House of Commons

Public Accounts Committee

# Financial Management in the European Union

## Thirty–second Report of Session 2008–09

*Report, together with formal minutes*

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## The Public Accounts Committee

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### Committee staff

The current staff of the Committee is Mark Etherton (Clerk), Lorna Horton (Senior Committee Assistant), Pam Morris (Committee Assistant), Jane Lauder (Committee Assistant) and Alex Paterson (Media Officer).

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# Summary

In 2007, European Union expenditure totalled €114.0 billion and revenue was €117.6 billion. In that year, the United Kingdom's net contribution was €6.1 billion, the highest after Germany. The sums involved emphasise the need for sound financial management and control within European Union Institutions and the Member States.

For the first time the Court did provide a positive Statement of Assurance on the *reliability* of the accounts because the accounts accurately recorded the underlying transactions. But for the fourteenth successive year, the European Court of Auditors did not provide a clear audit opinion (known as a Statement of Assurance) on the *legality and regularity* of expenditure. It found that an unacceptably high level of the account's underlying transactions did not comply with the rules and regulations. The lack of a clear opinion year on year significantly damages the Union's reputation for financial management and action urgently needs to be taken.

Since the Committee last reported on this subject in 2005, [1] the Commission has reduced the level of errors across the budget. But a major barrier to improving financial management in some areas of expenditure is the continued complexity of the regulations which applies particularly to Cohesion policy. This policy aims to remove disparities in economic performance across the European regions and continues to be the biggest source of error, with an estimated 11% of irregular spending.

The Court considers errors as material if in total they exceed 2% of total expenditure in each of the main policy areas. A Commission paper, published in December 2008, suggested different levels of error might be tolerable within different policy areas. It proposed that the more complex the policy, the higher the level of error that would be tolerated as there comes a point where the costs of control required exceed the value of the likely errors prevented. We are concerned about such a proposal because it would remove the incentive to simplify the rules for the European expenditure regimes which is essential to improve financial management.

The fundamental review of the European Union budget, currently underway, offers the Commission the opportunity to modernise the budget and strengthen its financial management. If the Commission does not take this opportunity, a positive Statement of Assurance is extremely unlikely and European Union citizens will continue to think that their funds are badly managed.

In 2007, Member States reported irregularities to the European Anti-Fraud Office (OLAF) totalling €1,425 million, including suspected frauds of €316 million. (An irregularity is a failure to comply with the Commission's regulations, and fraud is an irregularity committed intentionally which constitutes a criminal offence.) OLAF warned that its figures should be interpreted with caution as they depend on the timely and accurate reporting by Member States, making trends and progress in tackling irregularity and

1 Committee of Public Accounts, Eighteenth Report of Session 2004–05, *Financial Management of the European Union*, HC 289

suspected fraud difficult to assess.

Following a report by the Comptroller and Auditor General,[2] in March 2009 we visited the European Commission, the European Court of Auditors and the European Anti-Fraud Office to discuss financial management and to examine progress made since our last visit in March 2005. We are grateful to all those we met for their help and openness.

2 C&AG's Report, *Financial Management in the European Union*, HC (Session 2008–09) 349

# Conclusions and recommendations

1. **The Commission, working with Member States, has made a significant effort over recent years to improve the financial management of the European Union, and this effort is reflected in some progress since our last report.** The introduction of accruals accounting helped the Commission, for the first time, to achieve a clear opinion from the Court on the *reliability* of the 2007 accounts. On *legality and regularity*, the Court gave a clear opinion on some 45% of European Union expenditure, compared to an estimated 5% in 2003.

2. **There remains an unacceptably high level of error in some key budget areas and consequently, for the fourteenth successive year, the European Court of Auditors has not provided a positive overall Statement of Assurance on the legality and regularity of the underlying transactions.** Qualification of the accounts year after year undermines public confidence in the financial management of the European institutions and of Member States and devalues the significance of the qualification. Qualification should be an exceptional procedure not the norm, and yet, although the Court has noted improvements, the same criticisms are repeated year after year. The new Commission, in late 2009, in consultation with the European Parliament and the Council of the European Union, should publish a timetable for obtaining a positive Statement of Assurance. Concerted action is needed by the Commission, the Court of Auditors and Member States on a number of fronts to achieve a positive audit opinion.

3. **In 2005, we highlighted the inherent complexity of some European programmes as a major factor leading to error, but this complexity persists, as do the resultant errors.** Some of the most complex programme expenditure in the budget continues to be in the Cohesion policy area, which is responsible for some €42 billion of expenditure in 2007. It is usual for auditors to set a threshold before the audit opinion must be qualified. The Court set the threshold for the value of error which can be tolerated at 2% of the expenditure. In Cohesion policy the Court estimated that at least 11% of spending is subject to error. This level of error is unacceptable. Challenging targets should be set for the Commission to simplify regulations as much as possible and the relevant national delivery bodies should prioritise simplicity when interpreting Commission requirements.

4. **The Commission has proposed introducing higher levels of 'tolerable error' in areas of expenditure where the implementation of programmes is riskier and more prone to error, for example, in Cohesion policy.** The solution to such complexity does not lie in adjusting the level of tolerable error. This would undermine the accountability of European Union funds rather than enhance it, and European citizens would see this as lowering the bar; whether a €1 million error occurs within a complex or a simple area of expenditure should not make a difference to its acceptability. The European institutions concerned should consider the repercussions of such a change, including the risk of removing the incentive to simplify rules governing European funding at a time when simplification is needed.

5. **Ongoing problems with controls over Cohesion policy expenditure are, in effect, condemning the European Union accounts to qualification for many years to come.** The Court's 'traffic light' assessment of performance across expenditure areas, produced since 2007, has brought much needed clarity to where the challenges in financial management lie. This clarity should help in targeting activity to overcome those challenges. The Court could bring further clarity by providing a Statement of Assurance on each individual expenditure area in addition to that for the whole budget. If necessary, the Court should seek changes to its treaty obligations to effect this.

6. **The Commission has increased its focus on recovering ineligible expenditure through financial corrections.** Where the Commission identifies ineligible expenditure it seeks to recover the funds from the Member State. The Commission's activities in this area are to be commended and it should seek to recover all irregular expenditure. We hope that the threat of correction will lead to improved administration by Member States to ensure that corrections are, ultimately, unnecessary.

7. **The United Kingdom authorities made provisions for possible future financial corrections of over £400 million in 2007–08, and some £100 million of corrections have since been imposed.** Financial corrections made by the Commission often result in a loss to exchequer funds and it is unacceptable that the United Kingdom authorities, through mismanagement, have exposed the taxpayer to this level of recovery. The United Kingdom authorities must ensure they manage European funds more effectively in the future to minimise the likelihood of financial corrections.

8. **The number of Special Reports on value for money produced by the European Court of Auditors has increased but it could do more to assess whether European Union programmes are achieving their objectives in an efficient and effective manner.** The Court has increased the number of Special Reports it produces from five in 2005 to 12 in 2008. This is an improvement but still short of the level required to provide the necessary assurance that European Union funds are well used. We would like to see the growth in reports continue and encourage the Court to focus on the efficiency and effectiveness of programmes.

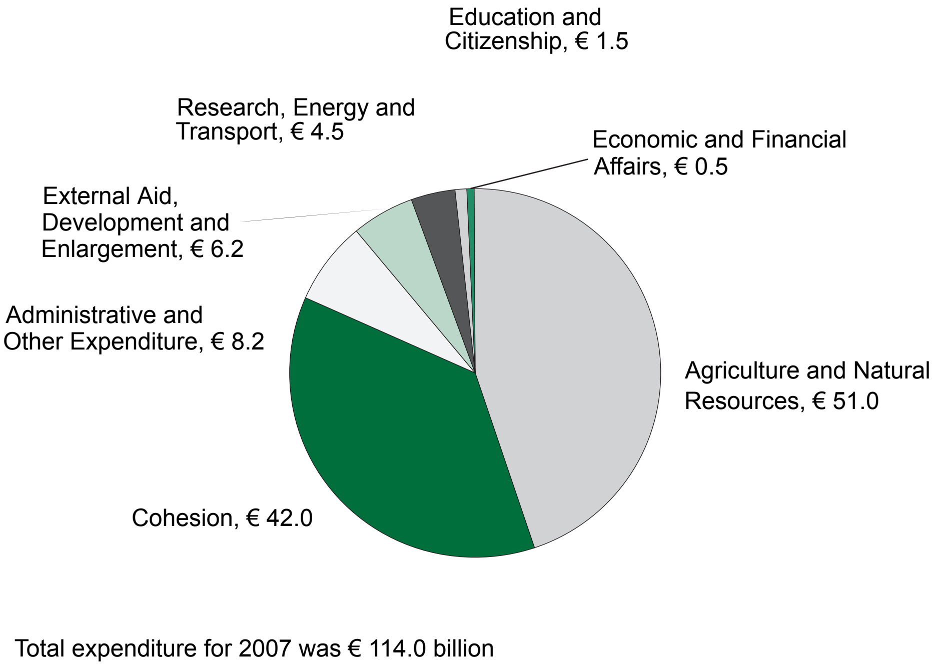
9. **The level of fraud and irregularity within the European budget is unclear.** OLAF continues to report that the reliability of published information on fraud and irregularity depends on the quality and timeliness of information submitted by Member States and should be treated with caution. To resolve this longstanding issue, on which we reported in 2005, OLAF and the Commission should press Member States to work with them to develop a consistent arrangement for recording and reporting irregularity and fraud across the European Union. OLAF should state alongside its published figures where it has concerns about the quality and timeliness of the information submitted.

10. **The Fundamental Review of the European Union budget presents the Commission with a rare opportunity to make long term changes to improve financial management.** The Commission, the Court and Member States should work together to ensure that suitable, practical changes are implemented, using this review as a springboard for large scale constructive action to resolve the issues which have blighted European Union financial management for years.

# 1 Findings of the European Court of Auditors and the European Anti Fraud Office

1. In 2007, expenditure by the European Union totalled €114.0 billion (**Figure 1**). The United Kingdom's gross contribution to the budget, including the rebate (€5.2 billion),[3] was €13.4 billion. Taking account of receipts from the European Union (€7.3 billion) the United Kingdom's net contribution was €6.1 billion, the second highest net contribution behind Germany.[4]

**Figure 1: Actual expenditure for 2007 by area (€ billion)**




*Source: C&AG's Report, Page 11, Figure 3*

2. Each year the Commission produces a consolidated account of the income and expenditure for the European Union. The account is audited by the European Court of Auditors, which sets out findings and conclusions in its Annual Report and Statement of Assurance. For the 14th year in succession, the Court did not provide a positive Statement of Assurance on the *legality and regularity* of European Union expenditure (in United Kingdom terms, a qualified opinion). But for the first time since 1994 the Court did give a positive Statement of Assurance on the *reliability* of the Commission's accounts, partly due to the Commission's successful introduction of accruals based accounting in 2005.[5]

3 C&AG's Report, para 1.5

4 C&AG's Report, para 1.4

5 C&AG's Report, paras 1.6–1.8

3. **Figure 2** presents the Court's assessment of the *legality and regularity* of underlying transactions for 2007. It shows that only two expenditure areas, covering just 8% of the budget (Administrative and Other Expenditure; and Economic and Financial Affairs), were deemed to have error rates below the acceptable threshold of 2%. The Court found material level of errors for the two largest expenditure areas—Agriculture and Natural Resources, and Cohesion policy (which aims to remove disparities in economic performance across the European regions). Together these accounted for over 80% of the European Union budget in 2007. Agriculture and Natural Resources had an error rate of between 2% and 5%.[6] In Cohesion policy the error was greater than 5% and the Court estimates that it was at least 11%.[7]

**Figure 2: The European Court of Auditors' specific assessments concerning *legality and regularity* of underlying transactions**

| Specific assessments of the 2007 Statement of Assurance Annual Report | Functioning of supervisory and control systems | Errors found through substantive testing |
|---|---|---|
| | | |
| Agriculture and Natural Resources | (2) | (3) |
| Cohesion | | |
| Administrative and Other Expenditure | | |
| External Aid, Development and Enlargement | | |
| Research, Energy and Transport | | |
| Education and Citizenship | | |
| Economic and Financial Affairs | | |
| Revenue (1) | | |

**Legend:**

Functioning of supervisory and control systems

| | |
|---|---|
| Effective | |
| Partially effective (4) | |
| Not effective | |

Error range (5)

| | |
|---|---|
| Less than 2% (below materiality threshold) | |
| Between 2% and 5% | |
| Greater than 5% | |

(1) See scope limitations in paragraphs 4.4 and 4.9 on page 84 of the Court's report for more information.
(2) The Court concluded that the Integrated Administration and Control System continued to be effective in limiting the risk of irregular expenditure where properly implemented and accurate and reliable data was introduced to support Single Payment Scheme payments based upon allocated entitlements.
(3) Rural development accounts for a disproportionately large part of the overall error rate: for the European Agricultural Guarantee Fund expenditure the Court estimated the value of error to be slightly below 2%.
(4) The Court classified systems as 'partially effective' where it judged some, but not all, control arrangements to work adequately. Consequently, taken as a whole, the controls might not succeed in restricting errors in the underlying transactions to an acceptable level.
(5) The error range does not reflect a confidence interval in a statistical sense. It is the Court's division of the scale of error rates into three intervals.

*Source: C&AG's Report, page 11, Figure 2*

6 C&AG's Report, paras 2.3–2.4

7 C&AG's Report, para 2.25

4. There are indications that since our Report in 2005 the Commission's work to reduce the level of error in the underlying transactions is paying off. In 2003, the Court could only provide a positive opinion on *legality and regularity* on an estimated 5% of European Union expenditure. In 2007, this figure had risen to around 45%. Despite the improvement the Court qualified its opinion for the majority of transactions (55%). The Court's 'traffic light' system (**Figure 2**) gives an indication of where improvement is still required. In 2007, only one of the seven expenditure areas (Cohesion policy) had an error rate classified as 'red' (above 5%) but it accounted for some 37% of the European Union expenditure.[8]

5. The Commission argues that the error ranges in **Figure 2** do not take account of the multi-year nature of programmes, especially in the Cohesion policy area. For example, if a programme spans five years or more it could be subject to several audits by the Commission and Member States and any errors would be identified and corrected up to, and including, the final audit at programme closure. Over the course of the programme, therefore, the Commission believes it will minimise errors and recoup any irregular payments that do occur. The Commission observes that the Court looks at a programme at one point in time and might identify an error which the Commission would have picked up, and rectified, at some future point. This view does not alter the Court's findings. The aim should be to prevent errors occurring in the first instance; correcting them is time consuming and costly and only adds to the administrative costs of programmes.

6. The Court has a duty to examine whether the financial management of the budget has been sound. This function corresponds, broadly, to value for money examinations by the Comptroller and Auditor General in the United Kingdom. In 2005, the Court produced five Special Reports, which we felt was inadequate, and we encouraged it to do more.[9] The Court increased the number to 12 in 2008 on topics ranging from The European Union's Agencies to Intelligent Energy.[10] We would like to see this growth continue and encourage the Court to focus on the efficiency and effectiveness of programmes.

7. The Office Européen de Lutte Anti-Fraude (OLAF), the European anti-fraud office, was established in June 1999. Its role is to protect the European Union's financial interests and to fight fraud, corruption and other irregular activity within European institutions and Member States. An irregularity is defined as a failure to comply with the Commission's regulations and fraud as an irregularity committed intentionally which constitutes a criminal offence. **Figure 3** shows, by expenditure area, the number and value of irregularities, including suspected fraud, reported to the OLAF for the 2006 and 2007 financial years. A complete analysis of the value of suspected fraud reported by each Member State is not published.

8 C&AG's Report, Figures 2–3

9 Committee of Public Accounts, *Financial management in the European Union*, page 6, Conclusion 8

10 C&AG's Report, Appendix 8

**Figure 3: Number and value of reported cases of irregularity, including suspected fraud, reported to OLAF by Member States for 2006 and 2007 (€ million)**

| Category of expenditure | 2006[a] | | | 2007 | | | Percentage Change 2006-2007 | |
|---|---|---|---|---|---|---|---|---|
| | Total number of cases | Total amount € million | Amount of suspected fraud € million | Total number of cases | Total Amount € million | Amount of suspected fraud € million | Total number of cases | Total Amount |
| Cohesion (Structural and Cohesion Funds) | 3,216 | 703 | 158 | 3,832 | 828 | 141 | 19.2 | 17.8 |
| Own Resources | 5,705 | 353 | 134 | 5,321 | 377 | 107 | -6.7 | 6.8 |
| Agriculture (EAGGF Guarantee Section) | 3,249 | 87 | 30 | 1,548 | 155 | 45 | -52.4 | 78.2 |
| Pre-accession funds | 395 | 14 | 2 | 332 | 32 | 5 | -15.9 | 128.6 |
| Direct expenditure [b] | - | - | - | 411 | 33 | 18 | | - |
| Total | 12,565 | 1,157 | 324 | 11,444[b] | 1,425 | 316 | -8.9 | 23.2 |

Notes:
a) The 2006 figures are restated as Member States often notify OLAF of irregularities (including suspected fraud) some time after the irregularity has occurred.
b) Commission departments reported figures for Direct expenditure to OLAF. They were reported for the first time in 2007; to ensure a like-for-like comparison they are removed from the year-on-year analysis.

*Source: C&AG's Report, page 39, Figure 11*

8. Member States reported to OLAF a total of 11,444 cases of irregularities, including suspected fraud, for 2007. The total value of these cases was €1,425 million, of which some €316 million (22%) was estimated as suspected fraud. The United Kingdom notified OLAF of 1,666 cases of irregularities, including suspected fraud, with a total value of €281 million. This is an increase over 2006 of 18% by number and 125% by value, and was due largely to the extensive control checks carried out in the Cohesion policy expenditure area.[11]

9. Assessing the precise levels of trends in irregularities, including suspected frauds, in terms of the number of cases and their geographical distribution is difficult. There are a number of reasons for this, including:

- the distinction between suspected fraud and other irregularities is not consistent across the Member States, as they have differing definitions of criminal offences and some do not distinguish between fraud and other irregularities at all, and
- data in **Figure 3** relates only to reported cases; some Member States report late and OLAF considers that it is possible that some are under-reporting.[12]

As a result, figures on reported irregularities and suspected fraud should be interpreted with caution and that it would be inappropriate to draw simple conclusions about the geographical distribution of fraud or the efficiency of services which contribute to the protection of financial interests. The quality of OLAF's data depends on the data received from Member States.[13]

11 C&AG's Report, para 2.44

12 C&AG's Report, para 2.45, Appendix 6, paras 6–7

13 C&AG's Report, para 2.45

# 2 Improving financial management

10. In 2005, we reported on financial management in the European Union and made a series of recommendations. These included the need for the Commission to strive for a positive Statement of Assurance and to simplify the rules governing schemes and programmes; and for the Court to give a clearer opinion on each of the individual expenditure areas and to undertake more value for money examinations.[14]

11. In 2006, the Commission published an 'Action Plan towards an Integrated Control Framework'[15] which identified specific actions which would lead to improvements in controls governing budget expenditure. These initiatives included:

i. Identifying a tolerable level of error by looking at the costs and benefits of the existing controls;

ii. Increasing the focus on recovering ineligible expenditure through increased financial corrections;

iii. Simplifying legislation, and

iv. Relying on Member States' audit of their use of European Union funds.

The following paragraphs outline some of the notable activities within each theme.

12. **Theme one:** In December 2008, the Commission published a paper to encourage debate on what error should be tolerated in different expenditure areas of European policy.[16] It is usual for auditors to set a threshold for the value of error which can be tolerated before the audit opinion must be qualified. For the Court this threshold is set at 2% of the value of the expenditure. The Commission's paper suggests that for expenditure areas with more complex regulatory regimes the level of tolerable error could be increased, as there comes a point where the costs of control exceed the value of the error prevented, detected or corrected, at which point it does not make economic sense to implement additional controls. The paper considers that the point where costs of control and benefits of implementing them are in balance could be the level of tolerable error, and the Commission has estimated the tolerable rate of error for Cohesion policy may lie around 5%.

13. **Theme two:** Legislation outlines how European funds should be spent. An irregularity arises if this legislation is not adhered to and the Commission can refuse to fund projects and recover monies through a financial correction. The Commission cites the level of corrections imposed as an indicator of the efficacy of its control systems. For 2008, it estimates that it will recover some €2.5 billion across both Agriculture and Cohesion policy expenditure, up from €1 billion in 2007. These corrections recover ineligible expenditure

14 Committee of Public Accounts, *Financial management in the European Union*, pages 5–6

15 *Communication from the Commission to the Council, the European Parliament and the European Court of Auditors—Commission Action Plan towards an Integrated Internal Control Framework COM (2006) 9*, European Commission, January 2006

16 http://ec.europa.eu/budget/library/sound_fin_mgt/com_2008_866_tolerable_risk.pdf

from the Member State, not from the final beneficiary of the expenditure. The Commission does not publish summary information on financial corrections by Member State.[17]

14. **Theme three:** The Action Plan recommended simplifying legislation as irregularities are more likely to occur when beneficiaries come up against complex eligibility criteria. The Commission simplified the regulations underpinning the 2007–13 Financial Framework, which sets out the budgetary priorities for the seven year period, and also simplified the Agriculture area by introducing the Single Payment Scheme. The Commission reported in early 2009, however, that simplification was not as extensive as it had hoped.[18]

15. **Theme four:** The Commission encouraged Member States to produce National Declarations on the use of European Union expenditure. In July 2008, the United Kingdom produced its first such declaration, an audited consolidated statement on its expenditure of European funds for 2006–07. The primary value of such declarations is to contribute to an improvement in financial management of European Union funds at an individual Member State level. This increased transparency at a national level may lead to a greater level of accountability and, as a result, reduce the level of errors observed, which is an essential condition for achieving a positive Statement of Assurance. As at March 2009 two other Member States, the Netherlands and Denmark, had produced this type of account.

16. Delivery of the Action Plan did not lead to a positive Statement of Assurance and improvements generated by the Plan will take some years to be realised. As we observed in 2005,[19] the key to reducing errors in European expenditure is the simplification of the often complex legislation in place in 27 countries and across seven expenditure headings. The rules governing European Union expenditure are complex as they are designed to achieve a range of outcomes in a variety of situations, in order to deliver prescriptive policy. But with such prescription comes complexity. The more situations the rules attempt to cover, the more complex the rules become and the greater the risk of error as national institutions and final beneficiaries are unable to apply the complicated rules correctly.

17. The problem of overly complex regulations is illustrated in the Cohesion policy area, which in 2007 suffered from at least 11% error. The start of a new Financial Framework for the period 2007–13 adds another layer of complexity, as although the 2000–06 Framework has ended, existing projects and related expenditure will not be completed until 2010. The different Frameworks have different rules governing the expenditure and so officials closing one set of programmes whilst opening others are working to two different sets of rules at the same time.[20] This increases the risk of errors being made.

18. The solution to such complexity does not lie in adjusting the level of tolerable error, which may, perversely, lead to an increase in the complexity of the regulations or a reduction in controls, as more error will be tolerated. Our concern at the risk of perverse

17 C&AG's Report, page 8, Recommendation iv

18 C&AG's Report, paras 3.8–3.23

19 Committee of Public Accounts, *Financial management in the European Union*, page 6, Conclusion 5

20 C&AG's Report, paras 2.38–2.39

incentives leads us to be highly sceptical about the proposed changes. The level of tolerable error should be considered in the context of monetary value, and as such it should not be increased, or used flexibly, because the regulatory regime is more complex. Whether a €1 million error, for example, occurs within a complex or a simple area of expenditure should not make any difference to its acceptability.

19. The Commission's increasing focus on recovering monies where errors occur increases the pressure on Member States to ensure expenditure is made in accordance with the rules. In the United Kingdom departmental resource accounts include provisions totalling over £400 million in 2007–08 relating to possible Commission financial corrections; some £100 million in financial corrections have since been imposed.[21] The recognition of, and provision for, possible financial corrections is entirely appropriate but the sums involved are worrying. They demonstrate that the United Kingdom's management of European Union funds falls short of our expectations, and formal financial correction means that the Exchequer and ultimately the United Kingdom taxpayer is funding the shortfall, as projects thought to be eligible for European funding will now be paid for instead by Parliamentary Supply.

20. Alongside the Action Plan, in May 2006 the European institutions agreed that the Commission should undertake a Fundamental Review of the European Union budget.[22] The objectives of the review include examining how the budget works and whether it should be managed differently. The review, which is due to report later this year, is therefore an important opportunity for European leaders to commit to budget modernisation, so that the Union is better able to deliver benefit to its citizens. As such it offers a rare opportunity to consider how financial management can be improved.

21 C&AG's Report, paras 2.15, 2.17, 2.33–2.34

22 C&AG's Report, paras 3.2–3.7

# Glossary

| | |
|---|---|
| Financial correction | Legislation outlines how European funds should be spent. If this legislation is not adhered to then the expenditure will be irregular. The Commission can refuse to fund projects with irregular expenditure and claw back any monies through a financial correction. |
| Financial Framework | The Parliament, the Council and the Commission agree in advance on the main budgetary priorities for a seven year period and establish a framework for Community expenditure, known as the Financial Framework. |
| Legality and regularity | Accounts are legal and regular if the underlying transactions conform to applicable laws and regulations and they are covered by sufficient budgetary appropriations. |
| Provision | A provision should be recognised in the accounts when an entity has a present obligation as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. |
| Reliability | Accounts are reliable if there is reasonable assurance that all account items are properly recorded and that the accounts faithfully reflect the financial position at the end of the year. |

# Formal Minutes

## Monday 15 June 2009

Members present:

Mr Edward Leigh, in the Chair

| | |
|---|---|
| Mr Richard Bacon | Mr Austin Mitchell |
| Angela Browning | Dr John Pugh |
| Mr Ian Davidson | Geraldine Smith |
| Nigel Griffiths | Rt Hon Alan Williams |

Draft Report (*Financial management in 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 20 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Glossary read and agreed to.

*Resolved,* That the Report be the Thirty-second Report of the Committee to the House.

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

[Adjourned till Wednesday 17 June at 3.30 pm

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