



HOUSE OF LORDS

European Union Committee

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50th Report of Session 2005–06

**Financial  
Management and  
Fraud in the  
European Union:  
Perceptions, Facts  
and Proposals**

Volume I: Report

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NOTE: References in the text of the report are as follows:

(Q) refers to a question in oral evidence

(p) refers to a page of written evidence

The Report of the Committee is published in Volume I (HL Paper 270-I) and the Evidence is published in Volume II (HL Paper 270-II)

## **FOREWORD—What this report is about**

The European Court of Auditors has now been unable for twelve successive years to give a positive Statement of Assurance to the accounts of the European Communities. This, together with its attendant press coverage, is an extremely serious problem for the European Union and the governments of the Member States.

However the failure to give a positive Statement of Assurance does not tell the whole story. This report puts the Court of Auditors' successive qualified Statements in context. Firstly, we argue that the lack of a positive Statement of Assurance does not necessarily indicate that high levels of fraudulent or corrupt transactions have taken place. Secondly, we note that Sir John Bourn, head of the National Audit Office, were he required to do so, would be unable to give a similar positive Statement of Assurance on the UK's accounts. We propose that:

- The Court should distinguish clearly between irregularity and fraud, publishing separate figures for the level of fraudulent transactions and administrative mistakes;
- Substantial improvements are needed to the methodology underpinning the Statement of Assurance to ensure that it is based on accurate and full data; and
- The Statement of Assurance should focus on giving a detailed summary of financial management in each of the spending categories and Member States.

The report continues with an analysis of the internal control systems operated within the Commission. We argue that audit of the Commission's accounts should be separated from the much broader remit of the Statement of Assurance. We have been presented with no evidence to support allegations of a culture of corruption within the Commission's administration. We consider that:

- The decentralised system of control introduced by the Prodi-Kinnock reforms has allocated financial responsibility to the appropriate level, so long as effective control systems are in place;
- Further responsibility should be taken on by Commission officials in the form of a system for signing off the accounts which culminates with the Directors General and the Secretary General; and
- Similar additional responsibilities must be taken on by the existing audit bodies within the Commission.

The report makes an assessment of the relationship between the Commission and the Member States in the expenditure categories which are jointly managed by them. These include agriculture and regional policy (structural fund) expenditure and account for over 80% of the total expenditure. To improve management in this area we call for:

- As over 80% of European funds are disbursed within the Member States, the Commission alone cannot be held responsible for the regularity of these transactions;

- The introduction of national Statements of Assurance signed by a minister or senior civil servant, audited to internationally recognised standards by the national Supreme Audit Institution and submitted to the Commission and to the national parliament;
- A list of those Member States demonstrating poor management of European funds to be produced by the European Court of Auditors; and
- Responsibility for the Court of Auditors' annual Statement of Assurance and audit to reside with the Budget Council, which is responsible for drawing up the budget, rather than, as now, the ECOFIN Council.

The report ends with a review of the role of the European Court of Auditors itself and an analysis of the fight against fraud. We conclude that, while the level of fraud is no higher than in comparable public expenditure programmes, including in the UK, the fight against fraud must go on.



# Financial Management and Fraud in the European Union: Perceptions, Facts and Proposals

## CHAPTER 1: BACKGROUND—THE BUDGET OF THE EUROPEAN COMMUNITIES AND ITS AUDIT

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1. From small beginnings in the 1960s, the budget of the European Communities (EC) has grown rapidly since the 1980s. Although still a small proportion of the total Gross Domestic Product (GDP) of the European Union (EU) (at around 1%), it is now a large absolute sum. For the financial year 2006, the EU budget allows for €121 billion in commitment appropriations (€112bn in payment appropriations)<sup>1</sup> and the recently agreed Financial Perspective for 2007–2013 makes total commitments of €843 billion<sup>2</sup> over the seven year period. Most of the spending (approximately 80%) funds the Common Agricultural Policy (CAP) and the structural and cohesion funds.
2. Responsibility for reporting on the legality and regularity of the EU's revenue and expenditure lies with the European Court of Auditors (ECA). The Court was established in 1975 but since the Maastricht Treaty was signed in 1992 it has been required<sup>3</sup>, in addition to conducting its annual audit, to provide a Statement of Assurance (or DAS from the French—*Déclaration d'Assurance*) on the income and expenditure of the EC budget for the outgoing financial year. However, in each year since 1994, the Court has not given a positive Statement of Assurance on the transactions underlying the expenditure side of the accounts.
3. We argue in Chapters 2 and 3 that the annual audit of the European Commission itself should be kept separate from the broader remit of the post-Maastricht Statement of Assurance. Confusion between the two objectives and the lack of positive assurance has led many, including a number of those we spoke to during our inquiry, to be critical of the state of financial management in the European Commission and the effect that this is having on the Union. Ivan Lewis MP, then Economic Secretary to HM Treasury, told us that “as long as the accounts cannot be signed off appropriately then that sense of a lack of confidence and that unease over accountability for the way taxpayers' money is being spent by the European Union will continue to be there. It is part of the bigger picture about the great unease of the citizens of Europe with the institution that is the

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<sup>1</sup> The accounting procedures for the EC budget distinguish between commitment and payment appropriations. Commitment appropriations are the total cost of legal obligations which can be entered into during the current year, for activities which will lead to payments in the current and future years. Payment appropriations are actual transfers of cash from the Community Budget to creditors during the current year, resulting from commitments made in the current or previous years.

<sup>2</sup> Notice 2006/C 139/01, Inter-institutional agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management, *Official Journal* C139, vol 49, 14 June 2006, Annex 1.

<sup>3</sup> Under Article 248.

European Union at the moment” (Q 45). Similarly, former MEP Terry Wynn, who was chairman of the European Parliament’s Committee on Budgetary Control, suggested that “those who want to knock the European Union will always be able to use the annual report of the Court of Auditors” (Q 268).

4. **We concur with the views presented to us that the lack of positive assurance from the European Court of Auditors in their annual Statement of Assurance is a serious problem for the European Union and the governments of its Member States. It was as a result of our concern over this that we decided to launch this inquiry.**

### Putting the lack of a positive Statement of Assurance in context

#### *Crises and developments in the Commission*

5. The lack of a positive Statement of Assurance should, however, be seen in a broader context. Since the resignation of the Commission headed by Jaques Santer in March 1999 amid allegations of “fraud, nepotism and mismanagement”<sup>4</sup> the European Commission has been seeking to address the issue. The incoming Commission, headed by Romano Prodi, issued a white paper dubbed “the Prodi-Kinnock White Paper” together with an accompanying action plan in March 2000<sup>5</sup>. These set out a wide-ranging programme of internal management reform. Of the proposed 98 actions, 37 related directly to financial management, audit and control. Many of these were taken directly from the Sound and Efficient Management (SEM) 2000 reforms which had been put forward by the Santer Commission in 1995<sup>6</sup>.
6. However, although some 85% of all spending was and still is carried out by Member State agencies, rather than by the central European Institutions themselves, the Prodi-Kinnock reforms (in contrast to earlier SEM reforms) did not seek to address the issue of Member State involvement in the management of EU spending programmes. This is known as shared management<sup>7</sup> in the lexicon. Rather the reforms focused on the role played by the European Institutions.
7. In spite of these reforms problems at both Commission and Member State level have continued to be highlighted by the Court of Auditors in its special and annual reports since 2000. In addition the 10 country enlargement of May 2004 has brought about even greater challenges for the Commission and the shared management system.
8. Furthermore, the Commission’s reputation for sound financial management and its commitment to reform was not enhanced by problems within one of its own long-established Directorates General. In 2003 serious financial

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<sup>4</sup> Committee of Independent Experts, 1999. First and Second Reports on Allegations Regarding Fraud, Mismanagement and Nepotism in the European Commission. Brussels.

<sup>5</sup> White Paper: Commission of the European Communities, 2000. Reforming the Commission: A White Paper—Part I: Communication from Mr Kinnock in agreement with the President and Mrs Shreyer. Brussels, European Commission. Commission of the European Communities, 2000. Action Plan: Reforming the Commission: A White Paper—Part II: Action Plan: Communication from Mr Kinnock in agreement with the President and Mrs Shreyer, Brussels, European Commission.

<sup>6</sup> Commission of the European Communities, 1995. *Sound and Efficient Management*. SEC (95) 1814 Final, Brussels: European Commission.

<sup>7</sup> Where management of funds is shared between the Commission and the authorities in the Member States.

irregularities involving the Commission's statistical agency, Eurostat, came to light. The case has raised questions about the strength of the internal control systems within the Commission, the efficacy of internal audit and OLAF<sup>8</sup> investigations and staff disciplinary procedures. Further concerns have been raised over the commitment to openness and transparency in relation to whistle blowing by officials. These and other issues have led some to claim that there is a "culture of corruption"<sup>9</sup> within the Commission. **Our investigation was not presented with any evidence of a culture of corruption in the Commission.**

9. In addition to the Prodi-Kinnock reforms, the Commission began introducing a new accruals-based accounting system in January 2005 which is an essential prerequisite to implementing some of those reforms. At the same time, the European Commission, the European Parliament, the European Court of Auditors, and the Council of Ministers have made (or in the Council's case responded to) proposals to improve internal and external control systems, including through reform of the Statement of Assurance, indicating that the problems besetting EU financial management are still significant and substantial. Details of the proposals can be found in the boxes at the beginning of Chapter 2.

#### *The meaning of a qualified audit opinion*

10. What is indicated by a lack of a positive Statement of Assurance has been a matter of some dispute during our inquiry. This lack of a widely understood definition was recognised by Mr Josef Bonnici, the Member of the European Court of Auditors responsible for the Statement of Assurance. He told us that the Court's worry was that "it can sometimes be misunderstood" (Q 83). There was, however, unanimous agreement among those we took evidence from that, as Ivan Lewis MP put it, "it is wrong that it is presented as mainly being about fraud because that is not accurate" (Q 44).
11. **We share the concern raised with us by the European Court of Auditors that their decision not to give a positive Statement of Assurance can be misunderstood. We recognise that the lack of a positive Statement of Assurance does not necessarily indicate that high levels of fraudulent or corrupt transactions have taken place. We do not seek to detract from the importance of the issue, nor from the evident underlying problems which have resulted in 12 successive qualified audit opinions. However, we consider that a more accurate reflection of the substance of the Court's annual audit and the Statement of Assurance would be achieved if these two functions were more clearly separated. In addition, the single Statement of Assurance should be split into a series of statements on each of the different spending categories.**

#### **Our past involvement and this inquiry**

12. We have taken a close and continuing interest in these matters. In addition to our annual reports on the EC budget, we have published a series of reports since 1988–89 on financial management and the fight against fraud (1988–89, 1992–93, 1993–94 (twice) and 1998–99), the European Court of

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<sup>8</sup> Europe's anti-fraud body—from the French *Office Européen de Lutte Anti-Fraude*.

<sup>9</sup> Q 249.

Auditors (1979–80, 1986–87 and 2000–01), the future financing of the EU (2004–05), and OLAF (2003–04)<sup>10</sup>. This report builds on a substantial body of work that we have carried out over the years.

13. We launched this current inquiry in February 2006 in response to the Court of Auditors' report on the 2004 Budget<sup>11</sup>. During our inquiry we have taken account of a number of other documents and proposals. We are currently maintaining the Parliamentary scrutiny reserve on the following documents as we consider them to be relevant to this inquiry:
- EM 5509/06: Commission Action Plan towards an Integrated Internal Control Framework
  - EM 8630/06: Member States' replies to the European Court of Auditors' 2004 Annual Report
  - EM 10480/06: Annual Report to the Discharge Authority on Internal Audits carried out in 2005
  - EM 10562/06: Synthesis of the Commission's management achievements in 2005—Communication from the Commission to the European Parliament, the Council and the European Court of Auditors
  - EM 11399/06: Progress report as at 31 March 2006 on modernising the European Commissions' accounting system
  - EM 9628/06: Modified proposal for a Council Regulation amending Regulation (EC, Euratom) No. 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities
  - Unnumbered EM submitted by HM Treasury on 10 October 2006: Report of the European Anti-Fraud Office—Sixth Activity Report for the Period 1 July 2004 to 31 December 2005
14. Our investigation has been informed by a large amount of both written and oral evidence. A full list of those who contributed to the inquiry is printed at Appendix 2. The written submissions we have received and the oral evidence we have heard are published in the volume accompanying this report. We would like to record here our thanks to Professor Roger Levy from the Caledonian Business School for all the help and advice he provided us in his role as Specialist Adviser.
15. **We make this report to the House for debate.**

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<sup>10</sup> On EU financial management and financing see European Union Committee, 5th Report (1998–99): *Fraud against the Community* (HL 27); European Union Committee, 13th Report (1992–93): *The Fight Against Fraud* (HL 44); European Union Committee, 6th Report (1993–94): *Fraud and Management in the Community's Finances* (HL 34); European Union Committee, 12th Report (1993–94): *Financial Control and Fraud in the Community* (HL 75); European Union Committee, 6th Report (1998–99): *Future Financing of the EU: who pays and how?* (HL 36); European Union Committee, 9th Report (1998–99): *Prosecuting fraud on the Communities' finances—the Corpus Juris* (HL 62); European Union Committee, 6th Report (2004–05): *Future Financing of the European Union* (HL 62). On the Court of Auditors: European Union Committee, 2nd Report (1979–80): *EEC Budget* (HL 17); European Union Committee, 6th Report (1986–87): *Court of Auditors* (HL 102); European Union Committee, 12th Report (2000–01): *The European Court of Auditors: The case for reform* (HL 63). On OLAF: European Union Committee, 24th Report (2003–04): *Strengthening OLAF, the European Anti-fraud Office* (HL 139).

<sup>11</sup> The Court's report and Statement of Assurance on the 2005 budget has now been published. We reprint this Statement of Assurance at Appendix 4.

## CHAPTER 2: THE STATEMENT OF ASSURANCE: ITS DEVELOPMENT AND ITS WEAKNESSES; PROPOSALS FOR REFORM

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16. Proposals for reform of the Statement of Assurance and wider financial management have come from, amongst others, the European Court of Auditors, the European Commission, the European Parliament and the Council. We summarise each of these in the boxes below.

### Proposals for reform

#### BOX 1

##### Proposals from the European Court of Auditors in 2004<sup>12</sup>

The European Court of Auditors proposed a new internal control system based on:

- An effective chain of controls operating to common standards and clearly defined objectives for each level;
- Applying, documenting and reporting controls openly and transparently;
- A clear and simple legislative framework;
- A definition from the Commission of minimum requirements for all levels;
- Setting the type and intensity of checks with reference to costs and benefits; and
- The Commission having responsibility for promoting improvements in partnership with the Member States.

#### BOX 2

##### Proposals from the Commission in 2005 and 2006

The Commission brought forward a Roadmap<sup>13</sup> and Action Plan<sup>14</sup> to an Integrated Internal Control Framework these:

A. Put new responsibilities on the Member States including requirements for:

- Annual ex ante Disclosure Statements and ex post Statements of Assurance signed off at the highest level;
- Each operational agency to make similar statements and declarations, backed up by independent auditor opinions;
- The appropriate Supreme Audit Institutions to exercise oversight and report on design and operational weaknesses; and
- The appropriate Supreme Audit Institutions to audit the ex post Declarations of Assurance and report the results to national legislatures.

B. Require from the Commission that:

- Each Director General's Annual Activity Report must give a clear and sound basis for financial assurance, including appropriate indicators;

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<sup>12</sup> Opinion 2004/2 OJ (2004/C 107/01).

<sup>13</sup> COM(2005) 252.

<sup>14</sup> COM(2006) 009.

- The Accounting Officer signs off the Commission's accounts annually;
  - The role of resource directors in the Directorates General are clarified and strengthened;
  - The Commission's follow up reports are strengthened so the Court can better assess what actions have been taken;
  - The management role of the annual synthesis report of the Annual Activity Reports is reinforced;
  - The scope for further rule simplification is explored;
  - A common methodology for risk assessment and for ensuring control requirements are proportionate to risk is introduced;
  - Guidelines on carrying out checks and controls are provided;
  - Types of errors and error rates for inclusion in Annual Activity Reports are defined; and
  - Cost-benefit analysis on the use of checks ex ante and ex post is used.
- C. Seek to improve co-operation between the Commission and the Member States through:
- A framework of incentive and coercive measures for compliance/non-compliance; and
  - A single audit system.

### **BOX 3**

#### **Reaction and proposals from the European Council in 2005**

At the November 2005 ECOFIN meeting, the Council<sup>15</sup>:

- Supported the Court's Opinion 2/2004 on the internal control system and the related issues of the simplification of Community legislation;
- Reserved its position on the Commission's Roadmap and Action Plan, asking the Commission and the Member States to provide an assessment of the present controls at sector and regional level;
- Reaffirmed the principle of shared management between the Commission and the Member States;
- Did not support the introduction of national Statements of Assurance;
- Encouraged the Member States who wish to do so to proceed with Contract of Confidence arrangements with the Commission for Structural Funds programmes;
- Supported operational level Declarations of Assurance from the Directorates General as an important element in the assurance process;
- Supported the strict distinction between internal and external audit, arguing that external bodies are not part of the internal control framework;
- Did not support steps to further the current framework of cooperation between the European Court of Auditors and national Supreme Audit Institutions; and
- Encouraged the European Court of Auditors to broaden the evidence base of the Statement of Assurance, to engage in dialogue with the Member States, to address the issue of multi-annual programmes, and to reach an understanding with the European Parliament regarding tolerable rates of error.

<sup>15</sup> ECOFIN conclusions, 8 November 2005, 13678/05 (Presse 277).

**BOX 4****Proposals from the European Parliament**

A In the annual *ex ante* Disclosure Statements (as proposed by the Commission) the Member States should include:

- A description of the managing authority's control systems;
- An assessment of their effectiveness;
- A joint remedial action plan agreed by the managing authority and the Commission (where required); and
- Confirmation by an external auditor or the national Supreme Audit Institution of the accuracy of the descriptions.

B The national Statement of Assurance should be based on a national equivalent to the Annual Activity Reports produced by the Directors General and should be signed by a competent minister or official.

C All paying agencies should be audited annually by an external auditor; their performance should be measured against pre-agreed indicators; failing agencies should have payments to them suspended or financial penalties imposed on them.

D The Commission should provide a Statement of Assurance on its accounts signed by the Accounting Officer and the Secretary General.

E The Court should engage further with national Supreme Audit Institutions in pursuit of the single audit process; and should extend its qualitative work.

**The Statement of Assurance**

17. The Statement of Assurance is provided for under Article 248 of the EC Treaty which sets out the general powers of the European Court of Auditors. These are:

- to examine the accounts of all revenue and expenditure of the Community with a view to its legality, regularity and sound financial management; and to publish special and annual reports, to make observations and publish opinions; and
- Additionally, the Court “shall provide the European Parliament and the Council with a Statement of Assurance (DAS) as to the reliability of the accounts and the legality and regularity of the underlying transactions”. This Statement may be supplemented by specific assessments for each major area of Community activity.

That the Court of Auditors has these various general powers has been a source of confusion. **We recommend that in future the annual examination and audit of all revenue and expenditure of the Commission should be separated from the broader objectives of the Statement of Assurance.**

18. The idea behind the Statement of Assurance was to give a true and fair view of the accounts as a whole. The requirement for the Court of Auditors to provide such a Statement was included at a late stage in the drafting of the Maastricht Treaty with strong backing from the UK and Dutch governments and the support of the European Parliament's Budgetary Control Committee

(COCOBU). The Court was not provided with any extra resources to carry out the Statement of Assurance, although in fact its staff numbers grew faster than those in the Commission in the years following Maastricht<sup>16</sup>. We reprint the full text of the Court's most recent Statement of Assurance, on the 2005 accounts, at Appendix 4.

19. To date there has never been a positive Statement given to the payments side. However, revenue and commitments have been judged reliable and regular in every year since 1994. The lack of a positive Statement has created a large amount of adverse publicity for the EU and has prompted the Commission and the European Parliament in particular to bring forward proposals to remedy the situation. Both of these Institutions see the achievement of a positive Statement of Assurance for payments as an important objective<sup>17</sup>, and indeed this is the *leitmotif* for the Commission's 2005 Roadmap for an integrated internal control framework<sup>18</sup>. In his oral evidence to us, Ivan Lewis MP, then Economic Secretary to HM Treasury, underlined the concerns that many felt about the lack of a positive Statement of Assurance. He told us that "In terms of the credibility and the reputation of the EU, it is a disaster really" (Q 44).
20. As noted above we share the concerns raised with us over the lack of a positive Statement of Assurance from the Court of Auditors since 1994 and consider that improving the financial management of European funds must be a priority. **We are pleased to see that the Commission and the European Parliament are actively addressing issues regarding European financial management which are raised by the Court of Auditors in their annual audits.**

### **DAS Methodology**

21. The legislation introducing the Statement of Assurance was permissive: it did not prescribe how the Statement should be conducted nor what methodology should be used. Furthermore it did not require specific assessments for each major area of activity. It was the decision of the Court itself to provide a single Statement of Assurance on all the accounts, rather than to provide a number of separate opinions.
22. We explored the decision to give a single Statement at some length during our inquiry, particularly with a view to comparing the Court's Statement with the statements and audits of other audit institutions. **Sir John Bourn, Comptroller and Auditor General at the UK's National Audit Office told us that, were he required to issue a single Statement of Assurance on the UK Government's accounts in the same way as the Court of Auditors does for Europe's accounts, he, like the Court, would be unable to do so (Q 192). This is because last year he issued a qualified opinion on 13 of the 500 accounts of the British Government which he audits (Q 190).**
23. **We consider that the Court's decision to give a single Statement of Assurance on the accounts as a whole means that a positive Statement**

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<sup>16</sup> Figures in Levy, R, 2000, *Implementing European Union Public Policy*, Cheltenham, Edward Elgar, Tables 2.5 and 2.6 pp. 49 and 52.

<sup>17</sup> See Boxes 2 and 4.

<sup>18</sup> COM (2005) 252 final; COM (2006) 9 final; COM (2006) 49 final.

**is difficult to achieve. We consider that it would be preferable for the Court to issue statements on each of the spending areas; in much the same way that the National Audit Office in the UK issues separate audits for each Government department. This would give a more accurate picture of the state of financial management in the Union and would make comparisons with other public bodies easier.**

*Transaction testing and the development of the Court's methodology*

24. To provide this single Statement the Court initially relied exclusively on sample transaction testing, whereby a selection of transactions is checked for irregularities. These samples are assumed to be representative of all the transactions which take place and hence the global error rate is extrapolated. In practical terms, transaction testing means that teams of auditors investigate a series of transactions with a view to identifying any errors. The investigation of a transaction is a full and thorough process. According to Mr David Bostock, the United Kingdom's Member of the Court of Auditors, it involves "going right to the recipient, going to the farmer, going to the farm in some cases, going to the Structural Fund recipient to see what has actually happened" (Q 89).
25. Over the years, the Court has added new elements to the methodology behind the Statement. According to our witnesses from the Court<sup>19</sup>, they have moved towards a risk-based approach. This includes the following:
- An assessment of supervisory systems and controls;
  - A review of the Annual Activity Reports<sup>20</sup> and Declarations from each of the Directors General in the Commission; and
  - An evaluation of the results of other auditors.

Before implementing these changes, the Court drew from the experience of a number of other Supreme Audit Institutions including the National Audit Office in the United Kingdom. The changes are, for Sir John Bourn Comptroller and Auditor General at the National Audit Office, an example of how "the procedures of the European Court of Auditors have come closer to those of the United Kingdom" (Q 190).

26. However, as a number of our witnesses pointed out<sup>21</sup> the Court's methodology still relies heavily on transaction testing. In this context, we note that in its statement of November 8 2005, the ECOFIN Council saw operational level declarations of assurance from the Directorates General as an important element in the assurance process. The ECOFIN Council has encouraged the Court to broaden the evidence base of the Statement of Assurance, engage in dialogue with Member States, address the issue of multi-annual programmes and reach an understanding with the European Parliament regarding tolerable rates of error<sup>22</sup>.

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<sup>19</sup> Q 81.

<sup>20</sup> On the basis of its annual management plan, each Directorate General monitors the realisation of policy objectives and establishes the link with the corresponding resources used during one year's activities. The annual activity report is also each Director General's management report to the Commission, concerning the performance of their duties. The the most recent Annual Activity Reports can be found at [http://ec.europa.eu/atwork/synthesis/aar/index\\_en.htm](http://ec.europa.eu/atwork/synthesis/aar/index_en.htm).

<sup>21</sup> QQ 192, 399.

<sup>22</sup> ECOFIN conclusions, 8 November 2005, 13678/05 (Presse 277).

27. This continued reliance on testing a sample of transactions has been the focus of much critical attention. In his evidence, Terry Wynn, former MEP, implied that the Court is setting itself a near impossible task. He draws a distinction between the two aspects of the Statement of Assurance—the accounts on the one hand which are basically sound, and some of the underlying transactions on the other. He argues that the statistical sampling method chosen by the Court (Monetary Unit Sampling), coupled with the relatively small sample of transactions (initially 300, now 500+), examined by the Court “made it practically impossible to get below the materiality threshold of 1% decided for a positive DAS in respect of transactions”<sup>23</sup>.
28. **We concur with the observation that the methodology employed by the Court still relies heavily on transaction testing. Due to the small number of transactions actually looked at each year we do not consider that this methodology can lead to an accurate picture of financial management. The Court should aim to improve the methodology behind the Statement’s production so as to provide more accurate data. We consider that these weaknesses must be remedied as a matter of priority so an accurate picture of the error rate can be obtained.**
29. **We are therefore pleased to see that the Court has responded to calls from the ECOFIN Council and added additional auditing techniques over the years. In particular we are pleased to see that the Court now conducts an assessment of supervisory systems and controls; reviews the Annual Activity Reports and Declarations from each of the Directors General in the Commission; and evaluates the results of other auditors. We consider that these need to be further developed to give a more rounded picture of performance over the year. In particular, greater use by the Court of the Annual Activity Reports could add positive pressure for their development into proper accounting tools.**

*The meaning of an irregularity*

30. In addition to the debate over the distinction between the accounts and the underlying transactions there is confusion over what should be recorded as an irregular transaction. Terry Wynn argued that the Court’s definition of erroneous transactions does not differentiate between intentional irregularities (viz. fraud) and those where there has been a substantial or formal mistake<sup>24 25</sup>. Vice President Kallas, the Commissioner responsible for audit and anti-fraud echoed this in his evidence. He pointed out that the distinction between fraud and irregularity “is quite clear. An irregularity is just a mistake” (Q 189): it is not deliberate and could be, for example, as minor as a slight delay in making a payment. Fraud, on the other hand, according to Mr Nicholas Ilett, Deputy Director of the European Anti-Fraud

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<sup>23</sup> <http://www.terrywynn.com>.

<sup>24</sup> A substantial error is an irregularity with a quantifiable effect on the budget, while a formal error is an irregularity where there may be an effect, but it is not possible to quantify it.

<sup>25</sup> There is further debate in this context over the issue of materiality. For accounting purposes a material error is defined as one that if corrected would cause the reader of the accounts to form a different view. The Commission has set out a 2% error tolerance threshold (viz. errors above 2% are considered to be material). The Court of Auditors applies this in its audits but has not expressed a view on what an ideal level would be.

Office, is “criminal activity, defined in the 1997 Convention as intentionally obtaining European funds to which one is not entitled or misusing them for the wrong purpose or depriving the EU of revenue” (Q 561).

31. **We encourage the Court to put in place measures clearly to distinguish between irregularity and fraud and to publish separate figures for the level of fraudulent transactions and administrative mistakes.**
32. Commissioner Kallas and Terry Wynn further argue that the overall error rate is exaggerated by taking both these types of irregularities into account. If the substantial or formal mistakes were discounted Terry Wynn goes so far as to assert that a positive Statement of Assurance could be made for payments<sup>26</sup>.
33. **Whilst the distinction between fraud and other irregularities must be made clear, we consider that administrative mistakes could still indicate deficiencies in the control systems operated by the Member States or the Commission. Attention should therefore be drawn to both administrative mistakes and fraudulent activity. Sources of error, from whatever quarter and for whatever reason under current definitions should be taken into account when calculating material error rates.**

#### **Dividing the Statement of Assurance into categories**

34. As noted above, it was the decision of the Court itself to provide a global Statement of Assurance. According to Terry Wynn, the European Parliament’s Committee on Budgetary Control has long asked for a “breakdown of the Member States or of the different areas like agriculture [or] structural funds” (Q 269). In the most recent Statement of Assurance available during the bulk of the evidence taken for our inquiry (for financial year 2004), some of our witnesses drew attention to the beginnings of the sectoral approach by the Court. Commissioner Kallas notes that the 2004 Statement gave a positive statement for the legality and regularity of commitments, revenue and payments for “the pre-accession strategy, administration and for agricultural payments covered by the Integrated Administrative and Control System (IACS), where properly applied” (p 34).
35. **We support the recent decision of the Court of Auditors to produce a Statement of Assurance giving details of each of the areas analysed. We recommend that this should be developed into a Statement which concentrates on an analysis of the audits conducted in each expenditure category and Member State rather than on the single Statement of Assurance on all the accounts.**
36. **We note with approval the achievements made by the Commission in developing a system for agricultural payments which led the Court to give a positive Statement of Assurance to this area for the first time in 2004.**

#### **National management of European funds**

37. A number of witnesses pointed out that the majority of the errors identified by the Court occurred in the Member States. According to one of our

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<sup>26</sup> Ibid.

witnesses, “80-plus percent” (Q 273) of the errors which the Court identifies are in the underlying payments transactions which are administered by the Member States. For some, the real responsibility for these errors should properly rest with Member State governments rather than with the Commission. Terry Wynn notes that the European Parliament has repeatedly asked the Court to draw up a black list of errant Member States, but that the Court has refused to do so<sup>27</sup>.

38. **We support calls for the European Court of Auditors to produce a list of those Member States demonstrating poor management of European funds. We consider that such a list would encourage all Member State governments to take this issue seriously. Such a list should only be produced on the basis of accurate data and so will require the development of a sound basis for payment transaction sampling.**

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<sup>27</sup> Q 302.

### CHAPTER 3: THE QUALITY OF INTERNAL CONTROL SYSTEMS WITHIN THE COMMISSION

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39. Given our extensive scrutiny of European financial management and the number of concerns raised with us in the evidence, we have devoted considerable effort on this occasion to reviewing the systems operating within the Commission. We have also reviewed the progress which has been made in redesigning and upgrading these systems. At the heart of this are questions raised with us over the Commission's systems, mechanisms and procedures. Most important among these are questions over the Commission's:
- Accounting system and supporting software;
  - Internal audit and control systems;
  - Signing off procedures;
  - New system of internal devolved management which was introduced by the Prodi-Kinnock reforms;
  - Risk management capabilities; and
  - Debt recovery procedures.

We consider each of these questions below. We suggest that these are issues which should be covered by the Court of Auditors in an annual report which is separate from the much broader remit of the *post* Maastricht Statement of Assurance.

#### The Commission's accounting system

##### *A commitment to improvement*

40. A secure and reliable accounting system is a pre-requisite for good financial management and the prevention and detection of fraud. The Court of Auditors has made many observations in each of its annual reports on the weaknesses in the Commission's accounting system and the problems with its software. In response the Commission has over the years introduced a number of improvements. These include:
- Upgrading the SINCOM software which is used for recording the transactions;
  - Bringing in accounting professionals to reform accounting procedures and standards; and
  - In 2005 introducing the internationally favoured accruals based accounting system.

According to Mr Gray, the Commission now not only aspires to but respects International Federation of Accountancy (IFAC) public sector accounting standards<sup>28</sup>.

41. In July 2006 the Commission published a report<sup>29</sup> describing the progress made in the transfer to full accruals accounting and other steps to modernise

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<sup>28</sup> Q 330.

<sup>29</sup> Communication from the Commission: Progress Report as at 31 March 2006 on Modernising the European Commission's Accounting System. COM (2006) 358 Final.

the accounting system. In the Government's accompanying Explanatory Memorandum the Minister, Ed Balls MP (Economic Secretary to HM Treasury), welcomes the efforts made by the Commission in successfully meeting the deadline to implement accruals based accounting. He notes that this has "made the EU one of the leaders in public accounting terms"<sup>30</sup> and that this should give the EU's citizens greater confidence that European funds are being managed properly.

42. **We recognise the commitment which the Commission has shown to improving its accounting system, particularly with regard to the introduction of accruals based accounting. We were pleased to hear from the Accounting Officer that the Commission now respects internationally recognised rules; and from the UK Minister that the EU is now one of the leaders in public accounting terms.**

### Segregation of duties

43. The evidence we heard from Mr Gray addresses the distinction between those in the Commission who authorise payments and those who execute payments as introduced by the Prodi-Kinnock reforms. In the system as currently operating, the authorisation of a payment requires a four stage process of checks by authorising officers followed by formal authorisation. At that point a request is sent to the accounting officers who actually make the payment.
44. This system was introduced in preference to a centralised *ex ante* authorisation procedure. This centralised system had been roundly criticised as "deresponsibilising" (Q 342) those tasked with approving expenditure. For Lord Kinnock, the primary aim of the reforms he introduced was to "introduce and sustain individual responsibility throughout the Commission"; and the existence of an *ex-ante* central financial control function "meant that responsibility could be allocated elsewhere and was allocated elsewhere" (Q 471).
45. Lord Kinnock went on to rebut those calling for a return to the *ex ante* authorisation procedure arguing that "if even a modified system of centralised financial control was reintroduced it would demolish the whole construction of and emphasis on the bearing of individual responsibility" (Q 471). Indeed the current authorisation process as described to us is similar to that which operates in UK Government departments.
46. **We therefore support the Commission's system of payment authorisation and execution as introduced by the Prodi-Kinnock reforms. We consider that segregating the authorisation and execution of payments is appropriate.**

### Continuing criticism

47. However, the criticism of the Commission continues. For example, Ms Andreasen's evidence makes a number of allegations regarding the practice of financial management within the Commission. She claims that:
- Basic accounting principles such as double entry book keeping are not respected;

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<sup>30</sup> EM 11399/06 para 18.

- The computer system is insecure and unreliable and does not allow audit tracking;
- There is a lack of segregation of duties between financial and operational managers;
- Advances are recorded as expenses leading to a failure subsequently to track eligibility, legality and regularity; and
- There is inaccurate recording of assets and liabilities.

48. In his evidence Ashley Mote MEP additionally charges that:

- Retrospective adjustments are made to the accounts;
- There are unspecified provisions in the balance sheet;
- EU employee pension liabilities are recorded on both sides of the balance sheet;
- Loans and debts are written off;
- “There is no paper trail recording transactions, agreements, payments, receipts or evidence of the goods or services paid for” (p 58); and
- “There is a significant element of corruption within ... the Commission’s administration” (Q 251).

He goes on to assert that there is “still no consolidation of accounts or central control...The Commission’s accounts are merely the sum of the numbers provided by the directorates” (p 58).

49. **During our inquiry we heard considerable evidence on the Commission’s financial management. None of that evidence supports the allegation that there is a significant element of corruption within the Commission.**

### **Double entry bookkeeping and the Commission’s accounting software**

50. On the question of double entry book keeping and the software to support it, there is a genuine divergence of opinion among the professionals at the very top of the Commission’s financial management hierarchy. According to Mr Gray, the current Accounting Officer, the Commission has always had a double entry system for the general accounts. He considers that the Commission has been using standard “rock solid” (p 86) SAP software since 1997–98 which does not allow anything else. He also notes that the previous systems also complied in this respect.

51. This is not the view taken by either Mr Muis or Ms Andreasen, both former Accounting Officers. In her evidence, Ms Andreasen claims that in the Commission, the introduction of a transaction at Directorate General level “does not require a debit and a credit” (Q 371). Both Mr Muis and Ms Andreasen argue that the records entered by the Directorates General into the general accounts are inadequate for genuine double entry book keeping. Furthermore they contest that the software systems developed locally in the Directorates General were fragile<sup>31</sup>. According to Mr Muis these local systems were left intact by the accounting reforms.

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<sup>31</sup> QQ 371, 419.

52. The Commission's July 2006 report addresses a number of issues which are relevant to this debate. These include updating the accounting software, the security of the software and the use of different software by the individual Directorates General and by the Commission at the central level. The report supports Mr Muis' assertion that the organisation and technology underpinning the local systems operating in the Directorates General were "untenable in the long run" (Q 419). It states that a feasibility study conducted in 2005 proposed updating the central budget management software so that it would be capable of incorporating local budgetary lines which are currently managed using different software. The July 2006 report notes that this new software is expected to be in operation by the end of 2006<sup>32</sup>.
53. **In spite of the improvements which have been made to the accounting system there are areas which remain in need of attention. We are concerned that there remains a question over whether local accounting systems in the Directorates General are indeed compliant with the standards needed for double entry book keeping. All accounting systems operating in the Commission should fully support double entry accounting. We expect the Commission to investigate these allegations and to publish a full account of its findings.**

#### Internal audit and control

54. Building an internal audit and control system was a cornerstone of both the Prodi-Kinnock reforms and the Commission's earlier SEM 2000 programme. In the context of the change to the system authorising payments, these reforms saw internal audit as the essential ingredient ensuring that controls and systems in the Directorates General are working properly. To this end the reforms established an Internal Audit Service (IAS) which takes a view of the whole Commission, together with internal audit capabilities specific to each Directorate General. These two structures are complemented by an Audit Progress Committee tasked with reviewing and supervising the work of the Internal Audit Service.
55. In his evidence Mr Gray described the distinction between the auditing functions in some detail:
- The internal audit capability within each Directorate General acts as an "interlocutor" (Q 332) between the Directorate General, the Internal Audit Service and the Chief Accounting Officer (presently Mr Gray himself); whereas
  - The Internal Audit Service<sup>33</sup> takes a broader view and is required, among other functions, to produce an annual report for the Council and the European Parliament on the Commission.

As well as acknowledging good progress, the Internal Audit Service report for 2005 "identified major remaining weaknesses in the design and set up of control systems, and in the effective implementation of standards and controls"<sup>34</sup>.

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<sup>32</sup> Op.cit.

<sup>33</sup> The Internal Audit Service's functions are set out under Articles 85, 86 and 87 of the Financial Regulation.

<sup>34</sup> European Commission, Annual Report to the Discharge Authority on Internal Audits Carried out in 2005, COM (2006) 279 Final, 7 June 2006.

56. Evidently then, there is still work to do. In this context, both the Court of Auditors' Opinion 2/2004 and the Commission's Roadmap identify improvements needed. The Court's Opinion noted that there were unclear and inconsistent control objectives within the Commission. These resulted from a number of factors:

- The piecemeal growth of the system of controls;
- A lack of coordination between control agencies in their activities;
- A dearth of information on the costs and benefits of controls; and
- An inconsistent application of controls both by the Commission and Member State agencies.

The Opinion proposed a new internal control system based on an effective chain of controls operating to common standards. Under the system:

- Each level of control is given clearly defined objectives;
- These controls are to be applied, documented and reported openly and transparently within a clear and simple legislative framework;
- The Commission is to define the minimum requirements for each level;
- The type and intensity of the checks carried out should be set by reference to their costs and benefits; and
- The Commission is given responsibility for promoting improvements in partnership with the Member States<sup>35</sup>.

57. Following this critique from the Court, the Commission issued its Roadmap to an Integrated Internal Control Framework. This identified actions in ten areas for the Commission internally. We summarise these in Box 2 above.

58. We will return to some of these issues. First, there is a lengthy charge sheet on the fundamentals of internal audit from Mr Muis in his written evidence. This is of great concern to us as we expressed our aspirations for the Commission's internal audit system when we reported in 2001. In that report we concluded by welcoming the establishment of the Internal Audit Service "which should make internal audit more effective"<sup>36</sup>.

59. In his evidence Mr Muis criticises the consistent lack of priority given to internal audit. His written contribution attacks what he considers to be:

- The "lack of leadership" (p 118) exhibited by DG BUDG;
- The tendency within the Commission to create new audit bodies rather to focus on the job of prevention errors; and
- "A pretty dysfunctional Audit Progress Committee..... aimed at keeping internal auditors in check; never querying the accounts, or Accountant,

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<sup>35</sup> European Court of Auditors, Opinion no. 2/2004 on the 'single audit' model (and a proposal for a Community internal control framework), Official Journal of the European Union C 107, 30 April 2004, pp 1–20.

<sup>36</sup> European Union Committee, 12th Report (2000–01): *The European Court of Auditors: The case for reform* (HL 63), paragraph 104.

or DG BUDG<sup>37</sup> on its work...and waiving responsibility for vetting Commission accounts” (p 118).

60. While we share the Court’s general analysis and welcome the Commission’s Roadmap proposals for self-reform, the evidence from Mr Muis makes clear to us that the root of many of the problems in the internal audit and control system is the question of responsibility. When we questioned Mr Muis on this issue he answered “through the silence of others” (Q 421). In his analysis, the accountants had never signed off on the systems; the internal auditors and Directors General had not signed off for the adequacy of the systems as a whole; the Chief Internal Auditor had never signed off the accounts as a whole; and the Audit Progress Committee had “exempted itself from responsibility for the accounts” (Q 421). In his experience, none of the Commission’s Chief Accountants “ever signed, or wanted to sign, or was even expected to sign off” (p 116).
61. **In contrast to the progress reported to us in relation to the Commission’s internal accounting system we are concerned that the Commission’s system of internal audit is inadequate. We urge the Commission to review fully the procedures in place and bring forward proposals to make the system more robust. These proposals should not seek to create new audit bodies. Rather they should focus on requiring Commission officials and existing audit bodies to take responsibility for the systems and the accounts.**

#### **Devolved management in the Commission**

62. The system of devolved management introduced by the Prodi-Kinnock reforms has been welcomed by many of our witnesses on the professional and managerial side<sup>38</sup>, but it is not without its critics from within and outside the Commission. There are many aspects to this criticism but, for the moment, we will confine our discussion to financial management issues. As we have seen, the European Parliament’s 2003 and 2004 discharge resolutions expressed support for improvements to the current system where 36 separate Annual Activity Reports form the basis of the Commission’s control guarantee. Ms Andreasen added to this, arguing that if taken in tandem with changes in the Financial Regulation, the reform weakened the control of payments through the abolition of the centralised *ex ante* approval system<sup>39</sup>.
63. **We are not convinced by these arguments for recentralising responsibility for financial transactions. Rather, we consider that the decentralised system introduced by the Prodi-Kinnock reform has allocated financial management responsibility to the appropriate level, so long as effective control systems are in place.**

#### *A system requiring Commission officials to take responsibility*

64. A further issue, as Ms Andreasen points out, is that the Directors General are operational managers rather than finance professionals, so there may be a conflict of interest in them signing off singly. For Mr Muis there is a simple

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<sup>37</sup> The Directorate General responsible for Budget, tasked with managing Community expenditure in the medium-term financial perspective and ensuring that the annual budgetary procedure runs smoothly.

<sup>38</sup> For example Lord Kinnock, Jules Muis and Brian Gray.

<sup>39</sup> p 103.

solution. He advocates creating a reverse cascade of co-signing off of accounts:

- Firstly, audit professionals and the designated accountant in each Directorate General would sign for their accounts;
- Secondly, each of the Directors General would sign for the accounts for which they are responsible;
- Thirdly, the Commission's Chief Accounting Officer (who would be independent of DG BUDG, which is not the case at the moment) would sign for the Commission's accounts; and
- The final signature would come from the Commission's Chief Financial Officer (perhaps the Secretary General).

Mr Muis also argued that this should be complemented at national level by a national Statement of Assurance with *ex ante* and *ex post* assurance elements, in which there would be a similar signing off process by the appropriate national officials.

65. As we have seen, the Prodi-Kinnock reforms decentralised management responsibility to the Directorates General. This was achieved by requiring the Directors General to produce and sign Annual Activity Reports. Mr Muis referred to these as the “silver bullet” (Q 425) because of their role as assurance statements from the head of the Directorate General that the money has been used for the purposes intended.
66. The Commission's Roadmap develops this concept by seeking to amend the Financial Regulation to require the Commission's Accounting Officer to sign a certificate of assurance for the accounts. Coupled to this is an enhanced the role for the Commission-wide annual synthesis of the Annual Activity Reports. These suggestions have gained support from the European Parliament in the 2003 and 2004 discharge resolutions. Further support has come from ECOFIN which called for an effective chain of controls operating to common standards<sup>40</sup>.
67. **We are strongly in favour of a system of signing off whereby responsibility for accounts is shouldered first by the accountants and auditors in each Directorate General and then at more and more senior levels. This system should culminate in the requirement for the Secretary General of the Commission to sign an assurance that the Commission's annual accounts are true and fair.** We will consider whether similar requirements in the Member States would be appropriate later.

### **Risk assessment**

68. In all the proposals we have reviewed, there are references to the use of risk analysis and risk management including cost-benefit analysis in the control context. This approach enables the targeting of control resources to where the risks to the budget are greatest. Thus, the Commission's Roadmap proposed the introduction of a common methodology for risk assessment and for ensuring control requirements are proportionate to risk. According to Ivan Lewis MP, this position is supported by the UK government which is

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<sup>40</sup> ECOFIN conclusions, 8 November 2005, 13678/05 (Presse 277).

prepared to accept higher levels of risk in some programme areas, for example humanitarian aid (Q 1).

69. According to written evidence from Mr Muis, a common methodology for risk assessment would require a common accounting system “held together by one data architecture” (p 119), an outcome which he believes the 2004 accounting reform has not achieved. In the absence of this, risk assessment for programmes should still be fundamental and routine, using qualitative assessments until the quantitative tools are available.
70. **We fully support the proposal in the Roadmap to introduce a common methodology for risk assessment. However we recognise that that the accounting system is not tailored to provide the data to which such a common methodology could be applied. We consider that efforts should be made to develop the accounting system to produce the necessary data. We endorse the use of qualitative methods to assess the risk in the meantime.**

### Debt recovery

71. A number of witnesses raised concerns with us over the Commission’s attitude to debt and its debt recovery procedures. In her evidence, Ms Andreasen pointed out that when she first joined the Commission, she noticed a discrepancy of €130 million between the closing balance for 2000 and the opening balance for 2001<sup>41</sup>. On investigation, she claimed these proved to be loans which had been written off without any explanation. However, according to Mr Gray, “the loans were not written off”. Rather a provision was made in the accounts to reflect doubts regarding their recoverability (p 98). Ashley Mote MEP expressed concern in his written evidence that Article 87 (4) of the 2002 Financial Regulation allows the writing off of debts below €1 million without any attempt at recovery. He claimed that this loophole was being “ruthlessly exploited” (p 57).
72. The Commission’s Accounting Officer, Mr Gray, set out the formal position. He told us that debts are recorded by the authorising departments and it is his responsibility as Accounting Officer to recover them<sup>42</sup>. In the system as currently operated by the Commission waivers are always recorded with those over €100,000 being reported to the European Parliament (15 were reported in 2005). Most of the waivers granted relate to overpaid or ineligible grant monies; very few concern commercial relationships. For debts above €1 million, the College of Commissioners must decide whether to grant the waiver. Below that figure decision rests with the Directors General, in consultation with the Accounting Officer. Indeed, Mr Gray questioned whether the involvement of the College of Commissioners for debts in excess of €1 million increased the level of scrutiny given to waiver process: “I wonder whether going to the College has any added value because the system is the same” (Q 350).
73. **We are generally satisfied with the Commission’s procedures and reporting requirements on debt waivers. We see no evidence of the “ruthless exploitation” of these procedures that some have suggested.**

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<sup>41</sup> Q 413.

<sup>42</sup> p 87.

## CHAPTER 4: SHARED MANAGEMENT—THE ALLOCATION OF FINANCIAL MANAGEMENT RESPONSIBILITIES BETWEEN THE COMMISSION AND THE MEMBER STATES

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### Who is responsible for financial management

74. Since the creation of the European Community and the adoption of the Treaty of Rome in 1957, the Commission has been responsible for implementing the Budget. Based on the original Article 205, the current Article 274 states that “the Commission shall implement the Budget, in accordance with the provisions of the regulations made pursuant to Article 279<sup>43</sup>, on its own responsibility and within the limits of the appropriations, having regard to the principles of sound financial management”. The final phrase was added in the Maastricht Treaty in order to underline the need for value for money.
75. A model with the Commission playing such a central role was appropriate for a time when the Community was made up of only six members and spending programmes such as the CAP and the structural funds did not exist. However, the Community has become a very different organisation: the implementation of the CAP in 1969; the development and then exponential growth of the structural and social funds from the late 1970s; and the series of enlargements to 25 and in the near future 27 members. In real terms, the EC Budget quadrupled in value in the quarter century from 1977 to 2002. Its main spending programmes are claims based with complex eligibility criteria and need detailed management. This complexity, along with a need for accountability and transparency in programme delivery and financial management, has meant ever more management responsibilities falling on the Commission and the implementing agencies in the Member States.
76. In recognition of these changed circumstances, and in deference to the subsidiarity principle upheld by Maastricht, Article 274 now also includes the provision that “Member States shall cooperate with the Commission to ensure that the appropriations are used in accordance with the principles of sound financial management”. Furthermore, the recent Interinstitutional Agreement on Budgetary Discipline and Sound Financial Management which gives force to the Financial Perspective 2007–2013 includes the requirement that “as part of their enhanced responsibilities for structural funds and in accordance with national constitutional requirements, the relevant audit authorities in Member States will produce an assessment concerning the compliance of management and control systems with the regulations of the Community. Member States therefore undertake to produce an annual summary at the appropriate national level of the available audits and declarations”<sup>44</sup>.
77. Particularly since the first reform of the structural funds in 1983, shared management between the Commission and the Member States in the big spending programmes has been a reality. However, for some we spoke to,

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<sup>43</sup> Article 279 enables the drawing up and implementation of a financial regulation (the most recent version dates from 2002: Council Regulation (EC, Euratom) no. 1605/2002 of 25 June 2002 on the Financial Regulation applicable to the general budget of the European Communities, Official Journal, L 248, 16.9.2002).

<sup>44</sup> Official Journal of the European Union (2006/C 139/ 01) Article 44.

rather than being helpful, adding the obligation to Article 274 requiring cooperation between Member States and the Commission introduced a new element of confusion and inconsistency. This is the view of shared management taken by Ashley Mote MEP who argues that “the net effect of the current process is that we see neither the Member States nor the Commission itself taking ultimate responsibility” (Q 218).

78. Among those we spoke to there were marked differences of view over who is ultimately responsible for sound financial management under Article 274. Some adopted a strict interpretation: Ms Andreasen, the Commission’s former Chief Accountant, observed that while irregular payments may occur in the Member States “the control starts with the Commission ... because the Commission is given the responsibility by Treaty but it also has the power” (Q 393). In her view, where Member States are implementing programmes, “the European Commission can add no other value than the adequate control and accurate accounting of the proper use of the European Budget” (p 102). As we have seen in the previous chapter, Ms Andreasen takes the view that the Commission’s *ex ante* expenditure approval system, whereby all transactions were authorised in advance by a central department, should be reinstated. However, under the current system she argued that the Commission should ensure that documentation is adequate to guarantee the legality and regularity of payments made, through its power to demand supporting documentation and to suspend advance payments.
79. **While the Commission should do its best to monitor the disbursement of funds we do not consider that it alone can be held responsible for the regularity of the large majority of European transactions (over 80%) which take place within Member States. We are pleased to see that both the Maastricht Treaty and the recent Financial Perspective agreement recognised the role of the Member States in ensuring proper financial management.**
80. Many of those we spoke to pointed out the disallowance and recovery procedures which the Commission currently operates. In practice the Commission both withholds advance payments and fines Member States in instances where it discovers eligibility rules have been breached. Mr Meadows, the Director General of DG REGIO<sup>45</sup> told us that in a single case in Greece the Commission has “clawed back 518 million euro which is a sizeable sum of resources” (Q 553).
81. Some of the evidence we have received suggests that in practice shared management is even more complex than Article 274 suggests because the implementing regulations of the CAP and the structural and cohesion funds are based on different principles. In the case of the CAP, there is no shared financing. All of the financing comes via the EC Budget, and the regulations prescribe very detailed standards with which the national agencies must comply (for example, levels and types of sample tests on grains, eligibility for the grubbing up of vines, payments of sheep and beef premiums, etc.). In the case of the structural and cohesion funds, the financing is shared between the EC Budget and the national authorities concerned. Whole area programmes

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<sup>45</sup> Directorate General for Regional Policy responsible for European measures to assist the economic and social development of the less-favoured regions of the European Union under Articles 158 and 160 of the Treaty.

are drawn up by the Member States<sup>46</sup> and then approved by the Commission. Programmes are made up of numerous local joint (EU-Member State) funded projects, which must comply with the general eligibility criteria concerning state aids and such stipulations that are contained within the relevant structural fund regulation. A local programme management committee is appointed, with day to day management residing at local level to a much greater extent than is the case with the CAP.

82. However, for those we spoke to from DG REGIO, the operational “difficulties flowing from shared management are not confusion as to who does what, the difficulties flowing from shared management are the extent of operations which one is trying to audit and to control” (Q 543). Mr Nicolas Martyn, director of the audit directorate in the Directorate General, told us that the Commission has the ultimate responsibility under the Treaty. In the day to day relationships between the Commission and the Member States this takes the form of a “supervisory role to make sure that system is working properly” (Q 543). On the audit front, DG REGIO operates a multi-annual strategy deciding on a risk basis how audit resources should be allocated. First a risk assessment is conducted at a global level. Then within each Member State a more detailed risk analysis takes place to identify high risk programmes. The Commission seeks to audit, as a priority, the riskier programmes (Q 548).

### Is the legislation too complex?

83. One of the observations made by the Court of Auditors both to us and in its published reports is that the legislative framework of control in these sectors is generally too complex and needs to be simplified. Mr da Silva Caldeira, one of the Members of the Court, told us that “we should aim to simplify the regulations which govern the different policies and programmes. The more complex the rules you have to follow, the higher the risk, at the end of the day, that you will have irregular transactions” (Q 106). That the regulations are too complex was acknowledged by the Commission both in Vice President Kallas’ written evidence to us and in numerous reform initiatives including the Prodi-Kinnock white paper and the 2005 Roadmap.
84. In oral evidence Mr Meadows of DG REGIO acknowledged that complexity can contribute to errors. He pointed out that although there will always be a certain degree of complexity associated with implementing regional policy programmes the Commission was aware of the obligation to “work constantly to try to make sure that ... you do not get unnecessary complexity” (Q 556). However, according to Mr Gray, the Commission’s Accounting Officer, the Commission’s work in this area was not always popular with the Member States: “it is one thing to design regulations and another thing to get them adopted by the Member States” (Q 356).
85. At a more general policy level, some of the complex eligibility criteria on which the main spending programmes rest are a major source of errors in the payment accounts. For Mr da Silva Caldeira this happens because “there is a tendency to break rules to simplify things” (Q 104).
86. **It is of great concern to us that the regulations underpinning the spending programmes continue to be very complex and that this**

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<sup>46</sup> This may include sub-federal authorities in federal states.

**complexity can lead to errors. We are pleased to see that the Commission and the Council have committed to simplifying the rules.**

### **The role of Member States in shared management**

87. This takes us to the other side of the argument, which says that in varying degrees it is the Member States rather than the Commission who are failing in their responsibilities. We have received evidence in support of this view from a number of sources including Commissioner Hübner, the Commissioner responsible for regional policy, as well as from the Dutch Senate, the European Court of Auditors and Mr Terry Wynn. The basis of their argument is that the overwhelming majority of irregularities found by the Court occur in the Member States.

#### *Delegation risk*

88. According to Mr Wynn, that the majority of irregularities occur in the Member States results from “delegation risk”<sup>47</sup>. He argues that delegation risk has four aspects:
- Member State (or sub-national authority) carelessness with EU funds compared to national funds;
  - the variable quality of control standards between (and within) Member States;
  - *ex-post* Commission recovery mechanisms diverting attention away from the need for early remedial action; and
  - the lengthy chain of management from budget approval to final commitment<sup>48</sup>.
89. Commissioner Hübner also refers to the failure of Member State authorities to assess and manage the risk of irregularity adequately (pp 178, 179).
90. **We share some of the concerns raised with us in respect of Member State management of EU funds. We consider it particularly unacceptable for the government of a Member State to treat European money with less care than national funds and urge the Council to make this clear. We are also concerned about the variability of control standards between Member States. We consider that all European expenditure should be subject to equivalent standards of control to ensure that the risk of fraud and error is minimised.**

### **A national DAS**

91. While the two sides of the debate may disagree on how the Treaty apportions responsibility, they need not necessarily disagree on measures for remediation. Thus, the proposals from the Dutch Senate call for more powers for the Commission as well as improvements within the Member

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<sup>47</sup> <http://www.terrywynn.com>.

<sup>48</sup> European Parliament, Elements of the system of financial management in the European Union Part II: Shared management, delegation risk and the role of national audit institutions, Committee on Budgetary Control working document 7 September 2005.

States (p 176). Furthermore we consider that there is nothing in Ms Andreasen's proposals for strengthening the Commission's role with which the European Parliament would disagree. As we shall see, the European Parliament's proposal for a national Statement of Assurance includes these elements.

92. At the invitation of the European Parliament, the Commission put forward the Roadmap to an Integrated Internal Control Framework in June 2005<sup>49</sup>. This has been supplemented more recently by a 16 point implementation action plan<sup>50</sup> for 2006–07. The Roadmap proposed new responsibilities for the Member States including:
- The provision of annual *ex ante* Disclosure Statements and *ex post* Declarations of Assurance signed off at the highest level—by the Finance Ministry;
  - A requirement that each operational agency make similar statements and declarations backed up by independent auditor opinions;
  - A request that the appropriate Supreme Audit Institutions (SAIs) exercise oversight and report on design and operational weaknesses; and
  - A request that the appropriate Supreme Audit Institutions audit the *ex post* declarations of assurance and report the results to national legislatures.
93. On the disclosure statement the European Parliament has suggested that it include four elements:
- A description of the Member State managing authority control systems;
  - An assessment of their effectiveness;
  - A joint Commission—managing authority remedial action plan if required; and
  - A confirmation of the accuracy of the descriptions by an external auditor or the national audit institution.

The European Parliament has advocated that the Commission should have rights to verify the Disclosure Statement, and impose penalties “affecting the overall funding of the Member State concerned”<sup>51</sup> if necessary.

94. The European Parliament went further than the Commission's Roadmap proposals for a declaration of assurance in a number of respects, arguing for:
- A global Statement of Assurance from the Commission signed off by the Accounting Officer and the Secretary General;
  - Basing the national Statement of Assurance on a national annual activity report signed by the Finance Minister level;
  - Annual audits of all paying agencies by an external auditor;
  - The establishment of (unspecified) performance indicators; and

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<sup>49</sup> Op.cit.

<sup>50</sup> Op.cit.

<sup>51</sup> Op.cit.

- The facility to suspend payments to agencies, or whole agencies themselves, and to impose financial penalties where agencies make mistakes or fail to reach targets<sup>52</sup>.
95. In oral and written evidence, the idea of a national Statement of Assurance has been supported by many witnesses including representatives from the UK Government and the National Audit Office. However, a national Statement of Assurance as conceived above is not without its problems and opponents, the latter including the ECOFIN Council which effectively rejected a national Statement of Assurance at its meeting in November 2005<sup>53</sup>. One of the reasons for this rejection was an objection to giving a political signature to such a declaration.
96. Mr Muis observes that the Supreme Audit Institutions have a “cold water fear in co-signing” (p 119) such a national Statement, while Terry Wynn admits that getting either the Supreme Audit Institutions to take the initiative or a sign-off at finance minister level are unrealistic expectations because the Supreme Audit Institutions fear being taken over and there is a hard core of opposition from some Member States to the whole idea of a national statement of assurance *per se* (Q 277).

*Sufficient interest in the Council?*

97. In its statement of 8 November 2005, ECOFIN did take a position on the Statement of Assurance which argued in favour of the Court of Auditors 2004 Opinion on internal control<sup>54</sup>. However, the ECOFIN conclusion included a rejection of the national Statement of Assurance concept in favour of an incremental improvement of the existing Statement. The conclusions also expressed support for more reforms within the Commission’s control environment, and for Commission-Member State “assessments of the present controls at sector and regional level and the value of existing statements and declarations”<sup>55</sup>.
98. The ECOFIN Council conclusions also encouraged the Member States to proceed with so-called Contract of Confidence arrangements with the Commission in the area of structural funds. According to Mr Meadow and Mr Martyn of DG REGIO these Contracts of Confidence denote that the Commission are “sufficiently satisfied with the way things are done” (Q 559) in a Member State or region that the Commission’s own audit activity is reduced. The Contracts of Confidence can be at national or sub-national level and require that the Commission is persuaded that the system functions properly and, in particular, that the work of the competent audit body can be relied on. The first of these Contracts has now been signed with Wales.
99. Whilst these Contracts require a strengthened relationship between the Commission and the competent national or sub national auditing body, ECOFIN wished to go no further than the current framework of cooperation between the Court of Auditors and the supreme audit institutions. In contrast to the view expressed by European Parliament, ECOFIN reasserted

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<sup>52</sup> Resolution of the European Parliament, on the discharge for implementing the general budget of the European Union for the financial year 2003, Official Journal of the European Union, L 196 27 July 2005

<sup>53</sup> ECOFIN conclusions, 8 November 2005, 13678/05 (Presse 277)

<sup>54</sup> See Box 1.

<sup>55</sup> ECOFIN conclusions, 8 November 2005, 13678/05 (Presse 277).

the strict distinction between internal and external audit which it concluded was “not part of the internal control framework”<sup>56</sup>.

100. In his oral evidence, Ivan Lewis MP, the former Economic Secretary, outlined the reasons why ECOFIN has taken this position against a national Statement of Assurance. First, there are legal difficulties in many Member States for a Minister to sign such a declaration. Second, there would be constitutional difficulties in federal states were one minister required to sign. Third, the Court of Auditors had not expressed support for the idea of a national Statement of Assurance; and finally it would be up to the Court to judge how any proposed changes would impact on the level of assurance it could give.
101. Nevertheless, in common with the Dutch government, the UK Government supported the Commission’s Roadmap and is broadly sympathetic to the idea of a national Statement of Assurance so long as it matches national procedures of departmental permanent secretaries (rather than ministers) signing off the annual accounts (Q 5).
102. Not content simply with expressing support for the idea, the Dutch government has gone one step further and unilaterally decided to provide a national Statement of Assurance. According to the representatives of the Dutch government we spoke to this was the decision of the finance minister who sought to introduce a national Statement as a pilot for other Member States to consider and follow (Q 520). Under the proposed Dutch scheme (which is expected to receive cabinet level approval in November) the finance minister will issue a national Statement on the use of European funds subject to shared management in The Netherlands. This Statement will be based on a number of sub-declarations from the ministers of the departments responsible for implementing the various programmes. The national Statement will be sent to the national parliament and to the national court of auditors who will conduct an audit of it. The national Statement and its corresponding audit will then be sent to the Commission (Q 511).
103. In spite of their intention to give the national Statement a political signature, there was recognition that this might not be possible in some other Member States. According to Mr Peter Bartholomeus, from the Dutch Ministry of Finance, “We do not think it is necessary for a minister to give the national declaration” (Q 527). He continued that it would remain a very good system were another body, possibly a civil servant or the Dutch court of auditors, to give the national declaration.
104. In his evidence to us Mr Wynn MEP, appeared to propose watering down the European Parliament’s proposals, conceding that the ministerial sign off is negotiable. He told us that it was not important whether the signature was from a politician “as long as someone is taking the responsibility for that and actually saying to the Commission, ‘we are happy that this money has been spent correctly’” (Q 279).
105. **We are strongly in favour of a national Statement of Assurance on the monies disbursed in each Member State. As in the Dutch pilot project, such a Statement should be sent to national parliaments as well as to the Commission as we consider that this will encourage the Member States to take responsibility for the systems and controls**

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<sup>56</sup> Ibid.

**they operate. Consideration should be given to ensuring the length of time the discharge procedure takes is not extended.**

106. **In line with the system operating in UK Government departments, we do not consider that a national Statement of Assurance requires a political signature.**

*Responsibility in the Council*

107. Within the Council of Ministers the Budget Council participates in the process of drawing up the Budget. However neither the Budget Council nor any other Council formation focuses to an equivalent extent either on what happens to the money once it has been spent, or on the report of the European Court of Auditors.
108. **We consider this lack of Council level consideration to be a serious weakness. We consider that the Budget Council should be at least as concerned with the Union's accounts as it is with drawing up the Budget. We therefore consider that the Budget Council should to prepare a report on the annual audit and Statement of Assurance from the Court of Auditors. This would be debated by the European Parliament at the same time as the Court of Auditors' report. In this way the Council of Ministers would be drawn much more closely into consideration of the accounts and into the process of ensuring that the financial systems of the Union meet appropriate international standards.**

*Responsibility in national parliaments*

109. There remains the question of what role National Parliaments should play in the annual audit process. Under the principle of subsidiarity this is for the parliaments themselves to determine. **None the less we consider that there is a clear role for national parliaments: not least because in the UK, for example, there is considerable misunderstanding of the real position. We consider that this stems, at least in part, from the sporadic and sometimes capricious way in which this issue is debated in the two Houses and discussed in the press.**
110. **There is a strong argument for a more consistent and regular approach to the audit and management of the European Union's accounts than may perhaps have been the case in the past in the European committees of both Houses. This in turn might lead to a regular annual debate on the topic on the floor of each House as part of the annual political cycle. Similar debates could be held in the Welsh Assembly and the Scottish Parliament.**

*A single national account and auditing problems in devolved or federal states*

111. In his evidence Sir John Bourn commented that it would make administrative sense if all European money being paid into a Member State were channelled through a single bank account. We understand the logic behind this idea, but are concerned that the political and practical consequences of this could pose problems.

112. **We are concerned that a single national European account would impose an additional layer of bureaucracy and would pose a number of difficulties in relation to devolved and federal states.**
113. On the issue of single audit within federal or devolved Member States, if the national Supreme Audit Institution is not the appropriate auditing institution the account or part thereof should be passed to the competent sub-national body for audit. Sub-national audits would be examined and collated by the national audit body before being sent to the European Court of Auditors.

#### **Sanctions for non-compliance**

114. On the issue of sanctions on Member States for non-compliance with programme regulations, the European Parliament has been very strong. They have proposed overall penalties on Member States, penalties on individual agencies and suspension of agencies by the Commission. However, neither the ECOFIN proposals nor the Commission's Roadmap have much to say on the subject.
115. **We note that the Commission has existing powers of disallowance of expenditure and recovery of funds, and the power to certify paying agencies in the agricultural sector. In the context of the reforms outlined above we consider that the existing Commission powers are sufficient.**

## CHAPTER 5: EXTERNAL AUDIT AND THE ROLE OF THE EUROPEAN COURT OF AUDITORS

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116. In Session 2000–01 we reported on the European Court of Auditors, its structure, functions and relationships with other Institutions<sup>57</sup>. Thus, although some of our witnesses have commented on these issues, it was not the purpose of our inquiry to retread this same ground. However, we will comment on those developments which have taken place since 2001 as they affect the Court and external audit more generally including the national Supreme Audit Institutions.

### The role of the Court and its workings with national Supreme Audit Institutions

117. In common with all Supreme Audit Institutions, the Court treads a fine line with the policy making and implementing bodies. The Members of the Court we met were very aware of the potential pitfalls of becoming “part of the political game” (Q 121) as they felt it would compromise their independence. However, through its reports, opinions and recommendations, the Court has contributed a steady input to the reforms. Many of the Court’s recommendations were swept up into the Prodi-Kinnock White Paper and action plan. Of particular note are the new internal audit system within the Commission and the phasing out of the *ex ante* expenditure approval system of which, as we have recorded above, the Court argued in favour. In spite of these there was some dissatisfaction from the Court that their contributions “are not fully regarded by those who are addressing the problems” (Q 106).

118. **We note the desire expressed to us by Members of the Court not to become “part of the political game”. We consider that it would be highly inappropriate for the Court to promote a political agenda.**

119. In relation to its relationships with national auditing bodies, the European Parliament has a different, more activist conception of the role of the Court than the Court itself. The Parliament’s discharge decision for the financial year 2003 examined the extent of incremental reform made to the Statement of Assurance over the years by the Court. While welcoming the elaboration of the Statement of Assurance methodology, the Parliament considered it “too modest”<sup>58</sup> and asked the Court to engage with national Supreme Audit Institutions in pursuit of the “single audit” concept. The Parliament also argued in favour of extending the “qualitative” aspect of the Statement of Assurance to take into account the multi-annual nature of many programmes. As a start, the European Parliament called on the Court to conduct a series of annual “benchmark” audits of the same programme area in all 25 Member States.

120. We have already alluded to witness evidence concerning the trepidation of Supreme Audit Institutions to engage in a national Statement of Assurance with a single audit model. In its 2/2004 Opinion, the Court said nothing about the development of a common external audit or of the incorporation of

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<sup>57</sup> European Union Committee, 12th Report (2000–01): *The European Court of Auditors: The case for reform* (HL 63)

<sup>58</sup> Op.cit.

the Court's or national Supreme Audit Institutions' activities into an overall control framework as suggested by the European Parliament. As external auditors, the Court argues that neither itself nor the national Supreme Audit Institutions are a direct element of the European Union's internal control framework—to be so, would compromise their ability to provide an independent overview. This is the view supported by ECOFIN as we have seen.

121. The Treaty requires that Supreme Audit Institutions “cooperate with the Court in undertaking its duties”. To facilitate this, the Court has established a Contact Committee comprising representatives of the Member State Supreme Audit Institutions. There are Supreme Audit Institution Liaison Officers whose role is to facilitate Court missions in the Member States. However, this has not resulted in joint, let alone single external audit because of the many practical, methodological, reporting and political obstacles in the way. With the adoption of common international accounting standards which the Court and the Supreme Audit Institutions support, this may become less of a problem.
122. In line with the proposals for national Statements of Assurance audited by the Supreme Audit Institution in each Member State there would be a supervisory role for the Court in setting down the accounting and auditing standards to be followed. In this respect the Court would audit the systems of each Supreme Audit Institution to ensure that the audits they produced were reliable.
123. **We are pleased to see the work the Court has done to develop its relationships with the Supreme Audit Institutions in the Member States. We hope that these will be further developed in the future with a view to giving the Court a supervisory role over the audits of European expenditure conducted by the Supreme Audit Institutions in the Member States.**

#### **Value for money audit**

124. If the Member States are to play a role in the Statement of Assurance through the eventual adoption of a national Statement of Assurance process, this may leave scope for the Court to develop other aspects of its work. Some witnesses referred to the importance of the Court's special reports which do look at issues of economy and effectiveness, much as the National Audit Office does<sup>59</sup>. In their evidence, the members of the Court also compared it on a few occasions to the US General Accounting Office (QQ 86, 105).
125. **We call upon the Court to bring forward concrete proposals to extend the aspects of its work which are not directly concerned with the annual Statement of Assurance. We consider that developments in the value for money and performance auditing side of the Court's work would be particularly valuable.**

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<sup>59</sup> This was also the case in evidence to the Committee's inquiry into the Court in session 2000–01. European Union Committee, 12th Report (2000–01): *The European Court of Auditors: The case for reform* (HL 63), paragraph 8.

## **CHAPTER 6: DEVELOPMENTS IN THE FIGHT AGAINST FRAUD**

126. As we commented in our ninth report of session 1998–99, we continue to take “a close interest in the protection of the European Union’s financial resources”<sup>60</sup>. We are pleased to see that we not alone in our concern. The European Parliament has, through the Budgetary Control Committee, put perennial pressure on the Commission. The Parliament was also instrumental in the establishment and expansion of UCLAF and its successor OLAF; and played a significant role in the fall of the Santer Commission. The Commission too has sought to reduce the level of fraud in the Community and has issued an annual report on the fight against fraud since 1993.

### **The rate of fraud**

127. The issue of the rate of fraud against the Budget has proved to be a controversial issue throughout our inquiry. Underpinning this is the difficulty that the rate cannot currently be established with any certainty. Mr Nicholas Ilett, the Deputy Director of OLAF, told us that estimates of fraud depend on data transferred to OLAF from the Member States. This is complicated in that there are differences in reporting behaviour between Member States (Q 566) and in “the quality of public administration within Member States” (Q 567).

128. According to the Commission, frauds accounted for €323 million in 2005. Although a significant amount, this is a little over 0.3% of the budget<sup>61</sup>. By comparison to the United Kingdom this is a very low rate: Ivan Lewis MP told us that fraud recorded against the Department of Work and Pension’s budget was £0.9 billion (Q 57). For Commissioner Kallas such a low rate means that “fraud has not penetrated the European budget” (Q 185). Ivan Lewis MP gave us a slightly different figure: according to his data, “in agriculture we are talking about 11 million euro/£7 million; in structural funds we are talking about 118 million euro/£80 million” (Q 43).

129. Mr Ilett from OLAF argued that this was “about the same order of magnitude as one sees quoted in relation to other types of public sector expenditure” (Q 562). His experience and that of his colleagues from across the Union was that things are no worse in Brussels than they are in the Member States’ own accounts. Indeed in some cases “it is rather better” (Q 572).

130. Mr Ilett went on to detail where he understood these frauds to be taking place. He felt that of the two biggest spending areas the overall level of fraud in the structural funds was higher than in agriculture. Furthermore, OLAF had evidence to suggest that the level of agricultural fraud had been falling since the mid-1990s (Q 565).

131. **Any fraud committed against the European Budget is a problem which should be addressed seriously by the Commission and the Member States. We conclude that, while the level of fraud is no higher than in comparable public expenditure programmes,**

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<sup>60</sup> European Union Committee, 9th Report (1998–99): *Prosecuting fraud on the Communities’ finances—the Corpus Juris* (HL 62), paragraph 105.

<sup>61</sup> Figures from the Commission cited in *Europolitics*, no. 3126, 14 July 2006.

**including in the UK, the fight must go on. We consider that efforts should be made to convey these messages to Europe's citizens more effectively.**

*Problems estimating the rate of fraud*

132. The difficulties with these estimates of the level of fraud is that they rely on self-reporting by the Member States who are then obliged to recover the sums fraudulently claimed through their own law enforcement systems. Irrespective of their individual capacities of detection which vary considerably, there is little incentive for Member States to discover fraudsters unless it affects the national budget (as it would do in the case of VAT fraud and fraud against jointly funded programmes), or where there was a chance the Commission would discover the fraud via an OLAF investigation.
133. **We are concerned that estimates of the level of fraud rely on self-reporting by the Member States. We consider that the Commission should bring forward proposals for a new, more objective, method of determining the rate of fraud.**

**OLAF's powers and activities**

134. In the evidence we received from Ashley Mote MEP was the allegation that "OLAF is a deeply compromised organisation" and that during the seven years that Mr Brüner has been President of the organisation it "has not yet succeeded in a single successful prosecution and the recovery of the monies involved" (Q 230). This, it seems to us, is built on a misunderstanding of the role of OLAF. As their evidence to us states, "OLAF investigators aim to determine to the standards of criminal proof in the relevant jurisdiction whether or not a case should be brought against a specific natural or legal person" (Q 561). OLAF has no role in pursuing the prosecution of those it has investigated as this is the responsibility of the relevant Member State.
135. OLAF does, however, make recommendations on the basis of its reports. According to OLAF's most recent report on its activities<sup>62</sup>, in 2005 of the 233 cases closed by OLAF 133 were recommended for follow-up by the relevant competent authority. The remaining 100 were closed with no follow-up recommendation
136. Mr Ilett told us that he is "happy that most of the cases which [OLAF] refer[s] to national jurisdictions lead to prosecutions" (Q 576). In support of this view Mrs Rosalind Wright QC, the Chair of OLAF's Supervisory Committee, told us that a "pretty impressive" three out of four of OLAF's reports reach trial (Q 591).
137. We were further encouraged to hear from Mrs Wright that the Supervisory Committee has made the suggestion to OLAF that it conduct a survey within the Member States on how its reports are received. This would give OLAF information on whether the Member States are able to use OLAF's reports; whether these reports can form the basis of prosecutions; and whether there are any additions which Member States would like to see in them.

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<sup>62</sup> Report of the European Anti-Fraud Office, Sixth Activity Report for the period 1 July 2004 to 31 December 2005.

138. **We are content with the extent of the investigations which OLAF has undertaken. We consider that OLAF should conduct a survey of the uses to which Member States put its reports. On the basis of the results of this survey OLAF will be able to improve the relevance of the information it passes relevant authorities in the Member States.**

### **OLAF's independence**

139. We reported on OLAF in Session 2003–04 against a background of dissatisfaction with the organisation stemming from the *Eurostat* affair. Our report made a number of proposals to amend the Commission Regulations governing OLAF<sup>63</sup>. We took the view that the Commission's proposals would do little to strengthen either the independence or effectiveness of OLAF, and recommended that the Council should take no decision on the proposed amendments until the Court of Auditors had reported on OLAF.
140. The Court of Auditors has now issued this report on OLAF<sup>64</sup>. On the question of OLAF's independence from the Commission, the Court concluded that OLAF's "hybrid" status of investigative autonomy but reporting to the Commission for other duties was positively advantageous, and that no change was needed. This was reinforced in evidence to us, including from Mrs Wright who argued that "there is nothing to suggest to my mind that there is anything damaging to OLAF's interest in being part of the Commission" (Q 594). At a practical level Mr Ilett told us of the benefits OLAF gains from being inside the Commission's administration including access to information, contacts and expertise. Crucially he stressed that he had never "been subjected to any kind of pressure by the Commission either to open or not to open an investigation or to take any other action otherwise affecting" OLAF's operations (Q 575).
141. The Court did, however, find weaknesses in the legal framework of OLAF investigations and in the "regulatory provisions concerning the governance of the Office" (essentially the relations between the Office and its Supervisory Committee were difficult). The Court considered that the latter needed to be re-examined.
142. The Court also recommended that OLAF focus its activities on investigative work to the exclusion of the other tasks such as the development of the Commission's fraud prevention strategy or the preparation of legislative and regulatory anti-fraud measures. At the operational level, the Court recommended a setting and respecting of deadlines for the completion of investigations; more effective cooperation with the relevant Member State authorities; the strengthening of the system for assessing results and improved staff training.
143. **We are convinced by the arguments presented in favour of keeping OLAF administratively within the Commission. On the basis of the evidence we have received we emphatically refute claims that OLAF is too close to the Commission or that the Commission seeks to divert and influence OLAF's investigative activities.**

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<sup>63</sup> See European Union Committee, 24th Report (2003–04): *Strengthening OLAF, the European Anti-fraud Office* (HL 139). Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1073/99 concerning investigations conducted by the European Anti-Fraud Office (OLAF) and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1074/99 concerning investigations conducted by the European Anti-Fraud Office (OLAF).

<sup>64</sup> European Court of Auditors, Special Report no. 1/2005 concerning the management of the European Anti-Fraud office (OLAF), together with the Commission's replies, Official Journal of the European Union, C 202, 18 August 2005, pp 1–32.

## CHAPTER 7: SUMMARY OF CONCLUSIONS

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### **Background—The budget of the European Communities and its audit**

144. We concur with the views presented to us that the lack of positive assurance from the European Court of Auditors in their annual Statement of Assurance is a serious problem for the European Union and the governments of its Member States. It was as a result of our concern over this that we decided to launch this inquiry. (paragraph 4)

### *Crises and developments in the Commission*

145. Our investigation was not presented with any evidence of a culture of corruption in the Commission. (paragraph 8)

### *The meaning of a qualified audit opinion*

146. We share the concern raised with us by the European Court of Auditors that their decision not to give a positive Statement of Assurance can be misunderstood. We recognise that the lack of a positive Statement of Assurance does not necessarily indicate that high levels of fraudulent or corrupt transactions have taken place. We do not seek to detract from the importance of the issue, nor from the evident underlying problems which have resulted in 12 successive qualified audit opinions. However, we consider that a more accurate reflection of the substance of the Court's annual audit and the Statement of Assurance would be achieved if these two functions were more clearly separated. In addition, the single Statement of Assurance should be split into a series of statements on each of the different spending categories. (paragraph 11)

### **The Statement of Assurance: its development and its weaknesses; proposals for reform**

147. We recommend that in future the annual examination and audit of all revenue and expenditure of the Commission should be separated from the broader objectives of the Statement of Assurance. (paragraph 17)
148. We are pleased to see that the Commission and the European Parliament are actively addressing issues regarding European financial management which are raised by the Court of Auditors in their annual audits. (paragraph 20)

### **DAS Methodology**

149. Sir John Bourn, Comptroller and Auditor General at the UK's National Audit Office told us that, were he required to issue a single Statement of Assurance on the UK Government's accounts in the same way as the Court of Auditors does for Europe's accounts, he, like the Court, would be unable to do so (Q 192). This is because last year he issued a qualified opinion on 13 of the 500 accounts of the British Government which he audits (Q 190). (paragraph 22)
150. We consider that the Court's decision to give a single Statement of Assurance on the accounts as a whole means that a positive Statement is difficult to achieve. We consider that it would be preferable for the Court to issue statements on each of the spending areas; in much the same way that the National Audit Office in the UK issues separate audits for each Government department. This would give a more accurate picture of the state of financial management in the Union and would make comparisons with other public bodies easier. (paragraph 23)

*Transaction testing and the development of the Court's methodology*

151. We concur with the observation that the methodology employed by the Court still relies heavily on transaction testing. Due to the small number of transactions actually looked at each year we do not consider that this methodology can lead to an accurate picture of financial management. The Court should aim to improve the methodology behind the Statement's production so as to provide more accurate data. We consider that these weaknesses must be remedied as a matter of priority so an accurate picture of the error rate can be obtained. (paragraph 28)
152. We are pleased to see that the Court has responded to calls from the ECOFIN Council and added additional auditing techniques over the years. In particular we are pleased to see that the Court now conducts an assessment of supervisory systems and controls; reviews the Annual Activity Reports and Declarations from each of the Directors General in the Commission; and evaluates of the results of other auditors. We consider that these need to be further developed to give a more rounded picture of performance over the year. In particular, greater use by the Court of the Annual Activity Reports could add positive pressure for their development into proper accounting tools. (paragraph 29)

*The meaning of an irregularity*

153. We encourage the Court to put in place measures clearly to distinguish between irregularity and fraud and to publish separate figures for the level of fraudulent transactions and administrative mistakes. (paragraph 31)
154. Whilst the distinction between fraud and other irregularities must be made clear, we consider that administrative mistakes could still indicate deficiencies in the control systems operated by the Member States or the Commission. Attention should therefore be drawn to both administrative mistakes and fraudulent activity. Sources of error, from whatever quarter and for whatever reason under current definitions should be taken into account when calculating material error rates. (paragraph 33)

**Dividing the Statement of Assurance into categories**

155. We support the recent decision of the Court of Auditors to produce a Statement of Assurance giving details of each of the areas analysed. We recommend that this should be developed into a Statement which concentrates on an analysis of the audits conducted each expenditure category and Member State rather than on the single Statement of Assurance on all the accounts. (paragraph 35)
156. We note with approval the achievements made by the Commission in developing a system for agricultural payments which led the Court to give a positive Statement of Assurance to this area for the first time in 2004. (paragraph 36)

**National management of European funds**

157. We support calls for the European Court of Auditors to produce a list of those Member States demonstrating poor management of European funds. We consider that such a list would encourage all the governments of the Member States to take this issue seriously. Such a list should only be produced on the basis of accurate data and so will require the development of a sound basis for payment transaction sampling. (paragraph 38)

### *A commitment to improvement*

158. We recognise the commitment which the Commission has shown to improving its accounting system, particularly with regard to the introduction of accruals based accounting. We were pleased to hear from the Accounting Officer that the Commission now respects internationally recognised rules; and from the UK Minister that the EU is now one of the leaders in public accounting terms. (paragraph 42)

### **Segregation of duties**

159. We therefore support the Commission's system of payment authorisation and execution as introduced by the Prodi-Kinnock reforms. We consider that segregating the authorisation and execution of payments is appropriate. (paragraph 46)

### **Continuing criticism**

160. During our inquiry we heard considerable evidence on the Commission's financial management. None of that evidence supports the allegation that there is a significant element of corruption within the Commission. (paragraph 49)

### **Double entry bookkeeping and the Commission's accounting software**

161. In spite of the improvements which have been made to the accounting system there are areas which remain in need of attention. We are concerned that there remains a question over whether local accounting systems in the Directorates General are indeed compliant with the standards needed for double entry book keeping. All accounting systems operated in the Commission should fully support double entry accounting. We expect the Commission to investigate these allegations and to publish a full account of its findings. (paragraph 53)

### **Internal audit and control**

162. In contrast to the progress reported to us in relation to the Commission's internal accounting system we are concerned that the Commission's system of internal audit is inadequate. We urge the Commission to review fully the procedures in place and bring forward proposals to make the system more robust. These proposals should not seek to create new audit bodies. Rather they should focus on requiring Commission officials and existing audit bodies to take responsibility for the systems and the accounts. (paragraph 61)

### **Devolved management in the Commission**

163. We are not convinced by the arguments for recentralising responsibility for financial transactions. Rather, we consider that the decentralised system introduced by the Prodi-Kinnock reform has allocated financial management responsibility to the appropriate level, so long as effective control systems are in place. (paragraph 63)

### *A system requiring Commission officials to take responsibility*

164. We are strongly in favour of a system of signing off whereby responsibility for accounts is shouldered first by the accountants and auditors in each Directorate General and then at more and more senior levels. This system should culminate in the requirement for the Secretary General of the Commission to sign an assurance that the Commission's annual accounts are true and fair. (paragraph 67)

### **Risk assessment**

165. We fully support the proposal in the Roadmap to introduce a common methodology for risk assessment. However we recognise that that the accounting system is not tailored to provide the data to which such a common methodology could be applied. We consider that efforts should be made to develop the accounting system to produce the necessary data. We endorse the use of qualitative methods to assess the risk in the meantime. (paragraph 70)

### **Debt recovery**

166. We are generally satisfied with the Commission's procedures and reporting requirements on debt waivers. We see no evidence of the "ruthless exploitation" of these procedures that some have suggested. (paragraph 73)

### **Who is responsible for financial management**

167. While the Commission should do its best to monitor the disbursement of funds we do not consider that the Commission can be held responsible for the regularity of the large majority of European transactions (over 80%) which take place within Member States. We are pleased to see that both the Maastricht Treaty and the recent Financial Perspective agreement recognised the role of the Member States in ensuring proper financial management. (paragraph 79)

### **Is the legislation too complex?**

168. It is of great concern to us that the regulations underpinning the spending programmes continue to be very complex and that this complexity can lead to errors. We are pleased to see that the Commission and the Council have committed to simplifying the rules. (paragraph 86)

### ***Delegation risk***

169. We share some of the concerns raised with us in respect of Member State management of EU funds. We consider it particularly unacceptable for the government of a Member State to treat European money with less care than national funds and urge the Council to make this clear. We are also concerned about the variability of control standards between Member States. We consider that all European expenditure should be subject to equivalent standard of control to ensure that the risk of fraud and error is minimised. (paragraph 90)

### ***Sufficient interest in the Council?***

170. We are strongly in favour of a national Statement of Assurance on the monies disbursed in each Member State. As in the Dutch pilot project, such a Statement should be sent to national parliaments as well as to the Commission as we consider that this will encourage the Member States to take responsibility for the systems and controls they operate. Consideration should be given to ensuring the length of time the discharge procedure takes is not extended. (paragraph 105)
171. In line with the system operating in UK Government departments, we do not consider that a national Statement of Assurance requires a political signature. (paragraph 106)

### *Responsibility in the Council*

172. We consider this lack of Council level consideration to be a serious weakness. We consider that the Budget Council should be at least as concerned with the Union's accounts as it is with drawing up the Budget. We therefore consider that the Budget Council should to prepare a report on the annual audit and Statement of Assurance from the Court of Auditors. This would be debated by the European Parliament at the same time as the Court of Auditors' report. In this way the Council of Ministers would be drawn much more closely into consideration of the accounts and into the process of ensuring that the financial systems of the Union meet appropriate international standards. (paragraph 108)

### *Responsibility in national parliaments*

173. None the less we consider that there is a clear role for national parliaments: not least because in the UK, for example, there is considerable misunderstanding of the real position. We consider that this stems, at least in part, from the sporadic and sometimes capricious way in which this issue is debated in the two Houses and discussed in the press. (paragraph 109)
174. There is a strong argument for a more consistent and regular approach to the audit and management of the European Union's accounts than may perhaps have been the case in the past in the European Committees of both Houses. This in turn might lead to a regular annual debate on the topic on the floor of each House as part of the annual political cycle. Similar debates could be held in the Welsh Assembly and the Scottish Parliament. (paragraph 110)

### **A single national account and auditing problems in devolved or federal states**

175. We are concerned that a single national European account would impose an additional layer of bureaucracy and would pose a number of difficulties in relation to devolved and federal states. (paragraph 112)

### **Sanctions for non-compliance**

176. We note that the Commission has existing powers of disallowance of expenditure and recovery of funds, and the power to certify paying agencies in the agricultural sector. In the context of the reforms outlined above we consider that the existing Commission powers are sufficient. (paragraph 115)

### **The role of the Court and its workings with national Supreme Audit Institutions**

177. We note the desire expressed to us by Members of the Court not to become "part of the political game". We consider that it would be highly inappropriate for the Court to promote a political agenda. (paragraph 118)
178. We are pleased to see the work the Court has done to develop its relationships with the Supreme Audit Institutions in the Member States. We hope that these will be further developed in the future with a view to giving the Court a supervisory role over the audits of European expenditure conducted by the Supreme Audit Institutions in the Member States. (paragraph 123)

### **Value for money audit**

179. We call upon the Court to bring forward concrete proposals to extend the aspects of its work which are not directly concerned with the annual Statement of Assurance. We consider that developments in the value for money and performance auditing side of the Court's work would be particularly valuable. (paragraph 125)

### **The rate of fraud**

180. Any fraud committed against the European Budget is a problem which should be addressed seriously by the Commission and the Member States. We conclude that while the level of fraud is no higher than in comparable public expenditure programmes, including in the UK the fight must go on. We consider that efforts should be made to convey these messages to Europe's citizens more effectively. (paragraph 131)

### *Problems estimating the rate of fraud*

181. We are concerned that estimates of the level of fraud rely on self-reporting by the Member States. We consider that the Commission should bring forward proposals for a new, more objective, method of determining the rate of fraud. (paragraph 133)

### **OLAF's powers and activities**

182. We are content with the extent of the investigations which OLAF has undertaken. We consider that OLAF should conduct a survey of the uses to which Member States put its reports. On the basis of the results of this survey OLAF will be able to improve the relevance of the information it passes relevant authorities in the Member States. (paragraph 138)

### **OLAF's independence**

183. We are convinced by the arguments presented in favour of keeping OLAF administratively within the Commission. On the basis of the evidence we have received we emphatically refute claims that OLAF is too close to the Commission or that the Commission seeks to divert and influence OLAF's investigative activities. (paragraph 143)

## APPENDIX 1: SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

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### Sub-Committee A

The members of the Sub-Committee which conducted this inquiry were:

Lord Blackwell  
Lord Cobbold  
Lord Inglewood  
Lord Jones  
Lord Jordan  
Lord Kerr of Kinlochard  
Lord Maclennan of Rogart  
Lord Radice (Chairman)  
Lord Steinberg  
Lord Watson of Richmond

### Declaration of Interests

A full list of Members' interest can be found in the Register of Lords Interests:  
<http://www.publications/parliament.uk/pa/ld/ldreg.htm>

Members declared the following interests as relevant to this inquiry:

Lord Blackwell

*No relevant interests*

Lord Cobbold

*No relevant interests*

Lord Inglewood

*Farmer*

*Chairman, Carr's Milling Industries plc (food and agriculture)*

Lord Jones

*No relevant interests*

Lord Jordan

*No relevant interests*

Lord Kerr of Kinlochard

*Chairman of Court and Council, Imperial College*

*Hon President of the Universities Association for Contemporary European Studies*

*Member of the Council of the Centre for European Reform*

Lord Maclennan of Rogart

*Farmer*

Lord Radice

*Board Member, European Movement*

Lord Steinberg

*No relevant interests*

Lord Watson of Richmond

*No relevant interests*

## APPENDIX 2: LIST OF WITNESSES

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The following witnesses gave evidence. Those marked \* gave oral evidence.

- \* Ms Marta Andreasen
- \* Directorate General for Regional Policy, European Commission
- Dutch Senate
- \* European Court of Auditors
- \* Mr Brian Gray, Accounting Officer, European Commission
- Commissioner Hübner, Commissioner for Regional Policy, European Commission
- Mr Dennis Harrison
- \* OLAF
- \* Supervisory Committee, OLAF
- \* Commissioner Kallas, Commissioner for Administrative Affairs, Audit and Anti-Fraud, European Commission
- \* Rt Hon the Lord Kinnock
- \* Mr Ivan Lewis MP, Economic Secretary, HM Treasury
- \* Ambassador de Marchant et d'Ansembourg, Dutch Embassy
- \* Mr Ashley Mote MEP, European Parliament
- \* Mr Jules Muis
- \* National Audit Office
- Mr John Purvis MEP, European Parliament
- Lord Williamson of Horton
- \* Mr Terry Wynn, then MEP, European Parliament

### **APPENDIX 3: CALL FOR EVIDENCE**

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The Sub-Committee, under the Chairmanship of Lord Radice, has decided to conduct an inquiry into the mechanisms to manage and audit the revenue and expenditure of the European Communities. The Sub-Committee will be identifying the fundamental problems which have led to 11 successive years in which the European Court of Auditors has not issued a positive statement of assurance on the accounts. The inquiry will seek to answer the following key questions:

- What are the fundamental problems that have led to 11 successive years in which the accounts have not been given a positive statement of assurance?
- Are the mechanisms which have been suggested by the Commission to improve management of the budget appropriate?
- Are these mechanisms likely to lead to a positive statement of assurance on a set of accounts by the end of the tenure of the Barroso Commission?
- Are there further steps which need to be taken?
- Can lessons be learnt from the accounting procedures and practices in other countries?
- Are the working methods, staffing and organisation of the European Court of Auditors appropriate?

The Sub-Committee would welcome written comments on these issues.

#### **GUIDANCE TO THOSE SUBMITTING WRITTEN EVIDENCE**

**Written evidence is invited in response to the questions above, to arrive by no later than Monday 17 April 2006.**

The questions above cover a broad range of topics and there is no need for individual submissions to deal with all the issues. Evidence should be kept as short as possible: submissions of not more than four sides of A4 paper of free-standing text, excluding any supporting annexes, are preferred. Paragraphs should be numbered.

Evidence should be sent in hard copy and electronically to the addresses below.

Evidence should be attributed and dated, with a note of the author's name and position. Please state whether evidence is submitted on an individual or corporate basis.

Evidence becomes the property of the Committee, and may be printed or circulated by the Committee at any stage. You may publicise or publish your evidence yourself, but in doing so you must indicate that it was prepared for the Committee.

Submissions will be acknowledged. Any enquiries should be addressed to: Ed Lock, Clerk of Sub-Committee A, Committee Office, House of Lords, London SW1A 0PW; telephone 020 7219 3616; fax 020 7219 6715; e-mail [locked@parliament.uk](mailto:locked@parliament.uk).

**This is a public call for evidence. You are encouraged to bring it to the attention of other groups and individuals who may not have received a copy directly.**

## **APPENDIX 4: THE 2005 STATEMENT OF ASSURANCE**

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The Court provides a Statement of Assurance in accordance with Article 248 of the EC Treaty on:

- the reliability of the accounts;
- the legality and regularity of underlying transactions.

The full text of the Statement is set out below.

I. Pursuant to the provisions of Article 248 of the Treaty the Court has examined the “Final annual accounts of the European Communities” consisting of the “Consolidated financial statements and the consolidated reports on implementation of the budget” for the financial year ended 31 December 2005.

II. In accordance with the Financial Regulation of 25 June 2002, the “Consolidated financial statements” for the financial year 2005 are prepared for the first time on the basis of accounting rules adopted by the Commission’s Accounting Officer which adapt accruals based accounting principles to the specific environment of the Communities, while the “Consolidated reports on implementation of the budget” continue to be primarily based on movements of cash. The change-over to accruals based accounting required a restatement of the opening balance sheet as at 1 January 2005 and important changes in the presentation and content of the “Consolidated financial statements”.

III. The “Final annual accounts of the European Communities” are consolidated by the Commission’s Accounting Officer and approved by the Commission. The Court’s responsibility is to provide, based on its audit, 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.

IV. The Court carried out its audit in accordance with its own policies and standards which are based on international standards that have been adapted to the Community context. Through its audit, the Court has obtained a reasonable basis for the opinion expressed below. In the case of revenue the scope of the Court’s audit work was limited. Firstly, VAT and GNI own resources are based on macroeconomic statistics for which the underlying data cannot be audited directly by the Court, and secondly, the audits of traditional own resources cannot cover the imports that have not been subject to custom supervision.

### **Reliability of the accounts**

V. In the Court’s opinion, the “Final annual accounts of the European Communities” were drawn up in accordance with the provisions of the Financial Regulation of 25 June 2002 and accounting rules adopted by the Commission’s Accounting Officer. Except for the effects of the observations in paragraphs VI to

VIII, they present fairly, in all material respects the financial position of the Communities as of 31 December 2005, and the results of their operations and cash flows for the year then ended.

VI. The Court notes that, in the context of a complex exercise (see paragraph II), the existing financial reporting framework has not been consistently applied, in particular for cut-off, and that accounting systems in certain Directorates-General of the Commission were not able to ensure the quality of financial information which led to multiple corrections after the presentation of the provisional accounts (see paragraphs VII and VIII).

VII. The Court's audit has identified errors in amounts registered in the accounting system as invoices/cost statements and pre-financing which, after corrections made to the provisional accounts, still have the following net financial impact on the elements of the consolidated financial statements listed below (see also paragraph VIII):

- (a) The consolidated opening balance sheet as at 1 January 2005, which adjusted the consolidated closing balance sheet as at 31 December 2004 on the basis of the new accruals based accounting principles, overstates the accounts payable by some 47 million euro and overstates the total amount of long term and short term pre financing by some 179 million euro. As a result, the net assets are overstated by some 132 million euro.
- (b) The errors identified in (a) above affected the consolidated closing balance sheet as at 31 December 2005 which overstates the accounts payable by some 508 million euro and the total amount of long term and short term pre-financing by some 822 million euro. As a result the net assets are overstated by some 314 million euro.

VIII. The Court's audit also confirmed the general reservation of the Director-General for Education and Culture covering the lack of assurance as regards the correctness of its share of the total amounts, included in both the consolidated opening balance sheet as at 1 January 2005 (assets amounting to 572,5 million euro and liabilities amounting to 198,5 million euro) and the consolidated closing balance sheet as at 31 December 2005 (assets amounting to 382,7 million euro and liabilities amounting to 187,3 million euro). Given the incidence of omissions and double or wrong postings within this Directorate-General, it is not possible to quantify the over- or understatement in its share of the assets and liabilities.

### **Legality and regularity of the underlying transactions**

IX. In areas where the supervisory and control systems are implemented in a manner which provides for an adequate risk management, the transactions underlying the final annual accounts of the European Communities, taken as a whole, are legal and regular. This is the case for revenue, commitments and payments for administrative expenditure and pre accession strategy with the exception of the SAPARD Programme. Moreover, for Common Agriculture Policy (CAP) expenditure the Court's audit shows that, where properly applied,

the integrated administration and control system (IACS) is an effective system to limit the risk of irregular expenditure.

X. Without calling into question the opinion expressed in paragraph IX, the Court emphasises that, in the area of pre-accession strategy, significant risks still exist at the level of the implementing organisations in the acceding and candidate countries for all programmes and instruments.

XI. The Court notes that in the other areas, payments are still materially affected by errors and the Commission and the Member and other beneficiary states need to make an increased effort to implement adequate supervisory and control systems, so as to improve the handling of the attendant risks. These areas are listed below, namely: Common Agricultural Policy, Structural measures, Internal policies and External actions.

- (a) In CAP expenditure, the Court found evidence that expenditure which is not subject to IACS, or where IACS is not properly applied or where it has only been recently introduced poses greater risk because control systems are not as effective. In addition, IACS inspection results are insufficiently verified and validated by an independent body and claims for EU aid are not usually checked on the spot by the latter. Clearance systems and post payment checks for CAP subsidies not covered by IACS do not provide reasonable assurance as to compliance with Community legislation. The Court concluded that CAP expenditure, viewed as a whole, was still materially affected by errors.
- (b) In structural measures, the Court again found that the Commission does not maintain effective supervision to mitigate the risk that the controls delegated to Member States fail to prevent reimbursement of overstated or ineligible expenditure. For both programming periods (1994–1999 and 2000–2006), the Court found that expenditure was not free of material irregularities. Some programs for the 1994 to 1999 period were closed without a sound basis.
- (c) In internal policies, despite the progress made in certain areas, the Court's audit revealed weaknesses in the supervisory and control systems which led to a material incidence of errors in payments to beneficiaries. Errors arise mainly from complicated cost reimbursement systems and unclear procedures and instructions governing the different programmes.
- (d) In external actions, the improvements of the Commission's supervisory and control systems have not yet had an impact at the implementing organisation level, where a material level of errors still exists, which can be attributed to the lack of a comprehensive approach to the supervision, control and audit of these organisations.

**APPENDIX 5: GLOSSARY**

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CAP	Common Agricultural Policy
DAS	Statement of Assurance (Déclaration d'Assurance)
EC	European Communities
ECA	European Court of Auditors
ECOFIN	European Council of Finance Ministers
EP	European Parliament
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
HMT	HM Treasury
IAS	Internal Audit Service
OLAF	European Anti-Fraud Office
SAI	Supreme Audit Institution
UCLAF	Unité de Coordination de La Lutte Anti-Fraude
VAT	Value Added Tax

## **APPENDIX 6: REPORTS**

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### **Recent Reports from the Select Committee**

Scrutinising EU Legislation—Public Awareness of the Role of the House of Lords (32nd Report session 2005–06, HL Paper 179)

Annual Report 2005 (25th Report session 2005–06, HL Paper 123)

The Future Financing of the Common Agricultural Policy (2nd Report session 2005–06, HL Paper 7)

Annual Report 2004 (32nd Report session 2003–04, HL Paper 186)

### **Session 2005–2006 Reports prepared by Sub-Committee A**

The 2007 EC Budget (39th Report, HL Paper 218)

A European Strategy for Jobs and Growth (28th Report, HL Paper 137)

The World Trade Organization: The Hong Kong Ministerial 13th–18th December 2005 (17th Report, HL Paper 77)

The 2006 EC Budget (5th Report, HL Paper 22)

### **Other Relevant Reports prepared by Sub-Committee A**

Future Financing of the European Union (6th Report session 2004–05, HL Paper 62)

Evidence from the Financial Secretary on the proposed reforms of the Stability and Growth Pact (7th Report session 2004–05, HL Paper 74)

The World Trade Organization: the role of the EU post-Cancún (16th Report session 2003–04, HL Paper 104)

Evidence from the Financial Secretary on the Stability and Growth Pact and the European Central Bank (14th Report session 2003–04, HL Paper 88)

The European Court of Auditors: The Case for Reform (12th Report session 2000–01, HL Paper 63)