



EUROPEAN COURT OF AUDITORS

**SPEECH BY MR VITOR CALDEIRA,
PRESIDENT OF THE EUROPEAN COURT OF AUDITORS**

**PRESENTATION OF THE 2007 ANNUAL REPORT TO THE
COMMITTEE ON BUDGETARY CONTROL OF THE
EUROPEAN PARLIAMENT**

BRUSSELS, 10 NOVEMBER 2008

The spoken text will prevail in the event of differences

Dear Chairman,
Honourable Members,
Ladies and Gentlemen,

It is an honour for me to present to this Committee the European Court of Auditors' **Annual Reports on the 2007 financial year.**

In addition to the Annual Report on the implementation of the 2007 general budget and the Annual Report on the **European Development Funds**, the Court has adopted **29 Specific Annual Reports** on the EU agencies and other decentralised bodies this year.

The Court adopted 11 **Special Reports** since the last discharge procedure providing the results of our performance audit work on diverse subjects ranging from the effectiveness of technical assistance in the context of capacity development, the control, inspection and sanction systems relating to the rules on conservation of Community fisheries resources to the evaluation of the EU Research and Technological Development (RTD).

Similarly, the Court has issued 6 **Opinions** on various issues of financial legislation and amendments to the Financial Regulation. Furthermore, the Court has contributed to the Commission's communication 'Reforming the Budget, Changing Europe'.

The 2007 Annual Report is structured around **groups of policy areas**, which correspond closely, but not entirely, with the 2007-2013 financial framework headings. As a consequence, compared to previous years, two new specific assessments have been introduced, one on Education and citizenship and one on Economic and financial affairs (previously covered under Internal policies), and two previous assessments (Pre-accession aid and External actions) have been merged into one on External aid, development and enlargement.

I wish to divide my presentation in four parts:

- the **overall messages** within the 2007 Annual Report;
- issues of relevance to **supervision and control**;
- **developments** observed in 2007 (assessment by area), and
- suggested **measures for the future.**

OVERALL MESSAGES

The Court concludes that the 2007 **annual accounts** of the European Communities give a fair presentation, in all material respects, of the financial position of the European Communities and the results of their operations and cash flows. The qualifications expressed in last year's annual report on the 2006 accounts are, due to the improvements that have taken place, no longer necessary. This is a positive development: for the first time under the accruals based accounting rules, the Court provides an unqualified opinion on the consolidated accounts.

As regards the **legality and regularity of the transactions** underlying the accounts, for 2007 the Court gives unqualified opinions for revenue, commitments and payments for economic and financial affairs and Administrative and other expenditure. In these areas the Court concludes that transactions are free from material error and supervisory and control systems are implemented in a manner which ensures adequate management of the risk of illegality and irregularity.

For Agriculture and natural resources; cohesion; research; energy and transport; external aid, development and enlargement; and education and citizenship the Court concludes that payments are still materially affected by errors, although to different degrees. Supervisory and control systems covering these areas are judged to be only partially effective. The Commission and the Member and other beneficiary states need to make further efforts to improve risk management.

In research, energy and transport the Court notes certain improvements in the supervisory and control systems. The same is true, at the level of the Commission, for the supervisory and control systems covering external aid, development and enlargement. In both instances these changes are however not significant enough to alter the nature of the opinions given.

Overall, the Court's audit opinion on the EU accounts is now unqualified while the opinion on underlying transactions remains broadly similar to that of last year.

To understand why material levels of error of legality and regularity persist, we need to examine the weaknesses related to **SUPERVISION AND CONTROL**.

The Court's audit has shown over the years that significant amounts of EU funds under **shared management** are irregularly spent. In these areas the EU funds are disbursed to millions of beneficiaries across the Union based on self-declaration of those who receive the funds; this is **inherently risky**.

Errors in general occur because final beneficiaries overstate costs, misunderstand or misapply the often **complex rules and regulations** that govern EU funds. This complexity can also lead to mistakes on the part of those paying out the funds. For 2007 the Court's audits in the areas of Agriculture and natural resources, Cohesion, Research, energy and transport as well as Education and citizenship show that such complexity has a considerable impact on the legality and regularity of payments.

To control these risks, there are **several layers of supervision and control** over EU funds: primary controls at the level of beneficiaries; secondary level controls to check that primary controls are designed and operating effectively and finally supervision by the Commission to ensure the working of the systems as a whole.

Since the majority of errors occur at the level of the final beneficiary they can however often only be detected by **primary level** - on-the-spot - controls. On-the-spot checks usually cover only a small proportion of individual claims, largely because of the costs involved. The Court finds weaknesses concerning the checks in agriculture and cohesion policies corresponding to weaknesses within the relevant authorities of the Member States. Cases of poor quality primary controls were also identified for direct management, including checks by the Commission on reimbursements to research beneficiaries failing to operate satisfactorily and poor quality audits carried out by independent auditors on individual claims.

Poor performance in primary level controls cannot be compensated for directly by **secondary level** controls. The effectiveness of the latter is therefore determined by their ability to promote adequate control arrangements at the primary level, rather than the ability to detect and correct individual errors. The Court's audit work on the 2007 financial year again found that secondary level checks by Member States and the Commission are not achieving the desired level of effectiveness. For example, the Court found weaknesses in the Commission's conformity clearance in agriculture, in audits in cohesion spending and in ex-post financial audits in Research, energy and transport.

Weak primary and secondary controls cannot be compensated for by the **Commission's supervision**. The purpose of this supervision is to ensure that adequate primary and secondary level control arrangements are in place, and are being operated effectively. Weaknesses at the lower levels should be identified (for example in annual activity reports), and measures should be taken to remedy the situation.

In many areas of the budget, mechanisms exist for **recovering incorrectly made payments** from beneficiaries or, where Member States have incorrectly administered expenditure schemes, "disallowing" some expenditure, i.e. refusing to finance it from the EU budget. It is sometimes claimed that, over time, these corrective actions correct or compensate for the errors in payments detected by the Court.

The Court's audit has highlighted that the Commission does not yet have reliable information on either the impact of corrective actions or their consequences for beneficiaries and for the budgets of the EU and Member states. The information provided on the correction mechanisms applied for agriculture and cohesion policies at Member State level is incomplete and unreliable. The Court concludes that corrective actions currently cannot yet be considered to be effective in mitigating errors and do not always ensure funds are recovered from those who wrongly receive them.

It is fair to acknowledge that the *Commission has made significant efforts* since 2000 to address the existing weaknesses in supervision and control systems, mainly through developing and implementing a reform programme to improve the management of the EU budget, centred mainly around its own responsibilities. In early 2006 the Commission launched an action plan for further improving the supervisory and control systems of the Union.

For 2007, the Court has identified further progress in the Commission's supervisory and control systems, in particular in the area of **monitoring and reporting**.

Regarding the Commission's Directorates-Generals' management representations, most annual activity reports and declarations, including those relating to cohesion and agriculture, are now more in line with the Court's own assessments. The financial impact of the reservations is higher than previously. However, the scope and scale of some reservations still appears to underestimate the problems.

In its **synthesis report** the Commission acknowledges that further efforts are needed to resolve a number of weaknesses in internal control systems, not only those highlighted by its Directorates-General but also others belonging to areas not considered satisfactory by the Court. The Court underlines that the Commission's assessment of its progress in improving control systems should focus not only on the introduction of the measures, but also on their effectiveness.

Concerning its **2006 action plan**, the Commission considers that, by the end of 2007, two thirds of the plan's sub-actions have been implemented. However, the Court notes that it is still too early for their impact on the legality and regularity of underlying transactions to be felt.

The Treaty requires Member States to cooperate with the Commission in implementing the EU budget to ensure that funds are used in accordance with sound financial management principles. There is a tendency towards an increased role for Member States, and often national SAI's, in the supervision and control of EU funds.

For example, 2007 was the first year for which Member States were required to produce an **annual summary** of available audits and declarations. The Annual Summaries, as well as voluntary initiatives from Members States to issue National Declarations can stimulate, as outlined in the Court's opinion 6/2007, improved management and control of EU funds

Although the process was adequately supervised by the Commission, annual summaries do not yet provide (e.g. due to the disparity of presentation) a reliable assessment of the functioning and effectiveness of the systems.

The Court endeavours to make use of the national SAIs' audit work on national declarations, under the conditions outlined in its opinion 6/2007. In general the Court aims to improve the cooperation with national SAIs, both by developing common auditing standards tailored for the EU area together with its fellow SAIs, and by bilateral cooperation with individual SAIs.

Allow me to focus now on the **DEVELOPMENTS OBSERVED in 2007** in the main groups of policy areas. What have we observed?

A quick answer is that the Court has found a **mixed picture** as you can see in the "traffic lights" diagram. Let us look at the individual specific assessments.

In the area of **cohesion**, the Court's 2007 audit findings concerned payments in respect of the 2000-2006 period, as spending for the 2007-2013 period for 2007 is only in the form of advances. As such, any improvements in the control systems for the new period will only become evident in future years.

The Court has established a sample estimate, based on which it concludes that at least 11 % of the total amount reimbursed should not have been reimbursed. In the cases audited by the Court this year the most frequent causes of incorrect expenditure reimbursements in the Structural Funds were inclusion of ineligible costs, over-declarations of money spent and serious failures to respect procurement rules.

The Court's estimate of the overall level of error in **agriculture and natural resources** is not significantly different from the value obtained last year, but does not take account of certain serious errors which could not be quantified.

Rural development accounts for a disproportionately large part of the overall error while for EAGF expenditure the Court estimates the value of the error rate to be slightly below the materiality threshold (2%).

The integrated administration and control system for agriculture (IACS) continues to be effective in limiting the risk of irregular expenditure where properly implemented and if accurate and reliable data on entitlements are introduced. The recent introduction in the single payment scheme (SPS) of support measures, such as those related to olive oil, is a positive development although it entails new risks that might lead, in the short term, to a higher frequency of errors. The Court considers that the systems for calculating entitlements were only partially effective and that they do not yet provide reasonable assurance that the annual SPS payments are correct.

For expenditure related to **external aid, development and enlargement**, the Court found errors concerning eligibility and lack of supporting evidence. Furthermore, delegations in beneficiary countries are still not succeeding in preventing weaknesses at project level while the Commission's system of checks on its own payments and contracts was generally effective.

The Court found improvements in the Commission's project audit system, although the quality of such audits is still not always sufficient. Procedures have to be further developed to derive full benefit from the additional risk-based project audits.

For the **research, energy and transport** area of expenditure, the Court concludes that, despite some improvements, the Commissions' supervision and control is only partly effective in mitigating the risk of overstatement of indirect costs (overheads) and personnel costs mainly due to a complex legal framework, with a large number of eligibility criteria. The Court has found that audit certification has not solved the problems and sanctions are not sufficiently applied. Recommendations focus on a possible introduction of a results-based, rather than input-based, financing system.

As regards payments underlying the policy group **education and citizenship**, the Court concludes that they are affected by a material level of error of legality and regularity. Its assessment of the supervisory and control systems is that they are only partially effective for the policy group as a whole.

The Court concludes that transactions in the area of **administrative expenditure** are free from material error and the supervisory and control systems in place conform to those required by the Financial Regulation. The Court acknowledges decisions and actions taken by the different institutions, including Parliament, based on previous recommendations made by the Court.

Finally, for **revenue** transactions and the **economic and financial affairs policy group** the Court concludes that they are free from material error and related supervisory and control systems are assessed as effective, although the Court draws attention to certain weaknesses.

This is the current situation. But, looking forward, we need to ask what more should be done, which **MEASURES FOR THE FUTURE** should be considered. Any such measures need to take the following principles into account.

A high level of supervision and reporting - although important - cannot compensate for inadequate lower level controls. However, the benefits of increasing the number of on-the-spot checks have to be weighed against the costs. All participants in the budget process need to recognise that not all final beneficiaries can be checked on-the-spot, and therefore there

will always be some residual risk of error. A key issue is, therefore, to manage the risk in order to keep it at an appropriate (tolerable) level. Costs of control are an important issue, both for the EU budget and Member or beneficiary States. The **cost/risk balance** in individual areas is of such importance that it should be approved at the political level (i.e. by the budget/discharge authorities) in the name of the citizens of the Union.

If a scheme cannot be satisfactorily implemented at an acceptable level of cost and with tolerable risk it should be reconsidered.

Establishing an internal control framework around these principles would allow control systems to be defined in terms of what they should achieve (output targets), as well as laying down agreed criteria against which to judge and audit their performance. The Court encourages the Commission to conclude its analysis on the cost of controls, and on the different levels of risk inherent in the spending areas. A realistic, transparent, rational and cost-effective approach to risk management would, in the Court's view, benefit contributors and beneficiaries alike.

The Court recommends the Commission to continue implementing the measures and actions aiming to improve its **monitoring and reporting**. The Commission should ensure that annual activity reports and declarations present a consistent assessment of the systems, compatible with the reservations presented. It should also collaborate with Member States to improve the information provided in annual summaries and demonstrate how it is used for increased assurance or added value in annual activity reports. Furthermore, it should complete an appropriate follow-up of the relevant measures of the action plan, including that on recovery systems. The Court gives a number of recommendations on improving the information on these multi-annual corrections and their impact.

The Court also calls for due consideration to be given to **simplification**. Well designed rules and regulations which are clear to interpret and simple to apply decrease the risk of error, streamline the required controls and consequently also reduce their cost. In areas such as rural development and research the Court has consistently advised the political authorities to consider simplifying the regulatory framework.

In conclusion, Mr. Chairman, I would like to draw your attention to the more wide-ranging approach taken by the Court in its contribution to the current **review of the EU budget**, launched by the Commission in 2007. This review should address the quality of EU

budgetary transactions - legality, regularity and value for money - as well as spending priorities and equity.

The Court stresses key principles to be applied in designing arrangements for EU spending: clarity of objectives, simplification, realism, transparency and accountability. The Court also recommends the political authorities to be prepared to think radically about the design of expenditure programmes for example by recasting them in term of outputs, by considering critically the appropriate level of national, regional and local discretion in managing programmes and by making better use of the concept of tolerable risk. It is better to set up schemes that run with relative ease than to attempt to compensate for complex eligibility procedures by complex governance and management arrangements.

Mr. Chairman, Honourable Members,

In times of financial turbulence and economic instability, the role of the Court is even more important and relevant. As the EU's external auditor it is our obligation to act as the independent guardian of the financial interests of the citizens of the Union. In presenting this annual report, it is our objective to contribute towards transparency and promote accountability, both essential factors in securing the ongoing trust of EU citizens in the Institutions that provide the basis for the functioning of the Union and direction for sustaining it into the future.

I kindly thank you for your attention.