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REPORT FROM THE COMMISSION

Member States' replies to the Court of Auditors' 2005 Annual Report

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1. INTRODUCTION

The European Court of Auditors ('the Court') must prepare its Annual Report within extremely tight deadlines imposed by the EC Treaty, which requires the Court to produce “*a statement of assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions...*”¹. In particular establishing assurance on transactions poses a challenge when performed on an annual basis – not least as the Court audits down to the final beneficiary level, necessitating more than 100 audit missions to Member States as part of the preparation of the 2005 Annual Report.

Time pressure also makes it very difficult to verify in due time before the Court finalises the Annual Report whether or not Member States agree with the Court's findings. The Commission, however, is obliged to issue a report on Member States' reactions to the Annual Report afterwards². Its services also commit themselves to follow up the Court's findings in detail and take the necessary remedial action.

The reactions to the 2005 Annual Report show that Member States disagree with a significant number of the findings made by the Court and used as the basis to partially qualify its statement of assurance ('DAS') presented in the 2005 Annual Report³.

Disagreement was more pronounced in structural actions than in agricultural policy – particularly on cases considered to have a financial impact on the EU budget. It was also more frequently the case in structural actions that Member States disputed findings which the Court considered to have maximum financial impact on the EU budget, i.e. to disqualify the whole transaction from EU funding.

The Commission tried to take the position of Member States into account when preparing its replies to the 2005 Annual Report. However, this was in many cases difficult as about half the replies from Member States to the Court's statements of preliminary findings were not available in sufficient time before the contradictory procedure between the Court and the Commission on the report in June/July 2006⁴.

This summary report provides an opportunity to consider how procedures can be improved and whether lessons can be learned. It is not to be seen as a further

¹ Article 248 in the *Treaty establishing the European Community*.

² In accordance with 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, the Commission sent a letter to each Member State on 23 October 2006 asking for comments on the Court's observations in the 2005 Annual Report (available on the Court's web-site www.eca.eu) as well as reactions to findings made by the Court and attributed to the Member State.

³ See Section 2 in the Commission Staff Working Document accompanying this report for a more detailed analysis of Member States' reactions to the findings made by the Court. Based on the replies received, the Commission estimates that Member States disagreed with 4-5 in 10 of the Court's findings concerning the 2005 DAS.

⁴ See Section 2 in the Commission Staff Working Document accompanying this report for a more detailed analysis of the statements of preliminary findings ('SPFs') sent by the Court to the Member States and underlying the 2005 DAS.

contradictory procedure between the Court and the Member States nor as part of the exchanges between the Commission and the Member States during the detailed follow-up of cases, which is currently taking place. Thus, the positions taken by the Member States and reported here are not necessarily shared by the Commission.

The Commission instead hopes the questions raised will be part of the continuous debate on the Integrated Internal Control Framework involving the European Parliament, the Council, the Court and the Commission.

The report presents an analysis of the findings made by the Court and underlying the 2005 DAS (section 2). It also considers the current procedure concerning exchange of information between the Court, the Member States and the Commission in relation to findings made by the Court (section 3). Conclusions are drawn at the end of the report (section 4).

2. 2005 DAS FINDINGS

The Court bases its DAS on several sources of evidence, not least findings made during audits of authorities and final beneficiaries in Member States⁵. Findings are categorized as either:

(a) *Systems-related*: These findings relate to the implementation of supervisory and control systems. The Court examines whether for instance the systems are set up correctly, whether duties are appropriately segregated, and whether controls are carried out correctly and as often as intended.

(b) *Formal*: The findings concern payments to final beneficiaries, like farmers, companies etc., and are considered as having either no potential financial impact on the general EU budget or a potential impact that is not quantifiable. This category covers for instance cases where EU participation in projects has not been publicized as required, public tendering procedures have not been fully complied with, or data registers are incomplete.

(c) *Substantive*: These findings also concern payments to final beneficiaries but are considered to have a (potential) financial impact on the general EU budget, which is quantifiable. This category covers for instance cases where the size of a field is smaller than claimed by the farmer, essential supporting documents are missing, or expenditure claimed by a project manager is ineligible.

All the findings made during audits in the Commission or in Member States along with other elements such as an analysis of the Annual Activity Reports and

⁵ The 2005 DAS was based on four sources of evidence: (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) testing of samples of transactions for each major area by carrying out checks down to final beneficiary level, (c) an analysis of the annual activity reports and declarations by 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. See point 1.59 in the 2005 Annual Report

declarations by the Directors-General in the Commission feed into the DAS and affects the final opinion of the Court as presented in the Annual Report.

To prepare this summary report the Commission asked Member States to indicate if they agreed fully, partially or not at all with the findings made by the Court⁶. A more detailed analysis of the replies concerning the findings underlying the 2005 DAS is presented in Section 2 of the Commission Staff Working Document accompanying this summary report. The main results of the analysis are that:

- Member States tended to agree more with the Court's findings made in agricultural policy than in structural actions.
- Substantive findings where the Court considered the full amount of the transaction to be in error were more than twice as frequent in structural actions as in agricultural policy.
- A discrepancy between the size of a field as measured by the Court and the area claimed by the farmer was the most common substantive finding within agricultural policy. Member States accepted more than 8 in 10 of these findings.
- Lack of essential supporting documents was the most common substantive finding within structural actions. Member States accepted less than 4 in 10 of these findings.

Member States sometimes indicated action taken in the instances where the Member States agreed with the finding made by the Court. Typical follow-up actions included for instance providing missing documentation, initiating recovery procedures and/or issuing better guidelines/instructions to authorities implementing on-the-ground. Depending on the outcome of recovery procedures launched, the final financial impact of findings made may be considerably smaller than estimated by the Court at the time of the Annual Report.

Several Member States also argued that the rules governing funding in the structural actions area are open to various interpretations. Ireland observed that owing to previous problems of interpretation, managing authorities were no longer allowing overheads to be included in claims submitted to the paying authority.

Findings concerning measurement of area (agricultural policy)

Member States accepted a large share of the findings made by the Court concerning areas claimed by final beneficiaries. Relatively small error rates were often calculated for these findings⁷. In the rather few cases where Member States did not agree with the Court's finding concerning the size of a field, they sometimes underlined that they had in fact complied with the legislation in force – despite the

⁶ Member States replied to about 60 per cent of the cases. The rate of reply was very high for findings within agricultural policy (almost 90 per cent) but somewhat lower within structural actions (around 50 per cent).

⁷ 28 per cent of the findings had error rates less than 2 per cent. A further 25 per cent of the findings had error rates between 2 and 5 per cent.

fact that the Court made a finding. However, these findings may have no impact on the Court's overall DAS.

For instance, in one case Poland commented on a finding concerning a farmer where the *"data declared in the application was verified as part of an administrative check based on the IACS reference database. [...] Bearing in mind that an administrative check based on the available reference data was carried out during the 2004 campaign, and did not reveal differences between the area declared in the application and the data contained in the reference data base, the amount of payment had been correctly calculated."*

France noted as a general remark in cases where the Court verified the size of fields that: *"As a rule, the Court's random choice of cases results in examination of cases which do not form part of the sample controlled by the French authorities. Moreover, the regulation states that 6.73% of cases should be controlled on the spot (France rounds this rate to 6.7%), leaving more than 90% which are not visited."* A similar observation was made by Sweden.

EU legislation is in principle based on proportionality between EU funds spent and costs of controls, leading to national authorities not being required to check all fields on the spot before making payments⁸. Due to the sampling approaches applied by the national authorities, the Commission and the Court, it is to be expected that the probability for findings in cases that have not been checked by the national authorities on the spot beforehand is higher, indicating the need to improve day-to-day management or even to increase the number of on-the-spot checks in the cases where the error rate is above the materiality threshold. Nevertheless, the national authorities may have complied fully with the rules in force.

Findings concerning missing documents

In the structural actions area, the most common substantive finding in the 2005 DAS exercise was a lack of essential supporting documents. Member States contested these findings in more than half the cases, usually on the ground that either the documents had been provided to the Court already or had been found in the meantime. Some Member States also maintained that the period for keeping documents in the 1994-99 period had been unclear.

Cases where Member States claimed to have uncovered the documents requested by the Court are listed below. The Commission is not in a position immediately to verify the information provided by Member States but a follow-up may be made.

Sweden informed that it followed up on the Court's findings of a European Social Fund programme by carrying out an audit of its own *"according to which the Court's criticisms are largely unfounded. The substance of many of the supporting documents, which according to the Court of Auditors were lacking was identified in the follow-up audit. [...] Given the fact that several years had elapsed since the*

⁸ The intensity and quality of primary controls in Structural Funds for 2000-06 is specified in a recent best practice note; Member States' level of checking may still not be adequate.

project was concluded, the supporting documents concerned were not always to be found with the beneficiaries but were held in the archives of the competent authority.

Ireland maintained that legislation concerning the 1994-1999 period was not clear as to the point from which documents should be retained, i.e. from the last payment on a project or from the last payment on a programme⁹.

Germany also noted a case where it disagreed with the Court's interpretation of this part of the legislation. Nevertheless, it stated that it had since the Court's audit "*received the files relating to three of these [four] cases. The Court of Auditors was informed of this situation and other details regarding the selected cases and the whereabouts of the supporting evidence in the course of the standard commenting procedure.*"

In cases where essential elements were missing and no other documentation could be provided alternatively, the Court classified these findings as substantive with an error rate of 100 per cent, i.e. with a significant financial impact on the general EU budget. Nevertheless, if the Commission subsequently finds that Member States have since produced the supporting documents – albeit with some delay – then the underlying payment could be judged legal and regular in a court of law and there will be no grounds for initiating a recovery procedure. Such findings could more fairly be presented as ‘absence of assurance in the time available for the audit’, instead of substantive errors.

3. PREPARATION OF THE COURT’S ANNUAL REPORT

The 2005 Annual Report was the first to be published by 31 October following the revision of the Financial Regulation in 2002. The Court thus had to meet a deadline which was one month shorter than in earlier years and thus also had one month less than usual to plan and carry out audit missions, analyse findings (often involving translation of documents received during the mission), inform auditees of the findings made and await and analyse replies from the auditees.

The severe time restriction faced by the Court in its preparation of the 2005 Annual Report should be borne in mind when considering the weaknesses identified below in the procedure for exchanging information between the Court, the Commission and Member States. Nevertheless, the difficulties encountered this year – albeit more severe than usual – were also encountered in earlier years.

To collect evidence for its DAS, the Court carries out audits in both the Commission and Member States. In the area of shared management, the 2005 DAS was based on findings made during more than 100 audit missions to Member States where the Court audited control systems and transactions to final beneficiaries such as farmers and companies receiving money from the Structural Funds.

⁹ Article 23(3) in Council Regulation (EEC) No 2082/93 of 20 July 1993 says that: “*For a period of three years following the last payment in respect of any operation, the responsible body and authorities shall keep available for the Commission all the supporting documents regarding expenditure and checks on the operation.*”

When missions are completed and the Court has finalised its analyses of the findings made, the Court sends a letter called a Statement of Preliminary Findings ('SPF') to the National Supreme Audit Institution in the Member State concerned by the findings. The Court normally invites the National Supreme Audit Institution to inform the Court of its reaction to the findings made within 6-8 weeks. The Commission receives a copy of both the SPF and the ensuing reply¹⁰.

On the basis of its findings in both the Commission and Member States, the Court establishes its draft report, which is discussed between the Court and the Commission services before final adoption by the Court. The Court is the external auditor of the Commission – and the Commission only – in line with the principle that the Commission is responsible for the implementation of the general EU budget. The contradictory procedure between auditor and auditee therefore involves only the Court and the Commission.

The DAS itself, i.e. the two-page statement at the very beginning of chapter 1 in the Annual Report, is not included in the draft report. It is not presented to the Commission during the contradictory procedure and is for that reason not accompanied by any Commission reply. The Court adopts the DAS when the contradictory procedure is finalised.

Member States in practice implement around 80 per cent of the general EU budget and the Court accordingly bases its opinion to a significant degree on findings made in Member States. Feedback from Member States on the findings made by the Court is consequently of great importance to the Commission when preparing its replies which are published along with the Court's observations in the Annual Report.

It is not extraordinary that an auditee does not agree fully with the findings of an auditor. The auditor has to perform an audit, adhering to international auditing standards and – in the case of the general EU budget – in respect of the legislation underlying the transactions made. In some cases, issues may be open to interpretation and the auditor and auditee may have differing views.

The objective of the Commission is to include the points of view of Member States in its replies where Member States do not fully agree with the Court's findings, and where the Commission finds that Member States are able to substantiate their position. But the Commission is aware when it accepts the final draft of the report that during the subsequent follow-up not all the remaining findings will be substantiated¹¹.

In the case of the 2005 Annual Report, the contradictory procedure took place in June/July 2006 during which time the Court and the Commission services met on several occasions to discuss the Court's draft report (adopted in May/June 2006) and the Commission's draft replies (prepared in June/July 2006). The Court adopted its

¹⁰ The Commission also receives statements of preliminary findings on audits the Court has carried out in the Commission.

¹¹ The Commission may not apply financial corrections based on the findings of other auditors without making its own assessment of each case (Article 4(3) of Regulation 448/2001) because its decisions are open to appeal to the Court of Justice.

2005 DAS in September 2006. The time until publication of the report (end October 2006) was needed for translation and printing of the Annual Report in all the official languages.

The Court sent almost 75 SPFs to Member States and received replies to the vast majority of these. Half of the replies were transmitted within the two month deadline and most of the remaining replies within an additional month. Nevertheless, around 3 in 4 replies were not available to the Court when it adopted its draft report and around half of the replies still arrived too late to be taken into account in the Commission's replies.

The consequences of the incomplete feedback from Member States before the final preparation of the Annual Report was noted by Spain which said that: *“The Report refers to matters arising from inspection visits whose final conclusions have not been received by Spain. It therefore seems that the conclusions contained in the 2005 Annual Report in some cases depend on an appraisal of the statements and comments submitted by the Member State following the provisional report concerning the inspection visit. Reference could therefore usefully be made to the situation of the specific procedures (whether final or provisional conclusions of the inspection visits are concerned, and whether comments have been made by the Member State.”*

Particular difficulties were also encountered in assuring that the figures included in the chapter concerning the common agricultural policy were correct. The 2005 Annual Report was the first to contain figures for the 10 new Member States. Slovenia, Malta and Poland pointed out in their response to the published Annual Report that some figures concerning their performance within agricultural policy and appearing in the 2005 Annual Report were revised subsequently.

In the extraordinary case of Slovenia, wrong figures concerning area aids and cows were provided at the time of the audit and subsequently included in the 2005 Annual Report. Concerning area aid, the percentage of applications inspected were initially calculated to be overstated by 53.5 per cent on the basis of data available but were corrected down to 1.8 per cent in the follow-up process which could not be reflected in a timely manner in the Annual Report¹². Similar figures initially provided concerning animals claimed by farmers but found not to exist or not to be eligible for subsidy were rightfully 11.8 per cent for suckler cows and 7.7 per cent for special beef premium instead of respectively 48.2 per cent and 56.2 per cent¹³.

Although the figures for Slovenia clearly were very different from other Member States and although the Commission in its reply included in the Annual Report had stated that the figures probably needed to be adjusted, corrections could not be taken into account in time for the Annual Report, and critical headlines based on the wrong figures appeared in both the international and national press. This issue has since been cleared up.

¹² See graph 5.3 in chapter 5 of the 2005 Annual Report.

¹³ Point 5.21 in chapter 5 of the 2005 Annual Report.

4. CONCLUSION

The feedback from Member States after the publication of the 2005 Annual Report indicated some issues in need of further consideration:

The level of on-the-spot checks required by legislation would have to be significantly increased if the Court were not to find errors exceeding the materiality threshold during its audit visits – though this level should also be proportional from a cost-benefit point of view.

Member States shall carry out the required minimum number of checks on the spot¹⁴. When the Court audits transactions not checked on the spot by Member States, it will probably find some errors, which may prevent it granting a positive statement on the underlying transactions.

This problem will continue as long as the Court has no political guidance from Parliament and Council as to the acceptable level of risk which should always take into consideration the costs and benefits of controls¹⁵.

The Court is required to provide an annual DAS. The strictly annual nature of this exercise may lead the Court to over-estimate the financial impact of errors on the general EU budget since it does not allow the Court to take into account measures taken subsequently to correct errors detected by the Court, the Commission or the Member States.

The real financial impact on the general EU budget of the findings made by the Court will for instance depend on whether recovery procedures initiated succeed or on whether missing documents are produced. The Court is naturally not able to wait an indefinite span of time before forming its opinion on the DAS but the Commission and Member States may find that the substantive findings made by the Court in the first instance may be corrected in the end. The proposal from Spain on indicating more clearly in the Annual Report the preliminary nature of some findings made might be helpful as would the indication of certain cases as a ‘failure to obtain assurance’ instead of as ‘substantive findings’.

Improvements in the communication between the Court and Member States seem possible and important.

The Court is by definition not able to conclude all its audits within the same financial year it is auditing. For instance, some audits in relation to the financial year 2005 had to be carried out in 2006 in order to cover transactions made in the end of 2005. This makes it difficult to ensure that all Member States’ reactions to the Court’s findings are available to both the Court and the Commission during the contradictory procedure.

¹⁴ The legislation sets out minimum standards. Member States may increase the number of controls – and should do so if error rates are higher than expected.

¹⁵ This point is among other issues addressed by the Action Plan towards an Integrated Internal Control Framework, COM(2006) 9.

A common understanding at the operational level between the Court, the Commission and Member States concerning procedures to be followed when checking transactions on the spot, treatment of errors, questionnaires to be used and formats for reporting and replying might be helpful in resolving or at least reducing this problem.

The Commission is responsible for executing – with the help of Member States – a budget of more than 120 billion euro of taxpayers' money each year. The Court examines whether transactions have been implemented in a legal and regular manner – supplemented by other audits, which look into whether funds have also been spent well. Based on the work of the Court, the Council makes a recommendation and the Parliament finally decides whether the Commission should be given discharge.

Resolving the issues set out above is of importance so that taxpayers can be assured that the basis for the discharge procedure is as comprehensive and accurate as possible within the limits set by the Treaty.