needs to be addressed by Commission services:

- The need to further harmonise the calculation of the residual error rate across the Commission;

- Weaknesses identified in external aid in relation to centralised and decentralised calls for proposals, and in particular, the need to improve the planning, reporting and monitoring of the controls exercised by EU Delegations in the area of grant management;

- Policy areas where the risk of error is still too high and the particular problems associated with shared management in the Cohesion Policy area;

- The need to better coordinate and harmonise control strategies at policy *family* level, in particular the programmes for on-the-spot controls in the research policy DGs;

- Deficiencies with control systems in Member States, in particular the first-level checks over claims by the services responsible for implementing aid schemes;

- Measures still in the process of being implemented at end-2011 to address some significant risks , such as improving governance, project management and accounting of fixed assets for the Global Navigation Satellites Systems (GNSS); improving the effectiveness of ex-ante checks on claims paid in the area of research; steering IT developments with the objective of avoiding duplication; monitoring by several services of payment deadlines and implementing an anti-fraud strategy.

3. ASSURANCE GATHERED THROUGH THE AARS AND RESERVATIONS MADE BY THE DIRECTORS-GENERAL

Having examined the AARs, and in particular the declarations signed by each Director-General, the Commission notes that they all give reasonable assurance regarding the use of resources for the intended purpose, observance of the principles of sound financial management and the fact that the control procedures used, give the necessary guarantees of the legality and regularity of the underlying transactions. Some AOD's have disclosed residual weaknesses and made reservations in their AARs, without calling into question the overall assurance given.

Fourteen Directors-General and two Directors of Executive Agencies issued a total of **twenty-seven reservations** in their 2011 AARs. Reservations have been made in 17 services, which together account for more than 90% of the Commission financial operations (expenditure and revenue). These included fourteen of the seventeen reservations already made in 2010 on which action was still ongoing at the end of 2011, plus thirteen new reservations. Three 2010 reservations were lifted.

The total amount at risk as quantified in the reservations increased significantly, from EUR 600 million in the 2010 AARs to a **potential maximum of EUR 3 564 million**[4] the 2011 AARs. This increase in the number of reservations and in monetary exposure in amounts at risk does not result from deterioration in the quality of financial management at the Commission. It is rather due to the combined effect of a number of technical and structural factors:

- Among these twenty-seven reservations, six concern the same issue and the same programme (FP7). This is because the seventh Framework Programme (FP7), which gained momentum in 2011 (see chapter 3.5), is managed by five Directorates-General and one Executive Agency and therefore leads to multiple reservations.
- The relative point of maturity in the multi-annual budget implementation cycle:
    - in direct management, the 2007-2013 generation of programmes have by now reached a level of implementation which, allows drawing conclusions from ex-post audits (which explains the introduction of the research FP7 reservation);
    - in shared management, Member States begin to report audit results from an increased sample of on-going operational programmes (which partially explains the increased scope of the reservations of the Directorate-General for Regional Policy);
    - most of the 2007-2013 programmes are now fully running. Increased level of implementation of 2007-2013 programmes lead to higher volumes of payments and therefore bear a higher inherent risk of error compared to previous years.
- In Cohesion Policy, the replacement (see chapter 3.3) of flat-rate management estimations by the actual error data reported by audit authorities in Member States has resulted in a

4 This is the sum of all quantified amounts in the reservations (EUR 1 982 million maximum) and an estimated amount at risk (EUR 1 582 million) for the DG BUDG's reservation regarding Traditional Own Resources. For those Directorates-General who reported a minimum and a maximum range, the maximum amount was considered.

better assessment of the regularity risks, but has also meant that a higher number of programmes come under reservation, with greater amounts at stake.

- The newly issued guidelines on how to consider pre-financing for the calculation of the residual error rates and the amounts at risk require services to include the previous pre-financing that has been cleared together with the interim and final balance payments, and thus prevents them from averaging down error rates detected in interim and final payments with the new pre-financing expenditure for which the error rate is still zero.
- For a number of programmes, the regularity risk is very close to the materiality threshold of 2 %. Slight, year-to-year variations in the detected error rate around the threshold result in intermittent reservations over time.

All Directors-General and Heads of Service have identified the main reasons for his/her reservation(s) and set out remedial actions to address it/them. Generally, the most common concerns stem from the **complex eligibility rules for grant beneficiaries** (an issue which affects funds under direct centralised management) and from the incorrect application of **public procurement rules** (a frequent cause of errors for shared and indirectly managed funds). The Commission has drawn operational conclusions from this experience and has made proposals for major simplification (see chapter 4.5 below) in the next generation of programmes.

After assessment of the control results, three reservations carried over from previous years were lifted. To lift a reservation, AOD's were asked to present the measures put in place to address the weaknesses identified, to show that the measures were effective and to demonstrate that the weaknesses had been effectively addressed. In most cases, this requires audit evidence that error rates have decreased to an acceptable level or that systems have been strengthened and are now functioning properly.

3.1. Revenue

Traditional own resources (TOR) represent 12.2 % of total revenue for the 2011 EU budget. They are established and collected by the Member States. Three quarters of these amounts are paid to the EU budget, the remaining quarter being retained by the Member States to cover collection costs. Given its geographical position, Belgium is a major contributor of TOR, accounting for 9.45 % of total TOR in 2011. Inspections carried out by the Commission and audits performed by the Court have highlighted a reconciliation issue between the amounts transferred and underlying records. The Director-General for the Budget has made a **reservation concerning insufficient assurance as to the reliability of the Belgian clearance and accounting systems**. The Commission has requested remedial action, including the enhancement of internal controls and full-scale external audits of the accounting system. In the meantime, there is uncertainty as to the correctness of the amounts of Belgian TOR credited to the Commission's account.

The Commission recalls the commitments undertaken by the authorities of the concerned Member State with respect to the action plans drawn up to remedy the deficiencies identified in its custom declaration processing systems, and reiterates that it will closely and strictly monitor its implementation.

3.2. Agriculture and Natural Resources

In its 2010 annual report, the Court concluded, based on the estimated error rate[5] just above 2%, that the Agriculture and Natural Resources chapter was affected by material error. At the same time, it indicated that the direct payments covered by the Integrated Administration and Control System (IACS), which represent 91.4% of total EAGF expenditure, were free from material error.

In his 2011 AAR, the Director-General for Agriculture and Rural Development made **three reservations**:

- Given the importance of IACS for the management and control of agricultural expenditure, and the serious **deficiencies in IACS in Bulgaria and Portugal**, the 2010 reservation was carried over for reputational reasons, even if the financial impact of the deficiencies did not exceed the materiality threshold. In 2010, this reservation covered Bulgaria, Romania and Portugal. In 2011, the reservation for Romania was lifted as the Commission audits determined that the Romanian action plan was completed and that the work done was considered to be appropriate.

- A new **reservation on expenditure for rural development measures** as a whole was made because the residual error rate (up to 2.36%) was determined to be slightly above the materiality threshold in 2011. This increase in the error rate is mainly because rural development is subject to a high number and/or complex conditions foreseen in the programmes that increase the risk of errors by beneficiaries and make controls by the national authorities more difficult and costly.

- A reputational reservation for **deficiencies in the supervision and control of certified organic products** was made. Events in 2011 showed that controls in the organic farming sector are considered as insufficient and that there might be weaknesses in EU supervision of the control systems of Member States and third countries, including supervision of the control bodies certifying organic products for import into the EU.

The Director-General for Maritime Affairs and Fisheries maintained her reservation concerning **the Financial Instrument for Fisheries Guidance (FIFG)** with regard to one programme in Germany, for which a correction will be required but which is pending a valuation exercise.

The Director-General for **Maritime Affairs and Fisheries issued a new reservation concerning European Fisheries Fund management and control systems and investments on board**, as errors with regard to the eligibility of expenditure had been identified, and it had been established that Member States do not sufficiently verify whether investments on board increase the ability of vessels to catch fish.

The Director-General for Climate Action maintained his previous reservation on account of the **reputational** damage to the Commission resulting from **a significant security breach in the national registries of the EU Emissions Trading System** (ETS).

The Director-General for Health and Consumers issued a reservation concerning the **accuracy of Member States' cost claims under the animal disease eradication and monitoring programmes in the food and feed policy area**. The main sources of the detected errors are

5 The Court of Auditors estimates the most likely error rate at 2.3%. (OJ C 326 of 10 November 2011, Annex 3.1).

cost claims from Member States that do not correctly apply the eligibility rules set out in the legislation. With a view to reducing the error rate in the feed and food area, the Director-General for Health and Consumers had already taken a number of steps in previous years. For example, a more precise and restrictive definition of eligible expenditure was introduced by a Commission decision for veterinary programmes starting on 1 January 2011. The introduction of lump sums as from 2012 will further reduce the errors made in Member States' cost claims in the coming years.

3.3. Cohesion, Energy and Transport

For many years, the Cohesion Policy has had an estimated error level higher than the other policy areas. In 2010, the Court estimated the most likely error rate for this chapter at 7.7 %. The detected error rate is **subject to year-on-year variations** and is influenced by the relative stage in the multiannual implementation cycle. 2010 was the first year in which most programmes under the current regulatory framework were fully running, and most national authorities had implemented projects and declared expenditure, thus increasing the inherent risk of errors.

The **Director-General for Regional Policy issued two reservations**: one reputational reservation on management and control systems for identified operational programmes in Germany, Hungary, Ireland, Italy, Spain and for cross-border programmes under the ERDF/Cohesion Fund for the 2000-2006 period; and another on ERDF/Cohesion Fund management and control systems for identified operational programmes in eighteen Member States[6], IPA management and control systems in the former Yugoslav Republic of Macedonia and European Territorial Cooperation programmes, and a programme for IPA[7]/cross-border cooperation for the period 2007-2013.

The **Director-General for Employment, Social Affairs and Inclusion made two reservations**: one concerns management and control systems for identified operational programmes in Germany, France, Italy and Spain under ESF 2000-2006, and the other for identified operational programmes in Belgium, the Czech Republic, Germany, Italy, Latvia, Lithuania, Romania, Slovakia, Spain and the United Kingdom under ESF 2007-2013 as well as for the former Yugoslav Republic of Macedonia IPA programme. Both reservations were made following serious deficiencies in key aspects of the management and control systems of the identified operational programmes.

Thes deficiencies linked to the reservations for both Directorates General concern, for instance, certification activities, high error rates, compliance with public procurement rules, eligibility rules, management verifications or lack of audit trail.

The Commission will continue to rigorously exercise its supervisory role by calling on Member States to immediately address the deficiencies detected in their management and control systems and also by timely interrupting or suspending payments as well as by making financial corrections whenever necessary. The Commission will focus its efforts in these areas, through concerted preventive and corrective action. In the triennial revision of the Financial Regulation, as well as in the sector-specific proposals, the Commission proposed that the national accredited authorities shall provide an annual management declaration of assurance for all programmes under shared management as is already the case for agricultural policy.

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6 Austria, Bulgaria, the Czech Republic, Estonia, France, Germany, Greece, Hungary, Italy, Latvia, Lithuania, the Netherlands, Poland, Romania, Slovenia, Slovakia, Spain, and the UK.

7 Instrument for Pre-Accession Assistance

The Cohesion DG's provide a quantification of the reservations by reporting the overall estimated amount at risk and by estimating the financial risk:

- The **overall estimated amount at risk (based on the validated error rate)** refers to the quantification of errors as a percentage of the 2011 interim payments for all 2007-2013 programmes and is calculated by the Commission on the basis of the audit of operations performed by the Audit Authorities and the resulting error rates reported in their 2011 Annual Control Reports, after validation by the Directorates-General concerned. The amount at risk is between 3.1% and 6.8% for the Directorate-General for Regional Policy and is between 2% and 2.5% for the Directorate-General for Employment, Social Affairs and Inclusion.

- The **estimated financial risk** refers to the impact of 2007-2013 programmes where the Directorates-General concerned did not have reasonable assurance and therefore made a reservation. The estimated financial impact of the reservations is between EUR 632 million and 1 427 million for the Directorate-General for Regional Policy and is EUR 59 million for the Directorate-General for Employment, Social Affairs and Inclusion. These amounts correspond to respectively 2.1% to 4.8% and 0.6% of the payments made in 2011.

In general, the quantification of reservations in the AARs of the Director-General for Regional Policy and the Director-General for Employment, Social Affairs and Inclusion are not directly comparable with the consolidated error rates for Cohesion Policy as estimated by the Court in its Annual Report. The main differences relate to:

- The *mix of programmes* being tested can have an impact on the test results: The Court is basing its calculation on a representative sample of transactions (payments) and is extrapolating this to all expenditures under Cohesion Policy whilst the rates calculated by the Commission are Fund specific and cover each programme or groups of programmes running under identical management and control systems.

- The *time difference*: the amount at risk is calculated by the Commission at a later stage in the control cycle compared to the error rate reported by the Court. In accordance with the relevant regulations, the Annual Control Reports submitted by Member States relate to 2010 expenditure whilst the error-rate reported annually by the Court is calculated on the basis of errors identified in the year concerned.

- The Commission implements *multiannual* control strategies, so the AOD's assess the functioning of the control systems accordingly. In contrast, the Court is required to express an annual audit opinion. While the risk of irregularities in a number of programmes can be considered manageable on a multiannual basis, it could be higher than the estimated averages in a number of programmes and Member States when measured on an annual basis. For this reason, **it is fully justified that the amount at risk reported in the AARs by the Commission services for structural actions takes into account the various mitigating and corrective actions in place under the multiannual management and control systems** (allowing corrections to be made some years after the disbursement of funds by the Member State to the beneficiaries and by the Commission to the Member State). Therefore, the error rate in the Court's DAS is typically higher, as it includes errors that can be corrected in subsequent years once all actors in the control chain have intervened.

- The quantification of error rates is sometimes based on *different assumptions* especially where the real value of the error is unknown. For instance, unlike the Commission services, the Court quantifies serious infringements of public procurement rules at the full value of the contract, whereas the real economic loss to the EU budget is limited to the additional profit margins for contractors benefiting from such infringements.

The Commission services have analysed the errors detected by the Court for the years 2006-2009 and presented their analysis in a working paper.[8] This paper demonstrates that non-compliance with eligibility criteria and errors in public procurement rules or procedures are the most common types of errors detected in Cohesion Policy. Inadequate audit trails and incorrect calculation of the co-financing rate for revenue-generating projects are also sources of error. The analysis carried out shows that the selection of projects and ineligible costs are the main eligibility errors, while in public procurement the main sources of error are assessment of bids, use of inappropriate tendering procedures, and publication issues.

In 2011, the Commission made proposals for the next multiannual financial framework, including a number of significant enhancements, in particular in shared management (which constitutes some 80 % of the budget), with a view to improving the design of funding schemes, addressing the risk of error, limiting the administrative burden for beneficiaries and other stakeholders and reducing the operating costs of controls. As part of the revision of the Financial Regulation, the Commission has proposed the introduction of annual management declarations of assurance by the accredited bodies for all programmes under shared management as is already the case for agricultural policy.

In its proposals for cohesion policy for 2014-2020 the Commission also proposed to further improve financial management and regularity of budget expenditure through 10 % retention of payments to Member States during the year and an annual clearance of accounts once Member States provide certified annual accounts for each programme.

The provision of reliable and complete financial information and audit data by the Member States is one example of an area where improvements are necessary. This is why the Commission will from this year onwards, transmit the annual summaries of the Member States with an analysis of their content to the Discharge Authority in accordance with the provisions of Article 319 of the Treaty. Where appropriate, the Commission will recommend to the national authorities how to further improve the reporting instruments notably on national audit results and opinions so they can better contribute to the Commission's assurance process.

The Commission calls on the Member States to demonstrate their commitment to improving accountability and transparency by reinforcing control measures where necessary, for the remainder of the current programming period, in particular as regards first-level management checks, before certifying expenditure to the Commission. It also calls on them to follow its guidance on the treatment of errors and annual control reports, as well as on annual summaries, to make them a valuable additional source of assurance for the Commission and a useful source of information for the discharge authority. The Commission encourages all Member States to follow the example of the 15 Member States[9] that have included assurance statements in their annual summaries and

[8] 'Analysis of Errors in Cohesion Policy for the Years 2006-2009, Actions taken by the Commission and the way forward', SEC(2011) 1179 final.

[9] For the ESF and ERDF, 15 Member States provided a voluntary 'Overall level of assurance statement' in their Annual Summary: Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Greece, Finland, France, Hungary, Portugal, Romania, Slovakia, Slovenia, Sweden and the United Kingdom.

to take other measures to demonstrate their commitment to the sound financial management of EU funds and transparency.

3.4. External aid, Development and Enlargement

Following the creation of the European External Action Service, the rules for administering and accounting for the EU budget have been clarified. EEAS staff and Commission staff were allocated separately in Delegations with the aim of distinguishing between Commission and EEAS core tasks within Delegations, while keeping a degree of flexibility. To ensure that staff (and other administrative resources) were being used for the purposes for which they were intended; Heads of Delegation have been given joint EEAS/Commission instructions and guidance[10] on the management of staff in Delegations.

Following the revision of the Financial Regulation on 24 November 2010, the Heads of EU Delegations have for the first time accompanied their annual Authorising Officer by sub-delegation report with a declaration of assurance.

Furthermore, Heads of Delegation have been provided with a jointly agreed EEAS/Commission framework[11] concerning the management of delegations of the European Union. For this purpose, the Steering Committee for Delegations ('EUDEL') (composed of representatives of the EEAS and of the Commission) has been set up.

As recommended by the European Court of Auditors, in order to further underpin the declaration of assurance in the AAR, the Directorate-General for Development and Cooperation developed a key indicator for the estimated financial impact of residual errors once all compliance controls have been implemented. Following the launch of the audit work, such an indicator is now expected to be available for the reporting year 2012. For the Directorate-General for Enlargement, such an indicator is already available for funds under decentralised management. A pilot work plan has been implemented in order to extend coverage to include funds under centralised management.

As stressed in the Internal Auditor overall opinion, the assurance provided by the controls over external aid, exercised by the deconcentrated delegations, needs to be improved through better planning and supervision.

3.5. Research and other internal policies

The Research DGs' common audit strategy (including an intensive audit campaign with extrapolation of systemic errors) for the **Sixth Framework Programme (FP6)** (2002-2006) has proved successful in terms of audit coverage and audit results achieved. At the end of the period, the multiannual residual error rate[12] had fallen substantially, reaching a level very close to the 2% target. Although the FP6 reservations have been maintained, the cost of controls would not justify additional efforts to get below 2%.

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10 Note from C. Day and D. O'Sullivan dated 20/12/2011 on the Management of staff in delegations.

11 JOIN(2012) 8 final, Joint decision of the Commission and the High Representative of the Union for Foreign Affairs and Security Policy of 28.03.2012 on cooperation mechanisms concerning the management of delegations of the European Union.

12 The multiannual residual error rate gives the real impact of errors on the EU budget, taking into account corrections and recoveries over the entire period of the framework programme.

As regards **FP6,** the error rate detected in 2011 by the **Director-General for the Information Society and Media** (below 2%) confirmed the approach already taken in 2010 of not further qualifying the declaration of assurance, as the multiannual error rate (i.e. measured for the whole FP6) was expected to drop below the target in the course of 2011.

The **Seventh Framework Research Programme (FP7) (2007-2013) gained momentum in 2011** as the programme passed its halfway point and the first projects, launched at the beginning of the programme, started to be concluded. As already indicated last year in the provisional error rates, representative audit samples showed that the error rate for the entire population exceeds the 2 % threshold. Consequently, the Research DGs and the Research Executive Agency[13] introduced reservations on FP7 as from 2011.

The simplification measures introduced in 2011 should have a positive impact on the error rate in future. The remaining scope to reduce errors will be addressed in particular through the following actions: improving guidance and feedback to participants and auditors on the most common errors; improvement of the ex-ante control strategy; and carrying out an appropriate number of ex-post audits to reduce, together with recovery actions, the residual error rate over a multiannual perspective. Even with these measures, the FP7 controls strategy will probably lead to a residual error rate at the end of the FP7 lifecycle of between 2 % and 5 %.

Under the current procedures, seven Authorising Officers by Delegation are responsible for the management of the Research budget. Each aims at establishing a representative error rate for his/her part of the budget. This leads to considerable planning constraints and multiple audits of the same beneficiaries by different services. For that reason, it was agreed that, as of 2012, a **Common Representative Audit Sample (CRAS)** would be introduced across the Research family. In particular, this will reduce the audit burden on beneficiaries by reducing the number of repeat audits.

The Director-General for **Communication maintained the reputational reservation, introduced for the first time in 2008, on potential non-compliance with applicable legislation on intellectual property rights by Commission services**. Most corrective action detailed in the action plan has been taken, but the constant evolution in the media field (such as the Media Monitoring System or the extensive use of new media) is creating new compliance challenges that have to be dealt with before this reservation can be lifted, something which is excepted to occur next year.

The error rate for actions managed centrally[14] by the Director-General for **Education, Audiovisual and Culture dropped below 2 %** and the 2010 reservation on centralised direct management could be lifted following the implementation of effective mitigating actions and the use of a more representative sample.

The Director of the Education, Audiovisual and Culture Executive Agency reported progress in the implementation of action plans to improve the control systems for management grants. The Education, Audiovisual and Culture Executive Agency lifted last year's reservation relating to the Culture and Youth programme following the reduced error rates. However, the **Executive Agency decided to issue a new reservation for the Life Long Learning (LLP) programme**. In order to deal with the aforementioned reservations, the Agency had already adopted an action plan following the AAR 2010 which foresaw mitigating measures for all

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13 REA for the 'Space' and 'Security' sub-activities only

14 The actions managed centrally represent 11% of the funds managed by the Director-General for Education Audiovisual and Culture

programmes managed by the Agency, including the LLP programme. The agency will continue its efforts to help beneficiaries comply with the requirements, in particular as concerns the provision of supporting documents.

The Director-General for **Home Affairs made two reservations** in the 2011 AAR, one **concerning reputational risks due to delays in implementing a large-scale IT system, the SIS II project**. For this project, significant progress was made in 2011 towards the successful deployment of this large scale IT system. The detailed action plan was fully implemented, but new events caused additional delays, such as the inability of the responsible Member State to provide one of the test tools originally envisaged for the testing and the emergence of new delays in national developments in certain Member States or delays at the level of the central system. The second, and new, reservation concerns the financial risk resulting from the residual error rate in the non-audited population of grants in the financial programmes 'Prevention, preparedness and consequence management of terrorism and other security-related risks' (CIPS) and 'Prevention of and fight against crime' (ISEC). These programmes target relatively new policy areas and new beneficiaries, and the Director-General for Home Affairs is confident that an increase in the number of audits combined with more and better information to beneficiaries will help reduce error rates in the near future.

The **Director-General for Enterprise and Industry extended his reservation relating to the reliability of financial reporting by the European Space Agency** (ESA). During 2011, the Commission's monitoring and control strategy for ESA was further strengthened: it will continue auditing the financial reports provided by ESA and will encourage and support ESA in implementing its action plan, developed to address the recommendations made by ESA's external Audit Committee and to improve the quality of financial reporting to the Commission. Given the actions currently under way, the Commission expects the issues to be corrected soon which will enable reducing and finally lifting this reservation. Additionally, the use of external experts has helped to ensure the reliability of the fixed assets amounts included on the EU balance sheet in 2011.

The Commission is satisfied with the work undertaken to address the issue of respect for intellectual property rights by all its services and encourages them to take the necessary steps so that this reservation can be lifted in 2012. It welcomes the guidelines[15] on managing intellectual property rights in the Commission.

The Commission welcomes the low residual error rate at the end of the Research FP6 lifecycle and takes note of the expectations and limitations set for the FP7 audit strategy.

The Commission notes the reservation for the LLP programme managed by the EAC Executive Agency, despite work done to better inform beneficiaries of the requirements. It invites the Agency to step up its efforts.

The Commission recognises that developing and managing large-scale IT systems such as SIS II presents particular challenges. It has put in place strong goverance mechanisms and will continue to give top priority to maintaining effective governance and close cooperation with stakeholders as far as SIS II is concerned.

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15 'Practical guidelines for EC staff on dealing with IP-, Copyright- and Trademark-protected works', November 2010.

4. Cross-cutting issues and solutions

4.1. The added value of the EU budget

Reporting on the Commission's management achievements is not only limited to reporting the compliance with financial rules and error rates. The quality of spending and the added value of the EU budget are important factors to be demonstrated. In their AARs, the Authorising Officers by Delegation explain how they have used the financial and human resources allocated to them to achieve the policy objectives set by the College, showing how policies have generated added value for EU society. The Standing Instructions for preparing the Annual Activity Reports call for more attention to this type of reporting.

In February 2012, based on Article 318 TFEU, the Commission reported[16] for the first time **on the evaluation of the EU's finances based on the results achieved.** It report seeks to provide an overview of the objectives of EU programmes, and the impacts and results achieved depending on the stage reached in the programmes at the time of evaluation. By covering each year a limited number of programmes for which relevant evaluations are available, this report can cover in the medium term a broad range of financial programmes under the different management methods. The report covers two main areas of EU direct financial intervention: Education and Culture and Research.

Also, the Internal Audit Service has made major efforts to define its performance audit framework and to develop an in-house training programme for auditors on this matter.

The Commission instructs the Secretariat General to explore opportunities for making the Annual Evaluation Report based on Article 318 TFEU more inclusive, covering the full range of activities financed by the budget, including the appropriate indications in relation to the discharge recommendations, while relying extensively on the available performance-related information such as evaluation reports, the AARs and the Activity Statements to the Draft Budget.

4.2. Transparent reporting on interruptions and suspension of payments, financial corrections and recoveries in shared management[17]

4.2.1. Information on interruption and suspension of payments by the Commission

In line with its commitment towards the discharge authority in its 2008 Action Plan to strengthen its supervisory role for structural actions, the Commission has encouraged its services to interrupt payments procedures and to propose suspension procedures as soon as the legal conditions are met. Regarding shared management, **the Commission interrupts or suspends** payment procedures as soon as there is evidence suggesting a significant deficiency in management and control systems of Member States.

The services carrying out transactions in shared management mode have reported all interruption/suspension decisions in their AARs. This information includes the operational programmes concerned, the Member States affected, the type of weaknesses, the main facts triggering each decision and the budgetary impact of the decision. This information constitutes an important dimension of reasonable assurance and accountability.

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16 COM(2012) 40 final.

17 The figures mentioned in this paragraph are provisional as they are pending the audit by the Court of Auditors of the provision 2011 accounts.

Following the introduction of the new interruption instrument for the 2007-2013 programming period, the Directors-General operating in shared management took, in 2011, formal decisions to **interrupt payment deadlines to 91 programmes** totalling EUR 2 634 million. The College also adopted four[18] decisions **suspending payments** to 2007-2013 programmes. Payments are not resumed until AOSD's obtain clear audit evidence that reasons for interruptions and/or suspensions have been remedied on the field, that the necessary financial corrections were carried out and that there is no further risks for future expenditure to be certified to the Commission.

The Commission confirms that AOD's should systematically interrupt payment procedures and propose to the College that procedures should be suspended as soon as the applicable conditions are met and until the necessary corrective measures have been implemented by the relevant national authorities.

4.2.2. Financial corrections imposed by the Commission on Member States

The other reported **financial corrections** were those **imposed by the Commission on Member States**. The Directorate-General for Regional Policy reported cumulative financial corrections resulting from EU audits in the period 2000-2011 of EUR 7.13 billion. The Directorate-General for Employment, Social Affairs and Inclusion reported EUR 1.8 billion and the Directorate-General for Agriculture and Rural Development reported EUR 7.7 billion.

The notes to the annual accounts of the European Union contain more extensive information on the financial corrections decided by the Commission and implemented in the course of the year as well as on recoveries.

4.2.3. Information from Member States on financial corrections and recoveries

Correcting amounts unduly paid is an important aspect of sound financial management. In 2011, continued efforts were made to impose financial corrections when necessary, improve the quality of Member State data on financial corrections and recoveries and promote the use of best practices so as to improve recovery mechanisms at Member State and EU level.

Regarding shared management, the AARs provide detailed information on the financial corrections implemented and reported by Member States to the Commission and an assessment of the national control systems. In the area of Cohesion Policy, Member States implement financial corrections resulting from their own audit work and from EU audits. These are reported with a one-year delay by 31 March, so in 2011 they reported on their 2010 corrections. Nevertheless, the AOSD's reported the most updated figures known till the date of signing their AARs.

Regarding Regional Policy, Member States reported that, by the end of 2010, they had made cumulative financial corrections of EUR 5.1 billion to the 2000-2006 programmes. Member States reported that these financial corrections were implemented through withdrawals (some EUR 4 billion or 78% of the total amount of recoveries) or recoveries from individual beneficiaries (some EUR 1.1 billion or 22%).

For 2007-2013 ERDF/CF programmes, Member States reported that in 2010 financial corrections of EUR 212 million were made (EUR 156 million as withdrawals, EUR 31 million

[18] One suspension decision concerning the ERDF programme in Calabria (Italy) and three suspension decisions concerning the ESF in the Baleares (Spain), Calabria (Italy) and Paca (France).

as recoveries and EUR 25 million as pending recoveries). For 2011, as the date of signature of the AAR, Member States reported corrections for a total of EUR 342 million for ERDF/CF programmes.

For 2007-2013 ESF programmes, Member States reported for 2010 financial corrections of EUR 52 million (EUR 33 million as withdrawals, EUR 4 million as recoveries and EUR 15 million as pending recoveries.)

4.3. Use of pre-financing

The Commission notes that the provisional 2011 annual accounts show a slight reduction in the amount of pre-financing. This amount is composed of three main elements:

- First, the traditional pre-financing in various programmes to ensure the necessary 'float' for beneficiaries to start their programmes and actions. The normal spending profile of multiannual programmes is characterised by higher amounts of pre-financing in the early years of the programming period. With several such programmes gaining momentum in 2010/2011, the proportion of pre-financing is thus losing in importance compared to final payments.

- Second, the Financial Instruments (FIs), which are increasingly used as a complementary means of funding in the Structural Funds and the EAFRD. By their nature, FIs entail a big share of up-front payments and are therefore assimilated to pre-financing. The Commission is strengthening monitoring in this domain as explained below in section 4.4.

- Finally, pre-financing paid to Member States under shared management and complemented by additional pre-financing as part of the package of measures adopted to fight the effects of the economic crisis. This pre-financing is also closely monitored against implementation.

While pre-financing in the various programmes is necessary to allow beneficiaries to start their projects, the financial interests of the EU need to be safeguarded and operational and cost-effectiveness constraints have to be taken into account. The Commission has proposed changes[19] to the Financial Regulation to improve the follow-up of pre-financing.

4.4. Financial instruments

Financial instruments (FIs) have a multiplier effect: they are a way of attracting additional resources from national or regional budgets, public or private banks and other investors so that the overall amount available for investment is increased. This multiplier effect differs according to the type of financial instrument, but early evaluation has found that each euro invested in an FIs could leverage between EUR 3.4 to 7.5 in additional funds.

The increased use of financial instruments constitutes a new challenge from an internal control and accountability perspective. The Commission monitors and reports on such instruments under Article 49 of the inter-institutional Agreement[20] for instruments implemented under centralised indirect management and for joint initiatives with the EIB and the EIF under Regional Policy.

[19] Proposed Article 87(4) of the reviewed Financial Regulation.

[20] Inter-institutional agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management (2006/C 139/01)

The Directorates-General using **FIs** cover the policy and governance-related aspects in Parts 1 and 2 of their AARs, and mention in Part 3 their monitoring of these instruments.

The Commission services have prepared a dedicated Staff Working Document[21] outlining the situation as regards the use of FIs in Member States as of the end of 2010 for Structural Funds. Furthermore, the applicable legal basis[22] has been amended so as to make reporting on financial and implementation issues a regular, standardised and compulsory procedure under the annual reporting on the implementation of programmes. This will considerably improve the information available to the Commission as from mid-2012. On this basis, the Commission will deliver, by October 2012, a first report on FIs.

The Directorate-General for Economic and Financial Affairs has included in its AAR a table listing all the FIs for which it has been designated Policy or Implementing DG as well as information on the monitoring and control arrangements and the responsibilities of all the partners involved, together with a description of the reporting requirements and accountability chains.

The Directorate-General for Agriculture and Rural Development has amended the applicable legal basis by improving the required conditions for setting up of certain financial instruments and for strengthening their implementation and use of resources returned to the instruments[23].

The Commission has launched an evaluation exercise to provide, by the end of 2012, an analysis per Member State as well as an overall evaluation of the use of financial instruments.

The Commission is also carrying out a thematic audit on the implementation of a sample of FIs, in order to assess the assurance that can be given on the implementation of these instruments, down to the level of individual recipients.

The Commission instructs all services to report on their FI activities in their AARs. It also instructs the services in charge of the Structural and Rural Development Funds to report on the results of the evaluation and the audit work undertaken in this area in their AARs for the year 2012.

The Commission calls on the other institutions to react positively to its proposal for the next programming period, where it proposes further enhancing the monitoring mechanisms for FIs.

4.5. The way forward: Cost-benefit of controls and internal control systems proportional to risk

The Commission has the responsibility, through robust controls and effective performance measurement, not only to ensure that funds are well spent but also to take measures to respond to the need to simplify its spending programmes in order to reduce the administrative burden and costs for beneficiaries of funds and for all actors involved, in line with the Commission's Smart Regulation agenda.[24] While progress has been made with current programmes,[25] the Commission has proposed more ambitious simplifications for the future.

[21] SWD(2012) 36 final.

[22] Regulation No 1083/2006 establishing general rules for the Structural Funds.

[23] Regulation No 679/2011 of 14.7.2011 amending the implementing regulation No 1974/2006 on the rural development fund (EAFRD)

[24] COM(2010) 543.

Sound financial management requires that **controls are effective, efficient and economical**. Control strategies should target controls on more risky areas: such targeted controls would provide reasonable assurance to the European taxpayer while enabling beneficiaries to concentrate on the achievement of policy objectives to a greater extent than today.

4.5.1. Revision of the Financial Regulation

The Financial Regulation contains the common financial rules and principles applicable to all policy areas. As a first step, in May 2010,[26] the Commission launched a process for revision of the Financial Regulation. The proposal reinforces the need to align control systems with the identified risks and the cost-effectiveness of controls. It sets out a clear general implementation framework, covering all modes of management (including a common framework for shared management) and establishing dedicated rules for innovative financial instruments and prizes. In the field of grants directly managed by the Commission, the proposal specifically promotes the use of simplified methods to 'calculate' eligible costs (such as lump sums, flat rates and standard scales of unit costs), facilitates the acceptance of costs declared according to the beneficiary's 'usual accounting practices', and introduces lighter procedures for small grants.

The current draft revised Financial Regulation will include provisions which will require services to provide information on the internal control system set up, an estimation of the costs and benefits of controls implied by such system and an assessment of the expected level of risk of error, when new or revised spending proposals are being presented to the legislative authority. The revised regulation will furthermore require the AOD to take account of the cost-effectiveness when setting up internal control systems and to provide an overall assessment of the costs and benefits of controls in the annual activity report.

In June 2011 and in anticipation of these requirements, Directorates-General included in the legislative proposals for the post-2013 spending programmes an estimation of the costs and benefits of controls implied by the control systems and an assessment of the expected level of risk of non-compliance with the applicable rules.

Given the central role of the Financial Regulation as a reference for the sector-specific legislation, the Commission urges the European Parliament and the Council to reach an agreement before the summer break.

4.5.2. Simplification Agenda for the MFF 2014-2020

The wider possibilities under the revised Financial Regulation have enabled the Commission to table proposals for more ambitious simplification measures adapted to beneficiaries and other stakeholders, ensuring that EU funds can be disbursed in a way that is clear, easy to understand, and simple to apply. The Commission has made a number of proposals to make controls more proportionate and cost-effective. For example in the Common Agricultural Policy, the proposed *Small Farmer's Scheme* would reduce the administrative burden on a significant number of farmers, without increasing the financial risk to the EU. Another example is the possibility for beneficiaries of research funds to use their normal accounting practices for preparing cost claims.

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25 For example in the Seventh Research Framework Programme, where dedicated simplification measures were introduced in 2011 and the time to grant has fallen by nearly 30 days.

26 COM(2010) 815 final.

To ensure that simplification does not open the door to increased risk of error, the Commission has been mindful of the need to propose balanced measures taking account of the costs and benefits of control and the expected level of non-compliance with regulatory requirements, as suggested by the Court in its Opinion 1/2010. In particular, the Commission has delivered on the following challenges identified by the Court: improvement of the design of funding schemes to strengthen management and control mechanisms; simplification of grant schemes while still achieving policy objectives; and appropriate benchmarks for assessing the management of risk which take account of the costs and benefits of controls.

These simplification elements would enable the Commission to better align its control systems with the identified risks and would reduce the probability of error.

4.6. Commission Anti-Fraud Strategy (CAFS)

Following the adoption of the new Commission Anti-Fraud Strategy,[27] an internal Action Plan has been prepared.[28] This will require all Directorates-General to develop an anti-fraud strategy at local level by 2013. Measures in this area (such as specific risk analysis of beneficiaries, close monitoring of selected projects or contracts, or any other measures to mitigate fraud risks) are already outlined in some of the Annual Activity Reports, together with the specific results of anti-fraud actions taken during the reporting year and any elements of assurance that can be drawn from them. This will be further generalised in the 2012 and 2013 AARs.

The Commission instructs the Services to include in their AARs information on fraud prevention as part of the assessment of their internal control systems, reflecting the implementation of the sectoral strategy and describing measures to mitigate fraud risks.

[27] COM(2011) 376 final.
[28] SEC(2011) 787 final.