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**REPLIES OF THE COMMISSION TO THE SPECIAL REPORT OF THE
EUROPEAN COURT OF AUDITORS**

**"ACHIEVING ECONOMY: KEEPING THE COSTS OF EU-FINANCED RURAL
DEVELOPMENT PROJECT GRANTS UNDER CONTROL"**

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EXECUTIVE SUMMARY

II. The Commission is fully committed to achieving better economy and efficiency in rural development expenditure, in particular when awarding grants for investment operations to private and public beneficiaries (reasonableness of costs). To this end, the Commission has adopted a more active and coordinated approach, with greater focus on economy, which it expects will lead to better financial management in the next MFF, as shown in the replies below.

III. The Commission carries out conformity audits in the Member States to verify that the expenditure paid is in compliance with the rules. In these audits the Commission has also found weaknesses regarding the reasonableness of costs. Financial corrections have already been made in this respect and a number of conformity clearance procedures are currently ongoing and should lead to further financial corrections.

IV. Paying agencies must comply with the accreditation criteria laid down in Annex I of Regulation 907/2014 (programme 2014-2020) before any payments may be made. Article 24(2)(d) of Commission Regulation (EU) No 65/2011 required Member States to assess the reasonableness of costs during administrative checks using a suitable evaluation system, such as reference costs, comparison of offers or evaluation committee. This provision has been maintained for the 2014-2020 period.

V. Initially, the provisions on the evaluation of the reasonableness of costs submitted were regarded as self-explanatory.¹ Indeed, at the time of recasting the previous legal framework which took place in spring 2010², no major difficulties had been brought to the attention of the Commission on this point. In the approval process of the recast, only one question (whether maximum costs were a suitable method) was presented and answered.

VI. Reply to VI (a)-(d)

During its own audits, the Commission has found similar weaknesses to those indicated by the Court and financial corrections have been applied to cover the risk to the fund. Some conformity clearance procedures are still ongoing and are likely to lead to further financial corrections.

The action plans developed by the Member States in the exercise of reducing the errors in the implementation of the rural development measures include better methods for assessing the reasonableness of costs.

For the 2014-2020 programming period the enhanced use of standard costs should reduce the risk of errors in this respect.

VIII. The ENRD will disseminate good practices through dedicated seminars and webpages.

¹ Article 24(2)(d) of Commission Regulation (EU) No 65/2011

² Regulation (EC) No 1975/2006

IX. The Commission accepts the Court's recommendation that Member States should have an effective and efficient control system in place up front. It will encourage the Member States to use the check-list and the criteria developed by the Court and contained in Annex I.

By January 2015, the Commission will also provide guidance on controls and penalties under rural development, including a specific section on reasonableness of costs and the checklist for Managing Authorities annexed in the Special Report.

Furthermore, training and sharing of experiences will be part of the European Network for Rural Development (ENRD) activities in the 2014-2020 period.

INTRODUCTION

3. As mentioned by the Court, the Commission carries out conformity audits in the Member States to verify that the expenditure paid is in compliance with the rules. In these audits the Commission has also found weaknesses regarding the reasonableness of costs. Financial corrections have already been made in this respect (e.g. 19 million euros for Bulgaria) and a number of conformity clearance procedures are currently ongoing and should lead to further financial corrections.

On 19/12/2013 the Commission adopted guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement. According to these guidelines, the non-respect of procurement rules is to be judged based on the principle of proportionality.

4. The Commission agrees that additional savings could be made and will take the Court's observations into account.

5. For the 2014-2020 programming period the possibility of using standard costs will be generalised and encouraged. This should reduce the risk for the Fund and also reduce the administrative burden for the Member States.

15. In its own audits, the Commission always assesses the reasonableness of costs for investment measures and the respect of public procurement procedures.

Almost all audits conducted by the Commission identified weaknesses with regard to the reasonableness of cost. These weaknesses should be addressed by the Member States and they are followed up in subsequent audits.

DG AGRI's system- and risk-based audit strategy takes into account the findings from previous DG AGRI audits, from the European Court of Auditors, from OLAF and from the national certification bodies in order to identify the most risky areas where future audits shall focus. In addition, the audit strategy for the period 2014 – 2020 will ensure a better coverage of the overall expenditure and intensive audit activities will continue to cover the most risky areas.

The action plans on "error rates" include preventive and corrective actions to address weaknesses related to the reasonableness of costs if such weaknesses have been detected by the Commission or the European Court of Auditors' audits.

The new CAP Regulation (EU) No 1306/2013 provides that the Commission may reduce or suspend interim payments to Member States if control systems are not effective or when remedial measures have not been implemented. A fast tool will be the possible interruption of interim payments in case of concerns on the legality and regularity of payments.

Considering the above, the Commission is confident that deficiencies will be revealed earlier, and that this will lead to a better mitigation of risks and a faster implementation of the necessary corrective actions.

21. The EAFRD is implemented under shared management. The Commission implements the budget and implementation tasks are shared with the Member States. The latter are required to take the necessary measures to ensure that the actions are financed correctly and in accordance with EU rules. While DG AGRI is fully assuming its responsibilities, the detection and correction of errors are first and foremost in the hands of the Member States.

The Commission carries out conformity audits in the Member States to verify that the expenditure paid is in compliance with the rules. These conformity audits could lead to financial corrections and a list of recommendations on how to improve the management and control system.

When Member States do not implement proposed actions, they may be subject to suspension of payments and financial corrections.

22. In addition, the Commission now also has the right to suspend payments under certain conditions, i.e. if there is a serious deficiency in the effective functioning of the management and control system and the Member State has failed to take the necessary action to remedy the situation.

24. Joint reply to paragraphs 24-28:

Financial corrections have already been made in this respect and a number of conformity clearance procedures are currently ongoing and should lead to further financial corrections.

In almost none of the audits performed by the Commission the reasonableness of costs could be considered as totally satisfactory. When such weaknesses were found, apart from the financial consequences, recommendations were issued. In some cases this led to corrective actions.

In its 2013 annual report, the European Court of Auditors observed that the Member States had enough information to detect and correct the majority of the errors found in the area of rural development. For investment measures, the Court observed that Member States could have detected and corrected all quantifiable errors in the transactions reviewed.³

It should be noted that the weaknesses identified by the Court in its audits for its annual reports are followed up by the Commission through desk audits or conformity audits or by the certifying body.

29. As described by the Court in paragraph 33, following the analysis, four seminars were organised with the Member State authorities. During the seminars the issues linked to the reasonableness of costs and public procurement were discussed and good practises shared. Member States are also implementing action plans on error rates, which in some cases include actions to improve the assessment of reasonableness of costs.

In the particular case of public procurement, a guidance document on most common irregularities in the management of ESI Funds has already been presented to Member States (4th Seminar Error Rate, Oct 2014).

30. For the new programming period 2014-2020, the Commission put forward simplified cost options (Flat rate financing, Standard scales of unit costs, Lump sums) as an efficient means to ensuring reasonableness of costs.

³ European Court of Auditors' Annual Report 2013, paragraph 4.8

Regulation (EU) No 1303/2013 includes options for the European Structural and Investment Funds to calculate eligible expenditure of grants and repayable assistance on the basis of real costs, but also on the basis of flat rate financing, standard scales of unit costs and lump sums.

Guidance on Simplified Cost Options (SCOs) has been prepared by the Commission in order to provide technical guidance on the three kinds of simplified costs applicable and to share the best practices with a view to encouraging Member States to use simplified costs. However, it is up to the Member States to decide whether to use the simplified cost options.

In a seminar on error rate organised in October 2014, guidance on how to prevent irregularities under public procurement procedures was presented to managing authorities and paying agencies of all Member States. Finally, guidance on controls and penalties under rural development will be made available before the end of 2014.

In addition, on 19/12/2013 the Commission adopted guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement.

As regards the assessment of the control systems in place, the Commission has found that well designed control systems were not always well implemented in practice.

32. The action plans were introduced following the Court of Auditors' findings in its annual report 2011. This has been a substantial task for the Member States.

The Commission has developed detailed tools to improve the quality of the action plans to address the root causes of error. These included the preparation of guidelines on topics such as simplified costs, public procurement, verifiability and controllability of the measures in the rural development plans as well as organising specific anti-fraud strategies.

In the latest update (September 2014) of the action plans, Member States had to take into account the Court and the Commission's audit findings to a much larger extent. Indeed, 46% of the actions presented by Member States addressed concrete audit findings, 50% of which came from the Court's reports.

It should be noted that the Commission's powers have been strengthened with the new CAP Regulation (EU) No 1306/2013. Article 41 (2) provides that interim payments to the Member State may be suspended or reduced when it is found that key components of the national control system are not effective or when the necessary remedial measures have not been implemented. Article 36 (7) provides for the interruption of interim payments as a first quick and reactive tool in case of concerns on the legality and regularity of payments.

Furthermore, in order to avoid financial corrections, each paying agency for which reservations have been made in DG AGRI's annual activity report, will have to act promptly.

33. In addition, the Commission provides anti-fraud seminars to the Paying Agencies in the Member States (and Candidate Countries). The seminars aim at sharing information on areas with a high risk of fraud and how to detect and prevent it. By the end of 2014, the following Member States will have been covered by these seminars: Austria, Belgium (Flanders), Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Latvia, Netherland, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain and Sweden. Seminars in the remaining Member States are under preparation.

34. In the 2007-2013 period for the majority of the rural development investment measures, there was no specific legal basis for the use of simplified cost options. Regulation (EU) No 1303/2013 (Article 67-68) has included the possibility for all European Structural and Investment Funds to implement these options and, therefore, it is expected that, with the help

of enhanced guidance by the Commission, a bigger share of the expenditure will be based on simplified cost options in the new programming period. Of course it is ultimately up to Member States to decide whether they want to make use of simplified cost options.

35. The action plans are focused on identification and correction of main sources of irregularities in the expenditure, including weaknesses in checking the reasonableness of costs. In fact, the Staff Working Document presented in June 2013 by the Commission⁴ included the poor assessment of the reasonableness of costs as one of the main roots of errors (RC10). Since then, Member States have progressively identified shortcomings in this field and have launched preventive and corrective actions.

42. See reply to paragraph 34.

Replies 44-49:

The monitoring and evaluation systems set up by Member States following Annex IV of R. 808/2014 (RD Implementing Act) could be a useful tool to assess the reasonableness of costs in the light of the outputs, results and impacts achieved and/or planned. The Commission will recommend Member States to improve the cost-efficiency and cost-effectiveness assessment of individual projects and operations.

52. Specific workshops on anti-fraud strategies are being organised in almost all Member States by DG AGRI.

See reply to paragraph 33 for further details.

54. Good practices in this field will be shared through the ENRD during the 2014-2020 period.

61. There are different methodologies that can be applied in order to determine the simplified cost options, as spelt out under Art 67(5) of Regulation (EU) No 1303/2013. Furthermore, according to Art 62(2) of Regulation (EU) No 1305/2013, the managing authorities shall include in their rural development programmes a statement confirming the adequacy and accuracy of the calculations. This statement must be carried out by a functionally independent body.

62. Under the current legal framework, the Commission cannot oblige Member States to update or periodically review the simplified cost options' methodology put in place by the managing authorities following Art 67 of Regulation (EU) No 1303/2013, although the Commission encourages that the systems in place reflect the development of market prices over the time.

Box 7 - Standard unit costs based on theoretical calculations can overstate the available market prices, resulting in overpayments

For the coming 2014-2020 period, such a system should be based on a fair, equitable and verifiable calculation, taking into account, *inter alia*, statistical data, historical data or usual cost accounting practices.

Specifically for the investment measures: the Commission will encourage the Members States periodically review the simplified costs option methodologies to be in line with the market developments.

⁴ Commission Staff Working document on the assessment of root causes of errors and corrective and preventive actions in the rural development policy (SWD(2013) 244 final).

71. The Commission encourages Member States to ensure that the systems in place reflect the development of market prices over the time.

Common Commission reply to paragraphs 78 and 79

There may be circumstances when the use of a higher cost supplier can be justified, as the Court describes in paragraphs 47 to 52, but the Commission agrees that manipulation is not acceptable.

80. The extreme cases are indeed cases that have often been seen in OLAF investigations.

81. The implementation of Commission Delegated Regulation (EU) No 907/2014 will help in the prevention and detection of fraud. Annex 1 of this Regulation provides that the Paying Agency has to ensure that staff training includes fraud awareness.

Under the new Regulation (EU) No 1306/2013, Commission Delegated Regulation (EU) No 907/2014 and Commission Implementing Regulation (EU) No 908/2014, Member States are obliged to more specifically address fraud as a risk for the funds. This subject is also specifically addressed in the anti-fraud seminars (cf. reply to paragraph 33).

86. Good practices in this field will be shared through the ENRD during the 2014-2020 period.

90. Article 48(3) of Commission Implementing Regulation (EU) No 809/2014 obliges Member States to verify the completed operation compared with the operation for which the application for support was submitted and granted. This provision should allow Member States to detect cases where the final output is not the same as the one the beneficiary initially committed to.

103. Initially, the provisions on the evaluation of the reasonableness of costs submitted were regarded as self-explanatory.⁵ Indeed, at the time of recasting the previous legal framework which took place in spring 2010⁶, no major difficulties had been brought to the attention of the Commission on this point. In the approval process of the recast, only one question (whether maximum costs were a suitable method) was presented and answered.

In the meantime, the Commission has prepared guidance on Simplified Cost Options (SCOs) in order to provide technical guidance on the three kinds of simplified costs applicable and to share the best practices with a view to encouraging Member States to use simplified costs. However, it is up to the Member States to decide whether to use the simplified cost options.

In a seminar on error rate organised in October 2014, guidance on how to prevent irregularities under public procurement procedures was presented to managing authorities and paying agencies of all Member States. Finally, guidance on controls and penalties under rural development will be made available before the end of 2014.

In addition, on 19/12/2013 the Commission adopted guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement.

For the programme 2014-2020, the Commission put forward simplified cost options (Flat rate financing, Standard scales of unit costs, Lump sums) as an efficient means to ensuring reasonableness of costs.

⁵ Article 24(2)(d) of Commission Regulation (EU) No 65/2011

⁶ Regulation (EC) No 1975/2006

Regulation (EU) No 1303/2013 includes options for the European Structural and Investment Funds to calculate eligible expenditure of grants and repayable assistance on the basis of real costs, but also on the basis of flat rate financing, standard scales of unit costs and lump sums.

As regards the assessment of the control systems in place, the Commission has found that well designed control systems were not always implemented well in practice.

110. The Commission accepts this recommendation. Member States should ensure up-front that they have efficient control systems in place. The Commission will encourage the Member States to use the check-list and the criteria developed by the Court and contained in Annex I.

By January 2015, the Commission will also provide guidance on controls and penalties under rural development, including a specific section on reasonableness of costs and the checklist for Managing Authorities annexed in the Special Report.

Furthermore, training and sharing of experiences will be part of the European Network for Rural Development (ENRD) activities in the 2014-2020 period.

111. The Commission accepts this recommendation and will follow-up with the Member States the actions taken.

As regards the performance risks, the Commission will encourage Member States in the framework of regular meetings to share experiences and good practices.

In relation to compliance risks, in March 2014 DG AGRI adopted a new multi-annual audit strategy for 2014-2020. This audit strategy continues to be risk-based; in order to achieve optimal audit coverage, it now features a rolling three-year audit programme applicable as from July 2014. This programme is supported by a Central Risk Analysis (CRA) and will be reviewed annually.

Financial corrections deriving from these audits are based on identified weaknesses in the implementation of the control systems and on an estimation of the financial risk that these weaknesses entail for the EU budget. On the basis of its audits, the Commission can also identify the actual sources and causes of the errors found and request the Member States to elaborate specific and targeted remedial actions.