National Audit Office

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# Financial Management in the European Union

# Summary

**1** In 2008, expenditure from the European Union budget totalled €116.5 billion and revenues were €125.7 billion. The United Kingdom made a net contribution of €2.8 billion, the fifth largest, following an abatement of €6.3 billion.

**2** This report follows our annual practice of updating the United Kingdom Parliament on the efforts being made by the European Commission (the Commission), working with Member States, to strengthen the financial management of the European Union. It represents a compilation of the audit findings of the European Court of Auditors (the Court); information from the European Anti-Fraud Office (OLAF); the results of our own previously published audit findings on the use of European Union money in the United Kingdom; and a review of the various initiatives under way to strengthen financial management.

**3** The report outlines the key themes influencing performance in the financial management of European Union funds, including complexity and shortcomings in control systems, and covers:

- the 2008 budget and the Court's audit opinion on the 2008 financial statements (Part One);
- performance on the main expenditure areas and reported incidences of fraud and irregularity (Part Two); and
- initiatives to improve financial management and accountability (Part Three).

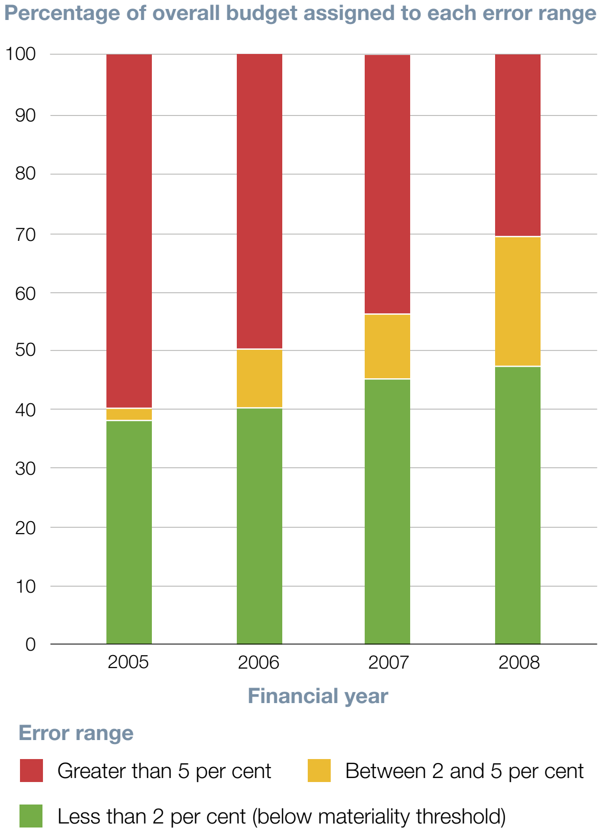
## Key findings

**4** In November 2009, the Court published its report on the Commission's implementation of the 2008 budget. For the second consecutive year, the Court provided a positive Statement of Assurance, without qualification, on the reliability of the accounts.

**5** For the fifteenth successive year, the Court did not provide a positive Statement of Assurance on the legality and regularity of most categories of European Union expenditure. For categories comprising 53 per cent of expenditure, including Cohesion and Rural Development, it reported a material level of error (**Figure 1**). The Court treats as material an error in excess of 2 per cent of total expenditure in that policy area.

**Figure 1**

The proportion of European Union payments between 2005-2008 affected by the three levels of error assigned by the Court




NOTE

1 The chart represents the percentage of budget according to the relevant error range established by the Court. In the case of the 'Agriculture and Natural Resources' area of the budget, the chart distinguishes between the 'Agriculture' and the 'Natural Resources' components.

*Source: The European Court of Auditors' Annual Report for the financial year 2008*

## Agriculture expenditure – 47 per cent of payments in 2008

**6** For the first time, agricultural expenditure achieved a "green" rating with its overall error rate falling just below the 2 per cent materiality threshold. Rural Development, which falls within the overall expenditure on agriculture, continued to contain a higher level of error, above the materiality threshold, but this has fallen since 2007.

**7** The Court raised a number of issues specific to the United Kingdom. These arose as a result of the United Kingdom's interpretation of European regulations differing from that of the Court, and from weaknesses with certain elements of the systems holding data used to generate payments. The European Commission did not agree fully with the Court's findings on the United Kingdom's interpretation of regulations and does not necessarily consider the expenditure brought into question by the Court to be irregular.

**8** In October 2009, the National Audit Office published a second progress report on the administration of the Single Payment Scheme in England. The report found that while the Department for Environment, Food and Rural Affairs (Defra) and the Rural Payments Agency (RPA) had brought forward the timetable for payments to farmers, progress in recovering overpayments has been slow and the RPA does not have a clear picture of the extent of overpayments, which the National Audit Office estimated to be between £55 million and £90 million.

**9** Defra and the RPA included provisions totalling some £247 million in their 2008-09 accounts, a balance brought forward from 2007-08, as an estimate for potential financial corrections arising from disallowed payments under the Single Payment Scheme and other remaining liabilities. During 2008-09, the Commission confirmed disallowance penalties of £92 million, £87 million of which related to Single Payment Scheme predecessors; the National Audit Office qualified the accounts of both Defra and the RPA on the grounds of irregular expenditure.

## Cohesion expenditure – 31 per cent of payments in 2008

**10** Cohesion projects are designed to reduce disparities in the level of economic, social and infrastructure development between regions. Expenditure on Cohesion continues to be the biggest source of error in the European Union budget. The Court concluded that this area was subject to material error, and reported that at least 11 per cent of the total amount reimbursed by the Commission in 2008 should not have been.

**11** The Court tested a sample of supervisory and control systems for recording, reporting and correcting errors found by Member States. It reported 'unsatisfactory' elements in five Member States, including the United Kingdom.

**12** While expenditure is being incurred on 2007-13 Financial Framework programmes, start-up has been slow. Closure of programmes from previous spending periods is ongoing. There is a risk that Member States will not utilise all European funding available; at the end of 2009, Scotland forfeited £16 million out of £27 million potential European support that it was unable to use within the two-year deadline set by the Council Regulation.

**13** In England, the Department of Communities and Local Government, which is responsible for European Regional Development Fund (ERDF) expenditure, included provisions of £75 million in its 2008-09 accounts for potential ineligible grant payments that may be subject to financial corrections. Similarly, in Scotland, there is a provision for £4.3 million. During 2008-09, the Commission confirmed disallowances of £47.3 million in respect of ineligible payments made during the 1994-99 ERDF programmes in the United Kingdom.

**14** The Department for Work and Pensions, which is responsible for European Social Fund (ESF) expenditure in England, recognised potential corrections of £38 million for liabilities that could arise as a result of closure procedures for the 2000-06 ESF programme. In Scotland there is a provision for £25.2 million.

## Irregularity and fraud

**15** Data from the European Anti-Fraud Office (OLAF) showed that the number of expenditure irregularities reported by Member States to the Commission, including possible fraud, increased by 9 per cent to 6,595 in 2008 from 6,047 in 2007, while decreasing in value by 24 per cent to €783 million from €1,024 million in 2007. The increase in number could be the result of: increased audit activity on Cohesion Policy programmes as the 2000-06 Financial Framework closure procedures are due for completion; and a change, in 2008, in the way some data was collected which limits year-on-year comparison, therefore data should be treated with caution. It is not possible to compare how the different Member States are performing due to different practices used at a national level for classifying cases and differences in timeliness of reporting.

**16** In 2008, the United Kingdom reported 490 expenditure irregularities (597 in 2007) with a total value of €124 million (€165 million in 2007). For Agriculture the reduction may partly be due to a delay in reporting, reflecting technical difficulties experienced with a new Europe-wide electronic reporting system. For Cohesion, a large amount of additional work was undertaken in 2007 in response to a number of control system weaknesses identified by the Commission which led to an increase in the number of reported cases; it was not necessary to repeat this work in 2008.

## Efforts to improve financial management

**17** In May 2006, the European Parliament, the Council and the Commission agreed that the Commission should undertake a review of the European Union budget, to report in 2008-09. The fundamental review of the budget is ongoing and offers an opportunity to realign the focus of European support and consider how financial management can be strengthened. The European Council set the Commission a deadline of December 2009 to present the budget review; the review has yet to be published.

**18** In December 2008, the Commission published a paper examining the concept of a tolerable risk of error in spending European Union funds. This paper argues that some expenditure areas are inherently more complex than others and therefore more prone to error. It advocates that different levels of materiality should be set for each policy area to reflect the cost of the additional controls that would be required to reduce error levels to acceptable levels. In a report published in June 2009, the United Kingdom Committee of Public Accounts noted its concern that such a proposal would remove the incentive to simplify the rules of European expenditure regimes that it considered essential to improve financial management.

**19** In October 2009, HM Treasury published the second audited Consolidated Statement on the use of European Union Funds in the United Kingdom covering the 2007-08 financial year. The audit report was qualified due to uncertainty over the completeness and reliability of data concerning transactions and balances and the inconsistent application of accounting policies across the Devolved Administrations of the United Kingdom. Whilst all entities complied, in all material respects, with reporting requirements in producing their own financial statements, transactions and balances have not always been recorded in a consistent manner for the purposes of the Consolidated Statement. The Netherlands, Denmark and Sweden produce their own versions of a national statement of European Union expenditure.

## Conclusion on financial management

**20** Over recent years there has been a detectable improvement in the financial management of European Funds across the European Union, most notably in agriculture which, with the exception of Rural Development expenditure, for the first time received a clear audit opinion from the European Court of Auditors for 2008. A series of initiatives have been put in train to deliver further improvements.

**21** There remain, however, seemingly intractable problems with reducing the high level of error associated with some significant areas of European Union spending, most notably Cohesion Policy. Whilst controls can be tightened and administration improved, many of the problems can be attributed to the sheer complexity of these programmes, implemented by large numbers of bodies, applying detailed and complex rules to multi-annual programmes that can take years to close-off beyond the end of their planned life. Some changes have been introduced for programmes in the 2007-13 Framework period but it is still too early to judge their likely impact.

**22** Weaknesses in the administration of European programmes in the United Kingdom over a period of years continue to have an impact on the taxpayer. During 2008-09, the United Kingdom received confirmation from the Commission of disallowances totalling some £140 million; made provision for further potential disallowances totalling £350 million in their 2008-09 accounts; and reported the potential for liabilities beyond that. This reflects a legacy of weaknesses extending back some years in specific areas, including the Single Payment Scheme in England, but it also illustrates a clear need for United Kingdom bodies to have in place controls over current and future expenditure of European monies that are sufficient to prevent the taxpayer suffering further significant disallowances into the future.

**23** Over the next year or so, the European Budget Review and work on developing the Financial Framework, commencing in 2014, will provide a key opportunity to press the case for simplification, creating programmes with clear and measurable objectives that add value, that are simple to apply, and capable of being managed efficiently from start to finish. Departments should press vigorously for substantive improvements to the design of the new programmes.

## Recommendations

a **The significant ongoing error rates associated with some elements of European Union expenditure, particularly on Cohesion Policy, are in part a reflection of the sheer complexity of administering these programmes.** In the next year or so the European Commission has a unique opportunity to develop programmes for the years ahead that address the weaknesses that have been evident. United Kingdom departments should develop a clear view on how they wish the main programmes to develop, including the need for clear and measurable objectives that identify the added value to be delivered. From the start they should press for programme design that promotes efficient administration consistent with the achievement of the objectives.

b **The number and value of irregularities for each policy area reported to the European Anti-Fraud Office (OLAF) varies significantly for each Member State from year to year.** Differences in recording practices amongst Member States and incomplete data reported to OLAF hinder any attempt to draw comparisons over time and between Member States. These weaknesses have persisted for some years. The United Kingdom Government should encourage OLAF to make known, alongside its published figures, where it has concerns about the quality and timeliness of the information submitted by individual Member States.

c **The United Kingdom was subject to financial corrections of £140 million imposed by the Commission during 2008-09 and has provisions for £350 million more.** It is not acceptable that departmental mismanagement reduces the funding available from the European Union and places an additional burden on Exchequer funds. HM Treasury should take a stronger lead in encouraging the effective financial management of European funds. In doing so it should set departments targets over the coming years to reduce the level of financial corrections with the ultimate target as close to zero as practicable.