



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 20.4.2006
COM(2006) 184 final

REPORT FROM THE COMMISSION

Member States' replies to the Court of Auditors' 2004 Annual Report

{SEC(2006)524}

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1. INTRODUCTION

The European Court of Auditors ('the Court' or 'ECA') published its *Annual report concerning the financial year 2004* ('2004 Annual report') on 15 November 2005¹. In the report, the Court presented its Statement of Assurance ('the DAS') and the supporting information, including observations concerning management in Member States.

As obliged by the Financial Regulation², the Commission informed Member States immediately of such observations as well as the findings identified by the Court during its audits and attributed to Member States. Member States were invited to submit their replies by 15 December 2005. The vast majority of Member States replied within or shortly after the very tight deadline, in many cases submitting very detailed comments.

As time was needed for translation and thorough analysis of the replies received, the Commission was not able to present its summary report by 15 February 2005, but Vice-President KALLAS informed the European Parliament and the Council (ECOFIN) of the preliminary findings³.

2006 brings two challenges in the area of external audit and discharge. One challenge is to implement the *Action Plan towards an Integrated Internal Control Framework*⁴ ('Action Plan') adopted by the Commission on 17 January 2006. The objective is to provide the Court with reasonable assurance that EU funds are spent in a legal and regular manner. However, the Action Plan will not deliver the expected results unless all relevant actors, i.e. the European Parliament, the Court of Auditors, the Member States and the Commission - taking into account their respective responsibilities and independence - each contribute to the implementation of the 16 actions.

Another challenge is the new and tighter deadline for preparing the Court's Annual report. As set out by the Financial Regulation⁵, the Annual report must from now on be published by 31 October at the latest, i.e. one month earlier than so far. This increases the demands on all involved parties in the preparation of the report – i.e. the Court, the Commission and Member States – to ensure that the preceding exchange of views on preliminary findings of the Court is done in an efficient manner.

¹ The report was published in the Official Journal C 301 of 30.11.2005. It is available on the Court's website: www.eca.eu.int.

² Article 143(6) in The Financial Regulation applicable to the general budget of the European Communities, Council Regulation (EC, Euratom) No 1605/2002 of 25.6.2002.

³ Cf. letter of 15 February 2006 from Vice-President KALLAS to Mr. Karl-Heinz GRASSER, President ECOFIN.

⁴ COM(2006) 9 of 17 January 2006.

⁵ Article 143(5).

Section 2 considers the difficulties linked to the stricter deadlines the Court has to meet on the Annual report. Section 3 presents remarks made by Member States on the audit and control framework. Section 4 contains an analysis of substantive findings attributed to Member States within agriculture policy and structural actions. Conclusions are drawn in section 5.⁶

2. PREPARATION OF THE COURT'S ANNUAL REPORT

Time available for preparing the 2005 Annual report is one month less than in earlier years due to the obligation to publish the report already by 31 October. This has implications for the Court as well as for the Commission and Member States.

During the financial year or shortly after, the Court carries out audits on procedures and transactions in the Commission and the Member States. In the Member States, the Court checks that the final beneficiary fulfils the conditions for aid (for example, that the area of a field or number of animals is correct, or that the project financed by the Structural Funds has been carried out) and that proper control procedures are in place.

After each audit mission, the Court analyses the findings and forwards its preliminary observations in so-called PF⁷ letters to the relevant Commissioner or to the national supreme audit institution, depending on whether funds are managed at a central or Member State level. Typically, the Court requests the Commission or the Member State to reply within 2 months. There is no obligation to reply to the Court but it is common practice – albeit many replies arrive later than the deadline set by the Court.

Until now, the Court had to receive Member States' replies during spring or early summer in order to be able to translate, analyse and to the extent possible incorporate the comments in the Annual report to be published by 30 November. This was due to the time needed for internal proceedings in the Court, the contradictory procedure with the Commission in June-September as well as translation of the report into now 20 languages.

However, as regards the financial year 2004, most Member States submitted their replies to substantive findings⁸ in June or later. This was on the one hand due to the Court sending out a significant share of the PF letters in May-July⁹, and on the other hand due to Member States in many cases transmitting replies more than 60 days after the receipt of the PF letter.

⁶ The analyses underlying this summary report are contained in *Working document from the Commission: Analysis of Member States' replies to the Court of Auditors' 2004 Annual Report* (SEC(2006) 524).

⁷ Statement of Preliminary Findings.

⁸ I.e. findings with financial consequences for the general budget of the European Union.

⁹ The Court has so far been obliged by the Financial Regulation (article 143(2)) to transmit its observations to Member States before 15 July. From the financial year 2005 onwards, the deadline is 15 June.

As a consequence, some Member States found that their replies were not taken into account by the Court. For instance, Finland in its observations on the 2004 Annual report pointed out *“that responses to the Court of Auditors’ preliminary observations have not always been taken into account in the conclusions presented in the annual report. For this reason, some of the conclusions are clearly wrong. Producing the responses and explanations often involves going to a lot of trouble compared to the minimum effect they then have on the Court of Auditors’ final conclusions.”*

This was supported by Poland which said that *“..we are concerned that the Court of Auditors has not taken account of our explanation of the errors found after the ECA inspection mission. As a result, the explanatory material now being sent to the European Commission is much the same as that previously sent to the Court.”*

The Court as a rule informs Member States of its analysis of the reply received from the national authorities. Such follow-up seems to be of importance in order to motivate Member States to react to the findings identified by the Court. As Poland points out *“.. in those cases where the Member State does not agree with the Court’s assessment of the facts, and has no indication whether the explanation provided by the institutions subject to inspection has been accepted, it can hardly be expected to answer questions about the nature of the errors found and whether remedial action has been taken or is planned.”*

In light of the even tighter deadlines from now on, specific consideration should perhaps be given to improve exchange of information on findings between the Court, the Commission and Member States, considering the particular problems linked to the timetable when preparing the Annual report. The implementation of actions 7, 8 and 9 of the Action Plan¹⁰, focused on sharing of audit and control results, will also contribute to an increased efficiency of such an exchange of information.

3. AUDIT AND CONTROL FRAMEWORK

The Court must each year provide the European Parliament and the Council “with a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions”¹¹. The statement is provided through the Annual report. The Court bases its statement on four sources of evidence¹²:

- (a) An examination of the way in which the supervisory and control systems set up both in the Community institutions and in the Member States and third countries work;
- (b) A testing of samples of transactions for each major area by carrying out checks down to final beneficiary level;

¹⁰ Action 7: Promote best practices for increasing cost-benefit of audits at project level. Action 8: Facilitate additional assurance from SAIs. Action 9: Construct effective tools for sharing audit and control results and promote the single audit approach.

¹¹ Cf. article 248(1) in the Treaty establishing the European Community.

¹² Cf. paragraph 1.46 in the 2004 Annual report.

- (c) An analysis of the annual activity reports and declarations of the Directors-General and of the procedures applied in drawing them up;
- (d) Where possible, an examination of the work of other auditors who are independent of Community management procedures.

Some Member States have in their replies to the Commission on the 2004 Annual report taken the opportunity to make comments on the overall approach to audits and controls.

For instance, the United Kingdom proposes that audits be set up *“more as system and benefit cost audits rather than transaction tracing audits [...] Transaction tracing audits bring up specific timed errors, often of minor amounts, which when extrapolated can make it look as though the whole programme is in error. These errors are also often corrected later but this is not recognised when checks take place within a specific period.”*

France seeks more information on the Court’s sampling method when auditing structural actions. The French authorities have not found any mention of the method in the Annual report and point out that *“general conclusions are drawn from findings relating to a very limited number of isolated operations, many of which involve very small amounts”*.

Denmark considers it extremely important that the work of the Member States’ Supreme Audit Institutions is incorporated in the Court’s DAS audit wherever possible. It says that the Danish National Audit Office for the first time has provided a statement on the use of EU funds in Denmark¹³ saying that *“Overall the National Audit Office takes the view that the administration, payment, accounting and control of EU funds were satisfactory and complied with the orders and regulations.”*

Germany stresses that costs of controls are considerable. It proposes that *“the cost of management and control systems in Member States should be assessed by the Commission to ensure that cost is proportionate to the results obtained.”*

These comments show the need to resolve issues such as:

- How to resolve the possible conflict between the Court’s annual statement and the fact that some internal controls are devised to operate over the duration of multi-annual programmes?
- How to ensure an appropriate balance between costs and benefits and that this balance is taken into account in the statement of assurance?
- How to make good use of existing controls and the expertise and resources existing in Supreme Audit Institutions at the national level?

¹³ The statement is included as a section (D) in the report on the audit of the national budget for 2004.

- The Action Plan tries to tackle these issues from several angles, in particular actions 3, 4, 7, 8 and 10¹⁴. The Action Plan focuses on the promotion of operational management declarations and synthesis reports at national level (action 5).

4. SUBSTANTIVE FINDINGS IN 2004

The Court provided information on the findings it made concerning the financial year 2004. As the Court did not indicate the method used to make the sample of transaction, conclusions as to whether the level of findings was significant could not be drawn.

The Commission asked Member States to comment in more detail on the substantive findings, i.e. findings with financial consequences for the EU budget. Most Member States provided the information but in some cases it was not possible for the Member States to recognize the findings in the provided lists as the codes attributed by the Court to the findings were not known to the Member State and did not match project numbers used by Member States and/or the Commission.

The audits performed reflect the different policies. Grants to farmers are often linked to the size of a field or the number of animals. Thus, within agriculture policy, the Court often goes on the spot to measure a field with the use of GPS equipment or count animals in order to verify if the farmer has declared the proper figures.

Within structural actions, grants are awarded to projects often at a regional level. The scale, design, timetable and types of final beneficiaries may vary significantly between projects. In these cases, the Court goes on the spot to verify if the project has actually been completed (has the bridge or motorway been built), if payments have been made correctly (is expenditure eligible, does an audit trail exist), if tendering procedures have been respected (was a tender carried out, was the right tenderer chosen), if the required checks have been made etc.

The variety of structural actions creates scope for differences in the interpretation of the rules and of the audit evidence which seems to be reflected in Member States tending to agree less with the Court in such cases than in cases concerning agriculture policy. When the Commission later follows up the Court's findings, it, too, is led on occasion to draw a different conclusion from the Court.

Sections 4.1 and 4.2 summarise comments made on findings concerning agriculture policy and structural actions. Sections on own resources and pre-accession aid have not been included as very few substantive findings have been identified for these two areas, reflecting the fact that these two sectors received a positive statement of assurance from the Court in 2004.

¹⁴ Action 3: Establish and harmonise better the presentation of control strategies and evidence providing reasonable assurance. Action 4: Initiate interinstitutional dialogue on risks to be tolerated in the underlying transactions. Action 7: Promote best practices for increasing cost-benefit of audits at project level. Action 8: Facilitate additional assurance from SAIs. Action 10: Conduct an initial estimation and analysis in the cost of controls.

4.1. Agriculture policy

For Member States, 2 in 3 substantive findings within agriculture policy in 2004 related to overdeclaration of the surface of a piece of land. Roughly speaking, the difference between the area declared and the area measured by the Court during its audit was less than 2 per cent in one quarter of the cases, was between 2 and 10 per cent in half the cases and more than 10 per cent in the remaining cases.

The total number of substantive findings identified by the Court related to 11 Member States. Most agreed with the Court – albeit in a few cases only partly due to *inter alia* difference of opinions on measuring methods. In some cases, the findings of the Court led to recovery of sums from farmers. However, in several cases, Member States did not initiate recoveries as they found the financial impact of the finding too small (Germany had a case representing less than EUR 100).

Although Member States tended to accept the conclusions of the Court, some did indicate that deviations in measurement of fields were to be expected/accepted. Checks sometimes took place in the next farm year when the farmer had changed the use and division of his fields, making it difficult to re-construct the field that was declared originally. In other cases, farmers had declared the size of a field as registered in the official land register but these registers were not necessarily in accordance with the measurement made by the Court. This problem may be amplified by the continuing improvement of measurement instruments. Finally, Germany had a case where it based its opinion on the measured surface with two decimals whereas the Court used a three-decimal figure. In the particular case, this was enough to change the classification of the measurement from acceptable to a finding.

Two of the 11 Member States tended to disagree with the Court. Only one substantive finding was attributed to the first Member State (Netherlands) which disagreed with the Court's decision to regard the lack of proof for the slaughter of one cow as a finding even though proof was provided to the Court after the audit mission. More findings were attributed to the other Member State (Greece) which, however, found that some of the underlying problems were of a temporary nature (e.g. money in bank accounts not yet paid to producers or returned to the EU budget). It also disagreed with the Court on other issues such as whether a farmer was entitled to a subsidy if he did not hold the deed on a piece of the land but had agreed to exchange the land with another farmer.

4.2. Structural actions

In 2004, Member States tended to agree with the Court in only a bit more than 1 of 3 cases with substantive findings within structural as opposed to around 2 of 3 cases within agriculture policy.

Typical examples where Member States disagreed or did not agree fully with the Court included the classification of expenditure (is it eligible or not), proof of co-financing and the existence of an audit-trail.

There seemed to be extremely few cases where the Court claimed that a wrong classification of expenditure was intentional. However, the findings indicated a need to clarify the rules and provide additional guidance in this area. As the Belgian authorities pointed out in one specific case where they did not agree with the Court: *“As far as we know, the concept of expenditure which does not comply with the rules has not been debated or defined in the regulations which apply to ESF [European Social Fund] structural aid, and it is therefore necessary to consider the nature of the foundation for declaring that expenditure does not comply, particularly since the auditors themselves recognise that this expenditure does not entail any indication of irregularity or illegality.”*

Member States also pointed out difficulties arising from the differences in the requirements for audit and control structures between programming periods. Spain mentioned that *“when the auditor concludes that ‘the audit trail was deficient’, this entails applying to the period 1994-1999 concepts which had not been defined until the period 2000-2006.”*

In addition to carrying out checks on transactions, the Court attempted to verify if Member States performed the compulsory 5 per cent checks, i.e. checking projects representing 5 per cent of the value of a programme. The Court found that the checks were often delayed and based on incomplete risk analysis.

The Member States mostly acknowledged that checks were delayed but Sweden pointed out that *“there is no requirement under the Regulation that checks in relation to the respective funds must reach 5 per cent at a particular point in time.”*

The financial consequences of substantive findings within structural actions tended to vary a lot more than for substantive findings within agriculture. In some cases, the findings may not have real financial consequences, for example because expenditure declared by the Member State and considered ineligible by the Court could be offset by additional expenditure not yet declared. Such cases are clarified by the Commission in its follow-up.

This also raises the issue of multi-annuality. As an example, Germany had a case where it acknowledged the finding and would correct it by applying a reduction to the following payment request. It would not accept that the finding had incurred a financial loss to the EU budget as the finding would ultimately have been discovered when the evidence of expenditure was checked at the final closure, if not before. However, the Court maintained that - as of the audit date - there was a finding.

5. CONCLUSION

The Commission welcomes the many full replies received from Member States. This annual feedback from Member States provides a valuable opportunity to pick up on horizontal issues linked to the Court of Auditors' Annual report. Based on the replies to the 2004 exercise, the Commission would like to draw attention to four issues:

- (1) Some Member States found it unsatisfactory that their replies were not reflected in the Court of Auditors' 2004 Annual report. This is partly due to the tight deadline which must be respected by the Court of Auditors when preparing its Annual report. In the considerations on how to make better use of the expertise of the national Supreme Audit Institutions and on how to achieve a single audit approach¹⁵, this particular problem should be addressed.
- (2) Some Member States made comments on the control structure as well as the DAS method itself, indicating that – in their opinion - the benefits did not match costs. This issue should be addressed at an operational level when estimating the costs of controls¹⁶ but also the strategic level when discussing risks to be tolerated¹⁷.
- (3) The more qualitative analysis of substantive findings within the areas of agriculture policy and structural actions has been made with the objective of identifying patterns across Member States. The analysis shows that there is a need to resolve or clarify issues such as: 1) what is the right method to measure the size of a field, 2) what is eligible expenditure within structural actions, 3) when shall the so-called 5 per cent checks for structural actions be made. Due to this uncertainty, the Commission in its follow-up may not be able to confirm the Court's findings. These issues are to a larger extent sector-specific gaps that are also intended to be addressed by the Action Plan¹⁸.
- (4) Member States tended to disagree more with the Court's findings in the structural actions area than within agriculture policy. The reason for this may be that Member States and the Court disagreed on what should be considered to be a wrongdoing in this area. Or it may be that the Member States and the Court disagreed on the level of risk to be accepted within structural actions. As the Court's sample was designed to check individual transactions – not verify if systems were in place and working – reasons for the disagreement could not be established. This highlights the need to undertake an interinstitutional dialogue on risks to be tolerated in the underlying transactions and the effects this may have on the Court's DAS method¹⁹.

Not only the Commission and Member States but also the Court of Auditors and to some extent the national Supreme Audit Institutions need to engage in order to resolve the issues raised by Member States. A framework for this cooperation is set out by the Action Plan which defines 16 specific actions to be implemented during 2006 and 2007 - of course in full respect of the roles, responsibilities and independence of all concerned.

¹⁵ Actions 8 and 9 in the Action Plan.

¹⁶ Action 10 in the Action Plan.

¹⁷ Action 4 in the Action Plan.

¹⁸ Actions 12-16 in the Action Plan.

¹⁹ Actions 3 and 4 in the Action Plan.