



House of Commons
Committee of Public Accounts

Financial management of the European Union

**Eighteenth Report of
Session 2004–05**

Report, together with formal minutes

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The Committee of Public Accounts

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Summary

In 2003, the European Union's budget was some €98.3 billion and the United Kingdom's gross contribution was €15.2 billion. After taking into account amounts received by United Kingdom beneficiaries and the rebate, the UK's net contribution was €4.0 billion. The sums involved emphasise the need for sound financial controls and robust financial management within European Union Institutions and in the Member States.

Historically accountability and audit arrangements of the European Union have been characterised by inertia among the Institutions. The high levels of fraud and irregularity generally thought to exist in the European Union operations have seriously damaged the Community's reputation. The fact that the European Court of Auditors has qualified the Union's accounts for ten successive years gives credence to this view. We believe that obtaining a positive Statement of Assurance is hopeless without dramatic changes to the Common Agriculture Policy and the Structural Funds to make them simple to control, thereby avoiding the high levels of fraud and error.

We recognise the difficulties in implementing complex schemes as in the United Kingdom the accounts of the Department of Work and Pensions have been qualified for the last 15 years due to fraud and error. We do not believe that the positive Statement of Assurance should be achieved by watering down the Court's approach and believe the Court is correct to resist pressure to do so. Rather the Court should maintain recognised international standards but consider providing separate Statements of Assurance for each area of expenditure and by Member State.

The Commission is committed to change but there is still a long way to go to secure the standards that European taxpayers are entitled to expect.

Statement of Assurance

The Court has never given a positive Statement of Assurance on the Community accounts since the Statement was introduced in 1994. This undermines public confidence in European Institutions. Despite its qualified opinion on the 2003 accounts, the Court noted that the Commission had made some progress in improving financial management. For example, the annual accountability reports produced by each Directorate General and the new accounting system.

There is considerable commitment on the part of the Commission, the Parliament and the Court to move towards a positive Statement of Assurance. The Court saw that this could be achieved if the Commission and Member States implemented a stronger framework of controls on which the Court could rely. The Court noted, however, that an adequate system of control over parts of the Common Agricultural Policy had taken years to implement. The scale of the task, across the whole budget, is therefore formidable and it is far from clear how quickly this worthy ambition can be achieved.

Value for money work

There is scope for more value for money work and reporting by the Court. The Court has a duty to examine “whether the financial management has been sound” corresponding broadly to the value for money reports by the Comptroller and Auditor General in the United Kingdom. The results of the Court’s work in this area are included in its Annual Report and in Special Reports. But the scale of this work is totally inadequate given the importance of ensuring the effective use of community funds.

Irregularities and fraud

In 2003, Member States reported irregularities, including alleged fraud, with the value of €922 million, to the European anti fraud office (OLAF). While this was 20% lower than in 2002, it was higher than in 1999, when OLAF was created.

The precise level of irregularity, including alleged fraud, is however unknown and is difficult to calculate. For example, data relate only to reported cases and Member States report irregularities and fraud in an inconsistent manner. Trends, and therefore progress, are difficult to assess. OLAF is currently developing a methodology for estimating the levels of fraud within individual sectors of the budget and intends to extend this to differentiate between fraud and irregularity.

UK Presidency

The United Kingdom’s Presidency of the European Union, in the second half of 2005, provides an ideal opportunity for the United Kingdom authorities to press for the improvements in financial management that will be an essential pre-requisite for the Court to provide a positive Statement of Assurance. They should press for the simplification of the Common Agriculture Policy and the Structural Funds. They should support, and encourage other Member States to support, the development of the road map for a positive Statement of Assurance. They should also emphasise the need to take a robust stance against fraud and irregularity.

Conclusions and recommendations

The Committee of Public Accounts visited the European Commission (the Commission), the European Court of Auditors (the Court), and the European Anti-Fraud Office (OLAF), in March 2005 to discuss the Comptroller and Auditor General's Report¹ on financial management in the European Union and to examine what progress there had been since the Committee's last visit in April 1999. We are grateful to all those with whom we met for their help and openness.

1. **Historically, accountability and audit arrangements of the European Union have been characterised by inertia among the Institutions.** Since the Committee's last visit, the Commission has started to implement a programme of reform and there is movement to more accountable and transparent ways of working. The Commission is committed to change but there is still a long way to go to secure the standards that European taxpayers are entitled to expect.
2. **The size of the European Union overall budget and the United Kingdom's contribution to it emphasises the need for strong financial management and frameworks of accountability.** For the tenth year in succession the Court qualified its opinion on the reliability of the Community annual accounts and did not provide a positive opinion on the main five out of the six payment headings. The lack of a positive Statement of Assurance undermines public confidence in European Institutions.
3. **Despite the continued qualification of the Community accounts, the Commission has made some progress in improving financial management.** The Court identified improvements in the quality of the annual reports intended to enhance the accountability of each Directorate-General and it noted that the Commission had made good progress in designing internal control systems. The introduction of a new accruals accounting system, with supporting IT, is another welcome development especially as the qualification on the reliability of the accounts was attributable largely to weaknesses in the previous accounting system. The Commission has also established an Internal Audit Service which reports to an independent audit committee with six members, two of which are external appointments.
4. **It is difficult to obtain a clear indication of the extent of the problems relating to the legality and regularity of European Union expenditure.** It would be helpful if the Court's annual report could indicate more clearly its assessment of the legality and regularity for each area of the budget. In addition, the report could usefully give an indication of how much progress or otherwise the Commission is making both generally and under each of the six expenditure headings and it could also point to developments within Member States. Such enhancements could assist the Commission and the Member States in making the necessary improvements to move forwards to an unqualified opinion on the accounts. In the meantime, the Court could consider the scope for producing a separate Statement of Assurance for each expenditure heading and for each Member State.

1 C&AG's Report, *Financial management of the European Union*, (HC 289, Session 2004–05)

5. **A major factor contributing to the qualified audit opinion is the level of errors identified by the Court. This is partly due to the complexity of schemes and programmes, particularly for payments under the Common Agricultural Policy and Structural Measures.** In designing schemes and programmes, the European Institutions should consider the relationship between desired outcomes of a particular scheme, the complexity of the rules governing it and the consequential likelihood of an error occurring. There is also a lack of common understanding between the Commission and the Court about the definition of error. This should be resolved.
6. **The Barroso Commission has committed, as one of its objectives for the next five years, to move towards a positive Statement of Assurance in order to enhance accountability.** The European Institutions, led by the Commission and supported by the Member States, have agreed on the need for a road map intended to achieve this objective. The road map will be built on the principles of the Community Internal Control Framework recommended by the Court. Under the road map, the Commission would be responsible for promoting improvements in internal controls in partnership with Member States.
7. **The commitment by all parties concerned to progress towards a positive Statement of Assurance is welcome, but the scale of the task ahead is formidable.** The European Union's budget covers six expenditure headings and is spent by 25 Member States as well as third countries and the Institutions. Some of the Member States have federal structures and autonomous regions. With this variety of transactions and the number of bodies and systems which manage and control them it is far from clear how quickly this worthy ambition can be achieved.
8. **There is scope for more value for money work and reporting by the Court.** The Court has a duty to examine "whether the financial management has been sound", corresponding broadly to audits of economy, efficiency and effectiveness by the Comptroller and Auditor General in the United Kingdom. The results of the Court's work in this area are included in its Annual Report and in Special Reports. But the scale of this work is totally inadequate given the importance of ensuring the effective use of Community funds.
9. **No independent review of the Court's work has taken place since it was set up in 1977.** Unlike the United Kingdom National Audit Office, the Court does not report on its own performance to anyone. The Court should therefore consider arranging a peer review of its approach and work to test the quality and relevance of what it does and demonstrate its willingness to learn from others.
10. **The precise level of fraud against European funds is unclear at present.** Differentiating between fraud and irregularity is complex. For example, Member States are required to report irregularities, including fraud, to the Office Européen de Lutte Anti Fraude (OLAF), the European anti-fraud office, but they do not do so on a consistent basis. OLAF's current work on a methodology to distinguish between irregularity and intentional fraud is clearly a priority.

11. The United Kingdom Government should utilise the occasion of the United Kingdom Presidency to improve accountability in the European Union.

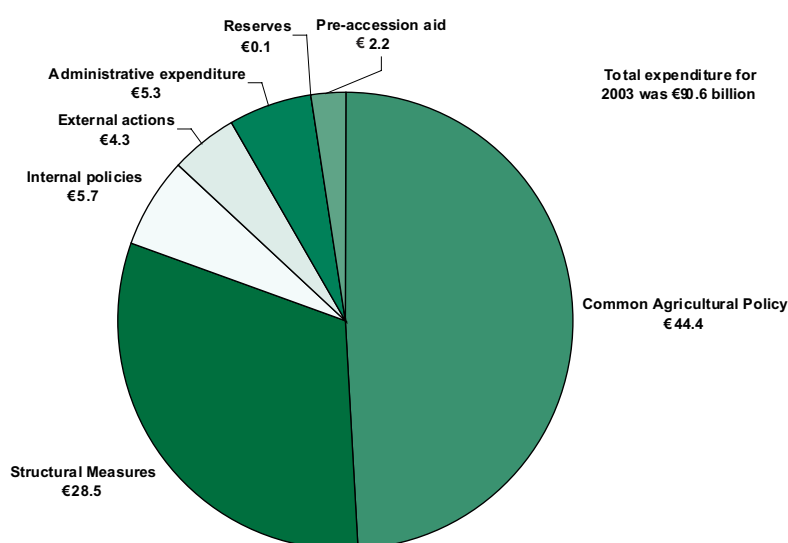
Specifically, it should:

- a) as a top priority, press for the simplification of the rules and regulations of the Common Agricultural Policy and Structural Funds to reduce the scope for fraud and error so as to increase the prospects of achieving a positive Statement of Assurance;
- b) support, and encourage other Member States to support, the development of the road map for a positive Statement of Assurance. In particular, attention should be focused on
 - identifying the reasons the Court is unable provide a positive Statement of Assurance on the legality and regularity of the underlying transactions;
 - the action the Commission and National Authorities need to take in each of the areas which are a cause for concern, with a specific focus on the major areas of European Union spending, support for agriculture through the Common Agricultural Policy and the Structural Measures; and
 - the prospects of National Authorities entering into 'Contracts of Confidence' and the likely value of such contracts for accountability;
- c) encourage, with other Member States and the Commission, an increased focus on value for money work in the Court given the importance of ensuring the effective use of community funds; and
- d) support OLAF's efforts to obtain a clearer picture of the scale of irregularity, including fraud, by:
 - encouraging Member States to (i) fulfil their obligation to protect Community Funds as they protect National Funds; (ii) deter crime against European interests by identifying those responsible and applying effective penalties and sanctions;
 - setting a good example to the other Member States by complying with OLAF's guidelines for reporting regularities; and
 - encouraging a programme of secondments to OLAF from a wide range of United Kingdom institutions, including the police force.

1 Statement of assurance

1. The European Union's final budget for 2003, following modifications and a reduction in the provision for Structural Funds, was €98.3 billion. Of this, actual expenditure was €90.6 billion, which is broken down in **Figure 1**. The United Kingdom's gross contribution to the budget was €15.2 billion. After taking into account amounts received from the European Union (€6.0 billion) and the rebate (€5.2 billion) the United Kingdom's net contribution was €4.0 billion, the second highest net contribution behind Germany. The size of the European Union's overall budget and the United Kingdom's contribution to it emphasises the need for strong financial management and frameworks of accountability.

Figure 1: Actual expenditure for 2003 by area



2. Expenditure in the European Union takes place in 25 countries and across six expenditure headings. Structurally, some Member States are organised along federal lines; others have autonomous regions. And Member States employ different methods for distributing funds to final beneficiaries. For example, in 2003, 85 paying Agencies across 15 Member States distributed monies under the Common Agricultural Policy. Additionally, payment schemes can be governed by complicated rules, designed to achieve a range of outcomes and accommodate a variety of situations. The environment in which expenditure takes place is therefore complex.

The Court's opinion on the Community accounts for the 2003 financial year

3. Each year the European Commission produces a consolidated account of the income and expenditure for the European Communities. The account is audited by the European Court of Auditors, the European Union's external auditors. Its conclusions are set out in its annual Statement of Assurance which summarises its opinion on the Community accounts. For the tenth year in succession the Court did not give a positive Statement of Assurance.

- Apart from one area of the accounts, sundry debtors, the Court concluded that accounts were reliable – that they had been drawn up in accordance with accounting principles and the Commission’s own regulations, and that they reflected faithfully income and expenditure for the year and the position as at the year end.
- The Court qualified its opinion on the legality and regularity of payments in five out of the six headings covering 94% of actual expenditure: Common Agricultural Policy, Structural Measures, internal policies, external actions, and pre-accession aid. Only in one category, administrative expenses, less than 6% of actual expenditure, was the opinion not qualified. The Court found that, in some cases, payments had been materially affected by error; in others, it identified weaknesses in supervisory systems and controls at the level of the Member State.

4. The Court’s annual examination of the Community account is based on four main sources of evidence.

- An examination of the operation of the supervisory systems and controls of Community institutions, Member States and other countries.
- A sample check of transactions for each major area, down to the level of the beneficiary. The sample is split according to expenditure headings, but is not stratified further by Member State.
- An analysis of annual accountability reports and declarations of the Directorates-General.
- An examination of the work of other auditors, who are independent of the Community’s management procedures.

Sample size is insufficiently large and insufficiently risk-based to be meaningful.

5. The Court treats an error which results in a measurable financial impact in the same way as a failure to comply with regulations. If the value of errors identified by the Court exceeds a pre-set threshold then the Court is unable to give a positive opinion. The Court does not publish error rates for individual areas of the budget or for Member States. We believe it should.

Value for Money work

6. The Court has a duty to examine whether the financial management of European Community funds has been sound. This corresponds to the value for money work of the National Audit Office in the United Kingdom. The results of the Court’s work in this area are included in its Annual Report and in Special Reports. For the 2003 financial year the Court published only eight special reports focussing on issues such as the management of pre-accession aid and the Commission’s management of the measures to control Foot and Mouth Disease. The number of such reports varies from year to year.

7. Given the amounts and variety of uses of community funds, this is a small number of reports compared to the number published by the United Kingdom National Audit Office.

It is therefore not providing the European taxpayer with the necessary assurance of the effective use of European Community Funds.

Progress in financial management

8. For the 2002 financial year, the Court qualified its opinion on the reliability of the accounts in four areas. For the 2003 financial year, the Court noted just one qualification implying an improvement in the Commission's approach to financial management. The Court attributed its qualification on the reliability of the accounts, as it had done in previous years, to weaknesses in the Commission's accounting system. On 1 January 2005, the Commission introduced a new accounting system and supporting IT. The Commission reported, at the end of January 2005, that the transition to the new system had been successful. As a result, for the first time in 2005, the Community accounts will be produced on an accruals rather than a cash basis.

9. The introduction of an accruals-based accounting system should, amongst other things, improve the Commission's control over assets and liabilities and its assessment of the true cost of each policy area. The Court has launched an audit of the process so far. The Court will publish its opinion on the first set of accounts produced under the new accounting system, for the 2005 financial year, at the end of 2006.

10. Following the Committee's previous visit, it concluded that there was a lack of clarity about who was accountable to whom and for what. The Court, in its annual report on the 2003 financial year pointed to other areas where the Commission's accountability and financial management had progressed. For example, Directors-General are required to produce an Annual Activity Report on the performance and achievements of their Directorate-General. The report's aim is to increase accountability. It includes a statement of assurance from the Director-General that the resources had been used for the purpose for which they had been intended and that controls were legal and regular. The Court identified improvements in the reports, such as the introduction of management indicators; and the monitoring of progress against recommendations made by internal and external audit. The Court also identified progress made by the Commission in the design of a new internal control framework.

11. In addition to the improvements noted by the Court, the Commission created an Internal Audit Service as part of the package of reforms introduced to improve financial management and accountability following the Commission's resignation in 2000. The Service is independent and reports to the Audit Progress Committee which is chaired by the Vice President of the European Union, who has responsibility for Administrative Affairs, Audit and Anti-Fraud. The Committee consists of four Commissioners and two external members, designed to ensure independence. The Service aims to help the Commission and the Directorates-General to, amongst other things, control risks and monitor compliance with the rules. It also carries out value for money investigations. Since it was created the Service has completed its first cycle of review which it believes provides it with a complete picture of risks across the Directorates-General.

Future developments

12. Despite such developments, the Court reported the need for further progress if it is to gain assurance in its audit work from these elements of the Commission's financial management framework and move towards a positive Statement of Assurance on the Community accounts. It also commented that the introduction of a control system for aspects of payments under the Common Agricultural Policy (known as the Integrated Administration and Control System) took around ten years to implement successfully.

13. The Barroso Commission has a set, as one of its strategic priorities for the next five years, the achievement of a positive Statement of Assurance. In pursuit of this aim, the Commission has promised to produce, by July 2005, a road map which aims to reach agreement with the other European Institutions, including the Court, on the way forward. The road map is based on the Community Internal Control Framework, recommended by the Court, which sets out principles to govern internal controls at all levels of administration within the Institutions of the European Union and at the level of the Member State.

14. In its report following its visit in 1999, the Committee noted the need to ensure that the Commission had in place whistleblowing procedures which protect staff who in good faith make unauthorised disclosures about misconduct within the organisation. In October 2004, the Commissioner with responsibility for Administrative Affairs, Audit and Anti-Fraud emphasised the need for guarantees for whistleblowers as part of a system that was open and transparent. He stressed that the procedures had changed following some high profile cases.

2 Irregularities, including fraud, and the work of the European anti-fraud office

15. The Office Européen de Lutte Anti-Fraude (OLAF), the European anti-fraud office, was established in June 1999. While the focus of the Court's work is on formal errors and ambiguous rules, OLAF deals largely with criminal acts. Its role is to protect the European Union's financial interests, to fight fraud, corruption and other irregular activity within European Institutions and Member States. OLAF is part of the Commission, under the authority of the Vice-President for Administrative Affairs, Audit and Anti-Fraud. It has budgetary and administrative autonomy and is operationally independent from other aspects of the Commission's work. OLAF's work is overseen by a Supervisory Committee, which is composed of five independent persons appointed from outside the European Institutions.

16. OLAF fulfils its mission by conducting internal (within the Commission and/or other Member States) and external (in Member States) investigations. With the majority of the European funds spent in Member States, it is not surprising that the majority of OLAF's investigations – around 90% of cases currently under investigation by OLAF – were external. OLAF was concerned that its work should focus on those areas of the budget most at threat from irregularities and fraud (such as the main spending programmes, external aid, and customs duties). Examples of OLAF's work are shown in **Figure 2**.

Figure 2: Examples of OLAF's work

Alleged financing of terrorism

In February 2003, following allegations that European funds were used to finance terrorism or other illegal activity, OLAF opened an external investigation into alleged irregularities relating to the financial assistance provided by the European Commission to the Palestinian Authority since the end of 2000.

OLAF's investigators visited the region in October 2003, January 2004 and October 2004, and held information gathering meetings with representatives from a range of national and international bodies (such as the IMF, the World Bank, Middle Eastern countries, the private sector and Member States). Despite improvements to the financial control systems within the Palestinian Authority following the OLAF investigation, OLAF concluded that the systems were not yet sufficiently consolidated to exclude all risk of misuse.

Sugar imports from the Balkans

In April 2002, OLAF requested that Member States reinforced control measures on imports of sugar declared at customs clearance in the European Union originating in the western Balkans. The Greek customs authorities sampled sugar consignments imported into Greece in order to establish whether these consisted of cane or beet sugar. Their analysis indicated that most imports declared as of Croatian origin in fact consisted of a mixture of cane and beet sugar (cane sugar is not produced in Croatia). The Greek judicial authorities opened a criminal investigation and requested assistance from OLAF investigators.

The Greek judicial authorities performed an international commission in Croatia in June 2003 in which OLAF officials participated as experts. The Commission established that some 24,000 tons of sugar had been mis-described as being of Croatian origin (confirmed by the Croatian authorities) and leading the cancellation of 1,000 certificates of origin. Recovery procedures have begun in the Member States in relation to customs duties estimated at about €10 million. In addition, the Italian judicial authorities began a criminal investigation against an Italian trading company involved in the operations following the transmission of information by OLAF.

17. OLAF's work benefits from the expertise brought to it by a programme of inward secondments from the Member States in areas such as investigating, languages, and information technology. For example, OLAF receives valuable support from secondees from HM Customs and Excise. Currently, however, it does not have any police officers from the United Kingdom on secondment. Given the contribution made by police officers from other Member States, OLAF believed it would benefit from such an addition to its work force.

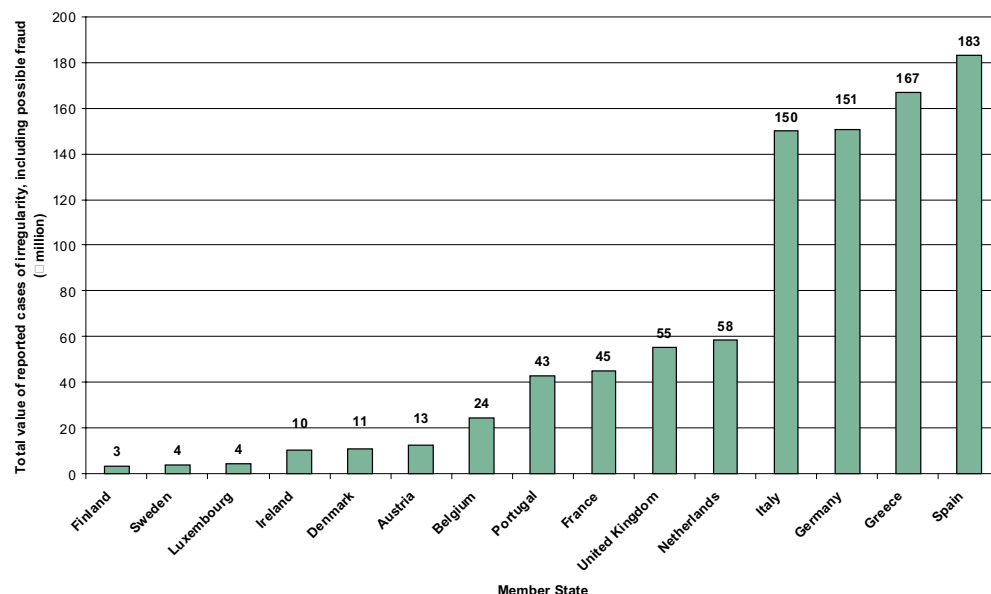
The level of irregularity, including alleged fraud, reported by Member States

18. Member States are obliged to report fraud and irregularity valued over a certain amount, for revenue and for expenditure under the Common Agricultural Policy and Structural Measures. The Commission defines an irregularity as a failure to comply with the Commission's regulations; and it defines fraud as a deliberate criminal act with the intent to achieve financial advantage. OLAF produces an annual report summarising the information received from Member States.

19. During 2003, a total of 8,177 cases of irregularities, including suspected fraud, were reported to OLAF by Member States. The total value of these cases was €922 million. Both the number and value of cases were around 20% less than in 2002. The main reason for the improvement was an almost 50% reduction in the number of cases reported under Structural Measures expenditure. This arose because the closure in 2002 of the structural programmes had identified more irregularities than usual. This reduction more than compensated for the 5% increase in the number of cases reported under revenue headings. All three types of irregularities showed a decrease in the value of cases reported between 2002 and 2003.

20. The number and value of cases of irregularity, including alleged fraud, notified to OLAF varies between Member States. **Figure 3** shows, by Member State, the value of irregularities, including alleged fraud, reported to the OLAF for the 2003 financial year. For 2003, the United Kingdom notified OLAF of 922 cases of irregularities, including alleged fraud, with a value of €55 million.

Figure 3: Value of reported cases of irregularity, including possible fraud, reported by Member States for 2003 (€ million)



21. OLAF's work on revenue irregularities and fraud — such as customs frauds and illegal dumping of goods — is important because, in quantitative terms, it can have a harmful impact on the interests of both the Community and Member States. If customs duties are evaded because of fraud, taxpayers in Member States have to pay increased contributions to the European Union budget. OLAF's activities in relation to revenue irregularities are intended to assist Member States in recovering the duties that have been evaded.

Assessing the precise level of fraud

22. Despite the collection of data on irregularities, including alleged fraud, for over five years, the precise levels involved, in terms of the number of cases and their value, remains unclear. Making an assessment as to whether the levels of irregularity and fraud have increased or decreased is therefore difficult, for a number of reasons.

- Data relate only to reported cases.
- An increase in the number of reported cases could be due to improved detecting and reporting on the part of Member States or by specific events such as audits at the end of Structural Funds programmes.
- Member States do not report fraud, and other irregularities, on a consistent basis. Some Member States, for example, consider that fraud can only be recognised once a conviction has been obtained through the national legal system.
- Distinguishing between irregularity and fraud is complex. Cases are identified unevenly within expenditure programmes and reported levels can fluctuate year on year (OLAF will make adjustments to data year on year based on new information received from Member States and the application of its own quality assurance procedures). Numbers reported can also fluctuate due to the inclusion of figures following the resolution of long-running cases which straddle years.

23. OLAF is currently looking to improve the quality and integrity of information on irregularity and fraud and to overcome some of the barriers to accurate reporting highlighted in the previous paragraph. For example, it is developing a methodology which will distinguish between fraud and irregularity, and it is taking steps to estimate the levels of fraud that exist within individual sectors of the budget.

24. Regulation (EC) 1681/94 provides a framework for the communication and follow-up of irregularities detected by Member States. In a Special Report in 2001 the Court noted some failures in the implementation of the Regulation in the six Member States, including the United Kingdom, in which it carried out its work. The Commission noted that this was due to problems faced by Member States in interpreting the Regulation. Subsequent follow-up work by the Commission identified that some progress had been made. It also found, however, that some Member States, once again including the United Kingdom, did not communicate the irregularities it had identified in a timely manner. The Commission noted that this was due to problems faced by Member States interpreting the regulation and made specific recommendations for Member States to implement.

Formal minutes

Wednesday 23 March 2005

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mr Ian Davidson
Frank Field

Jim Sheridan
Gerry Steinberg
Mr Alan Williams

The Committee deliberated.

Draft Report (Financial management of the European Union), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 24 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Eighteenth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

[Adjourned until Wednesday 6 April at 3.30 pm

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