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EUROPEAN COMMISSION

Brussels, 10.9.2010
SEC(2010) 1012 final

REPLY OF THE COMMISSION TO THE SPECIAL REPORT
"AUDIT OF THE CLEARANCE OF ACCOUNTS PROCEDURE"

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EXECUTIVE SUMMARY

III. The Commission considers that within the overall framework for the management and control of agricultural expenditure, the new work required from the certification bodies is an important and useful element for the purpose of gaining reasonable assurance on the legality and regularity of the underlying transactions. These new requirements were first introduced for financial year 2007 and while modified and expanded for financial year 2008 have, since then, in substance remained unchanged. The new requirements were also discussed with the Certification Bodies in an annual conference.

As a result the situation in financial year 2009 (after the end of the audited period) has improved substantially for all the new elements of assurance mentioned (i.e. those concerning legality and regularity of payments).

IV. The conformity clearance procedure is designed to exclude expenditure from EU financing which has been incurred in a way that has infringed EU law. In contrast, it is not a mechanism by which irregular payments to beneficiaries are recovered which, according to the principle of shared management and the rules of Article 9(1)(a)(iii) of Council Regulation (EC) No 1290/2005 and Article 53b(2)(c) of the Financial Regulation, is the sole responsibility of Member States. Where irregular payments to individual beneficiaries are or can be identified as a result of the conformity clearance procedures, Member States are required to follow them up by recovery actions against these beneficiaries.

Article 31(2) of Regulation (EC) No 1290/2005 provides that financial corrections shall be determined on the basis of the nature and gravity of the infringement and of the financial damage caused to the EU. Where possible, the amount is calculated on the basis of the loss actually caused or on the basis of an extrapolation. Where this is not possible, flat-rates are used which, in accordance with the legal requirements, take account of the severity of the deficiencies in the national control system in order to reflect the financial risk for the EU. The Commission's system thereby establishes a clear hierarchy of methods to be used and therefore, the Commission does not agree that in a given case there are "options" open to it as to the type of financial correction to be applied. The Commission considers that there is a valid link between the amount of the correction and the amount of irregular payments made as a result of the deficiencies in the system. Conformity clearance includes cases where the deficiencies found are limited to the control system in place and cannot be linked to individual irregular payments to beneficiaries but, because of the flat rate approach taken for control deficiencies, the risk to the EU budget is covered, e.g. when a Member State does not accomplish the minimum number of controls.

Moreover, as agricultural expenditure is implemented under shared management, the Member States are better placed than the Commission to assess and provide evidence of the real financial loss or risk for the EU budget. The operational handbook explicitly recognises this and requires the Commission to take such evidence, if reliable, into account. A more precise calculation of the financial loss for the EU budget therefore requires the active co-operation of the Member State concerned at all levels of the conformity clearance procedure because only the Member State has all the necessary information to make such a calculation. Unfortunately, however, despite the Commission's requests, Member States often do not avail themselves of this possibility. Since the reform of the system in 1996, flat-rate corrections account for

slightly less than 70% of the amount of total corrections by value. However, the Commission considers it to be more appropriate to look at the number of cases with a financial correction where a flat-rate was used. Here, only 45% of all cases are based on a flat-rate approach and, if the last ten conformity decisions are taken, this percentage drops further to 37%. This demonstrates the Commission's continuous effort to limit the use of flat-rates as much as possible.

Since the methodology used by the Commission to calculate financial corrections is based on its best estimate of the risk to the EU budget, it cannot by definition amount to a sanction.

As part of this effort, the Commission recently set out to Member States the conditions under which it is prepared to limit the amount of any financial correction to the error rate found by the Member State, in the transactions at final beneficiary level and reported in its control statistics for the aid scheme concerned.

Financial corrections are an accounting correction and not a sanction on Member States' authorities. The flat rate methodology has been upheld by the Court of Justice as being in conformity with the legal rules governing the conformity work,. In particular, the Court of Justice has confirmed that it is not up to the Commission to undertake the checks necessary to put a precise figure to the losses incurred, but rather it is for the Member State to show that the Commission's estimate was excessive.

The use of flat rate corrections was also endorsed by the European Parliament in its 2007 discharge resolution (§ 83) for cases where Member States do not comply with their legal obligations.

Alternative methods for the calculation of financial corrections referred to by the Court would require a substantial increase in audit resources which would not be in line with any cost-benefit analysis.

V. The financial clearance decision is taken around six months after the end of the financial year in question. Through this decision, the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. The fact that the decision is without prejudice to subsequent conformity decisions imposing financial corrections on Member States is explicitly provided for in Article 30 of Regulation (EC) No 1290/2005 which has the same legal status as the Financial Regulation. Moreover, in substance, it is fully compatible with the Financial Regulation, which for any other expenditure provides that the Commission can make ex-post checks up to 5 years after the discharge decision on the year in which the final payment was made. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the 5-year period has lapsed.

The amount of expenditure which is likely to be excluded from financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements. Together with the financial clearance decision, this disclosure provides the European Parliament and the Council with the information they require for the discharge procedure.

The observation of the Court relates to a fundamental principle of the clearance of accounts systems as provided for in its current legal basis, which the Commission is bound to apply (since 1996). It was not objected to by any of the parties intervening in the adoption of the legislation. As such the observation could be best considered in the context of a possible review of the legislation.

VI. The Commission considers the current system to function well and to achieve its overall objectives. It will, however, continue to improve its operations in practice and, where

necessary, submit appropriate proposals for further improvements to the European Parliament and the Council for the post-2013 period.

INTRODUCTION

2. Article 42(1) of the Implementing rules dealing with the implementation of Articles 53b and 53c of the Financial Regulation defines that the purpose of the clearance of accounts shall be to ensure that expenditure by the Member States in the context of shared management [...] and which may be chargeable to the EU budget is in order and consistent with the applicable EU rules.

5. The Belle working group set up by the Commission in 1991 was mandated to study the operations involved in the clearance of accounts procedure in order both to assess their effectiveness and efficiency in achieving the general aims of the CAP and the Financial Regulation and, if necessary, to propose legislative and/or administrative means of enforcing those operations.

(b) Each financial correction included in a conformity decision is linked to a specific financial year which is identified in the Annex of this decision.

BOX 1

(b) The checks undertaken by the PAs are based on management and control systems for which the minimum requirements are laid down by the Commission.

6. Under the reformed system, the financial clearance decision is adopted by 30 April of the year following the financial year concerned. Thus the reformed clearance of accounts procedure has significantly accelerated the timescale for clearing the PAs' accounts.

PART I - THE FINANCIAL CLEARANCE OF ACCOUNTS

21. Reliance on the work of other auditors, where judged appropriate, is foreseen in International Auditing Standards and the Commission's guidelines. The CBs may rely on the work of the internal audit units (IAU) if they have sufficiently verified such work.

An audit mission in November 2009 to the Danish CB, covering primarily financial year 2009, did not reveal any major deficiencies in either body with regard to working documents and checklists.

With regard to the Court's observation in footnote 9 that in Denmark the IAU was involved in the selection process of the CB, which was finally contracted directly by the PA after proposal by the IAU, it should be noted that the CB's contract was renewed for financial years 2009 and 2010 with the signatory being the Competent Authority.

22. In the majority of cases the Court's findings relate to weaknesses in the CBs' documentation of their audit work, rather than the work itself.

CBs should compile sufficient audit evidence in support of their findings. The Commission considers this issue as part of its risk analysis, although it can only assess this directly during its visits to the CBs selected for audit. Although the exact layout and content of working papers and checklists should be left to the professional judgment of CBs, the Commission has made (and will continue to make) recommendations in this key area where it finds weaknesses.

Beyond the general requirements for substantive testing of expenditure according to guideline No 3, CBs are required for SPS to check that the payments can be derived from the underlying entitlements. However, there is no requirement to verify within the substantive testing the entitlements as such.

24. The guidelines have been revised for financial year 2009 to further clarify how the test of completeness and accuracy of the debtors' ledger and Annex III/IIIA of Regulation (EC) No 885/2006 should be carried out and reported upon. An analysis of the certification reports with regard to financial year 2009 shows that since the Court's audit improvements have been made in this respect.

In addition to the work carried out by the CBs, the Commission has over the past three years audited 14 PAs in 11 Member States as regards their follow-up of irregularity cases and their reporting under Annex III of Regulation (EC) No 885/2006. In general, the PAs have adequate procedures in place to protect the financial interests of the European Union. Deficiencies found during these audits are being followed in the context of conformity clearance procedures.

26. The Commission has recently put forward a system¹ by which Member States can, from 2010, reinforce the overall framework for gaining reasonable assurance on legality and regularity of transactions at the level of final beneficiaries. To this end, CBs should extend their work beyond the present requirements by fully reperforming, for a given expenditure population, a representative sample of transactions which the PA in question has checked on-the-spot. The work would cover the entire handling of the file, from receipt of the aid application to the calculation and execution of the final payment.

28. The Commission agrees that further improvements can and should be made and it is regularly raising the issue with the Member States. However, there is no requirement to test and assess each key and ancillary control that should be in place at the PA.

29. In the view of the Commission, an opinion on the internal control procedures would not require specific testing and assessment of the reliability of each key and ancillary control. Regulation (EC) No 885/2006 does not require the CB to conclude on whether all possible controls are operational, but it only requires the CB to review the paying agency's compliance with the accreditation criteria (Annex I of Regulation (EC) No 885/2006).

However, CBs would be required to assess these aspects under the new system described in the Commission's reply to point 26.

30. Where necessary the Commission has pointed out in formal communications to MS that delegated bodies shall also be identified and tested. There is, however, no requirement to visit and test every delegated body every year.

31. The modification aimed at clarifying obligations which already existed before and at improving the reporting from the CBs.

32. The Commission considers that the revised guidelines adequately specify the full scope of the audit task. PAs are expected to reconcile all information in their submitted annual questionnaires to the underlying database information. CBs are to check that this has been done and to indicate whether discrepancies have been found. They should also check the existence and adequacy of the audit trail.

To test the accuracy of the database, CBs must take a sample of at least 20 field inspection reports per set of statistics and check that the data they contain has been correctly entered into the database.

¹ Document D/413722/2009.

CBs are required to clearly conclude on the above elements. Notwithstanding the improvements in this area in financial year 2009, the Commission will consider whether further clarification in the guidelines is needed.

33.

(a) PAs are expected to perform this reconciliation. CBs are expected to check that it has been done properly. This was made very clear to Member States in the summary report for financial year 2008² and recommendations have been made in this respect to Member States (PAs and CBs) where appropriate. As a result, the Commission considers that the situation improved for financial year 2009. According to the reports of the CBs for financial year 2009, a complete reconciliation was accomplished for the majority of paying agencies.

(b) – (c) Joint reply to points (b) and (c):

The Commission acknowledges the deficiencies identified by the Court concerning financial year 2007 and 2008 and has raised these issues with the Member States concerned. As a result, the Commission considers that the situation has improved significantly for financial year 2009. An analysis of certification reports shows that in around 90% of cases, the CBs carried out the work at the levels required by the Commission's guidelines, with a few exceptions.

34. For the reasons set out below, the Commission takes the view that the shortcomings identified do not place significant limitations on their use for assurance purposes by the Commission:

- The error rates established by the Commission on the basis of the control statistics provided by the Member States are consistent over several years.
- An analysis of the certification reports with regard to financial year 2009 shows that clear improvements have been made by CBs.
- The statistical information is the result of a very large sample of applications checked³ and even if a safety margin of a 25 % increase in the error rates were applied, the residual error rates would still be below 2 %.
- The error rates established by the Court in its DAS 2008 exercise are consistent with the residual error rates established by the Commission on the basis of the control statistics provided by the Member States.

With regard to the sampling methodologies used by the PAs in selecting claims for on-the-spot checks, random based samples are normally required. Although the random based samples do not follow a statistical methodology such as monetary unit sampling (MUS), the samples are normally large enough to provide reasonable assurance as to their representativeness.

35. The Commission acknowledges the deficiencies identified by the Court concerning financial years 2007 and 2008 and it has already disclosed the information in the AAR of those years. It has raised these issues with the Member States concerned and considers that, as a result, the situation has improved significantly for financial year 2009. An analysis of the CBs reports shows that they carried out the work at the levels required by the guidelines, with

² AGR/2009/80073-00-03/EN of 3 April 2009

³ SPS/SAPS: 600 315 applications checked; animals: 798 119 animals checked (suckler cow premium and special beef premium); export refunds: 13 023 declarations checked; 275 491 checks carried out on beneficiaries for area related rural development measures (cfr. Annual Activity Report 2009 of DG Agriculture and Rural Development, footnote 33, page 61).

a few exceptions, in over 90% of the IACS cases (both Funds), concluding in 92% (EAGF) and 87% (EAFRD) of these cases that the quality of the on-the-spot checks was at least adequate. For the non-IACS populations, CBs met the work requirements, with a few exceptions, in over 80% of cases, and concluded similarly in 90% (EAGF) and 87% (EAFRD) of all cases.

The Commission considers that these modifications have been introduced (the English version of the revised guidelines was introduced already in July 2008) sufficiently in advance to enable CBs to comply with the new guidelines.

36. The Commission agrees that further improvements can and should be made and it is regularly pursuing the issue with the Member States.

37. Even though the Commission agrees that, in general, a re-performance of a previous check provides a better assessment of the quality of the on-the-spot checks, it is still possible to evaluate the control environment through inspections accompanied by the CB. In certain cases it may also not be possible to re-perform a check. These problems are inherent in many ex-post controls performed by external auditors.

Moreover, accompanied field inspections would reduce the administrative burden on the farmer.

38. For the reasons set out in its reply to point 34, the Commission considers that the Court's findings do not place significant limitations on the use that can be made of the control statistics for assurance purposes.

The new system for the reinforcement of assurance referred to is not a reaction to weaknesses in the work of the CBs but, rather, an attempt to reinforce the assurance already given by the current system.

41. By issuing the guideline No 4 on the statement of assurance, a common methodology is provided on how to draw up the SoA. It sets out the applicable legal provisions and provides recommendations from the Commission with a view to ensuring that the SoAs are drawn up on the basis of comparable criteria.

43. The revised guideline on the SoA was presented to the Member States for the first time in June 2008 and finalised in July 2008. This was sufficiently in time for the directors of the PAs to prepare their SoA to be signed by January 2009. An earlier revision was not possible because the results of the previous year's exercise first needed to be evaluated.

The Commission considers that the guidelines are adequately detailed. Further to analysing the SoAs received for financial year 2008, the guideline was further revised. The 2009 revision treats in separate annexes how to carry out the analysis of the control statistics explicitly requesting detailed information where the error rate in a population is above 2%, where the comparison with the situation in the previous financial year shows a significant deterioration or, where the error rate in a population is implausibly low and how to deal with the requirement to disclose the basis on which the statement of assurance is drawn. Templates for transmission of control statistics were provided by the Commission in order to ensure uniformity of the data supplied by the Member States to the Commission.

44. The requirement that each statement of assurance should be accompanied by a list of the documents examined and the work performed by the director of the paying agency before signing his statement, was fulfilled in 75 out of 82 cases for financial year 2008. The analysis of the control statistics was provided in 32 cases and the comparison with the situation in the previous year in 24 cases.

The Commission analysis shows that, for the financial year 2009, the situation improved: all 88 PAs provided a list of the documents examined and a summary of the work performed and 83 PAs provided the required analysis of the control statistics.

45-46.

The assurance model underlying the SoAs follows from the Commission's guidelines and was discussed at the first meeting with the directors of the PAs in December 2007. At that occasion, the Commission also explicitly stated that the so-called cascade model based on "sub-SoAs" was insufficient and even discouraged its use, in particular for the execution of payments.

47. For financial year 2008, the analysis of the control statistics was provided in 32 cases and the comparison with the situation in the previous year in 24 cases. For financial year 2009, guideline No 4 has been revised with a view to improving this situation. In consequence, for this financial year, the required analysis of the control statistics was carried out by 84 out of 88 PAs.

48. The analysis of the control statistics is required to be carried out at aid scheme level, the threshold above 2% (at the level of a population) giving an indication for consideration of a reservation. However a reservation is only required if the following factors are cumulatively fulfilled:

- the examination of the qualitative aspects leads to a finding of significant deficiencies in a national control system as defined in point 4.2 (Qualitative aspects) of guideline No 4 and
- the amount of undue payments is estimated to exceed 2 % of the total payments made in the financial year in question under any of the populations referred to in point 4.3 (Quantitative aspects) of guideline No 4 and
- it has not been possible to counter the impact of the deficiencies by corrective measures.

The director of the PA is expected to make a reservation only if all these three conditions are fulfilled.

49. For the reasons set out in its reply to point 34, the Commission does not question the reliability of the control statistics.

51. It is correct that the work performed in the context of the certification would to a large extent provide an adequate basis also for the opinion on the SoA.

However, the CB should in addition check: whether the supporting information accompanying the Statement of Assurance is adequate and it should provide an opinion:

- (if applicable) whether the Paying Agency Director's reservations have been correctly disclosed;
- (if applicable) which audit population(s) should, in its opinion, have received a reservation, but did not;
- (if applicable) which audit population(s) did receive a reservation that was not required (i.e. the underlying issue(s) was/were not material);
- whether, in its opinion, the SoA complies in all material respects with Article 3 of Regulation (EC) No 885/2006 (Commission guideline No 4) for the financial year 16/10/xx to 15/10/xx+1.

Thus, the Commission is of the view that the opinion provides added value.

In financial year 2009, the French CB did follow the model required by guideline No 7.

52. From financial year 2009 onwards, the CBs have been better placed to assess this information because the revised guideline No 4 includes templates to be completed by the PA.

PART II - THE CONFORMITY CLEARANCE OF ACCOUNTS

54. The Court's graph 1 shows when the various conformity clearance decisions were adopted rather than the amounts excluded in respect of each financial year. The financial corrections on expenditure for each financial year, including estimates of future corrections, are shown in Commission Graph 1.

56. The Central Risk Analysis serves as a planning tool. In fact agricultural expenditure of the year N-2 was allocated to 76 different audit fields, each audit field is subject to a similar management and control system. As the expenditure under these audit fields was effected by different paying agencies, for planning purposes, 1 807 audit field/paying agency pairs were identified. For these audit field/paying agency pairs the following risk factors are taken into account: materiality (amounts of declared expenditure), last audit year (period elapsed since the last audit of the measure in question), inherent risk of the measure in question, control system risks (risk associated with the control system), paying agency risk (risk related to the paying agency) and finally taking into account the OLAF risk (related with OLAF denunciations and irregularities) and the Court of Auditors risk (related with the findings from the ECA). The composite risk is calculated by audit field/paying agency pair by multiplying materiality and the "weighed risk" which is a weighted average of the various risk indicators mentioned above. Based on the composite risk, the ranking of the audit field/paying agency pairs is established for the whole Directorate.

57-58.

For financial year 2009, the part of the expenditure covered by the Commission's conformity audits increased to 61%⁴. The Commission considers this to be an impressive and sufficient coverage and, therefore, does not consider that, as a result of the risk analysis, only a limited number of measures and PAs identified as priorities are subject to conformity audits. Moreover, for direct aids, which in financial year 2009 accounted for 72% of total agricultural expenditure and are covered by the IACS, all Member States with the exception of Luxembourg were audited over the past three years.

59. The 24 month rule is a deliberate choice of the EU legislator with a view to ensuring legal certainty for Member States. It is inherent in the application of this rule that certain expenditure cannot be subject to financial corrections although it may be affected by deficiencies. The Commission has repeatedly proposed an extension of this time limit, but these proposals were turned down by both the Council and the European Parliament.

60. The Commission considers that a complete coverage of all audit areas over, say, a three year period would not be possible even with significantly increased resources, and would go against the single audit concept⁵. It would be inefficient to devote human and financial resources to the audit of audit field/paying agency pairs with limited expenditure and a low risk. Therefore, the Commission carries out its conformity audit work on the basis of a central risk analysis, which incorporates all the necessary risk factors and is in line with internationally accepted auditing standards.

BOX 3

⁴ 26.5% for "Intervention on agricultural markets", 70.9% for "Direct aid" and 43.6% for "Rural development".

⁵ This would require the audit of some 1.800 audit areas over this time span in order to avoid that certain parts thereof can no longer be corrected due to the 24 month rule.

In the case referred to by the Court, the Commission has reacted on time to the information received and the risk has been correctly covered. Therefore, the Commission does not consider that the EUR 100 million referred to by the Court should have been subject to a financial correction.

The 24 month rule is a deliberate choice of the EU legislator with a view to ensuring legal certainty for Member States. It is inherent in the application of this rule that certain expenditure cannot be subject to financial corrections although it may be affected by deficiencies. The Commission has repeatedly proposed an extension of this time limit, but these proposals were turned down by both the Council and the European Parliament.

61. For direct aids, which in financial year 2009 accounted for 72% of total agricultural expenditure and are subject to the IACS, all Member States with the exception of Luxembourg were audited over the past three years 2007-2009 and, thus, within a time span which prevents the exclusionary effect of the 24 month rule.

The number of audit field/paying agency pairs is the consequence of the large number of different control systems for the various agricultural aid schemes and the number of PAs established by the Member States. Direct aids, however, only represented 12 audit fields in the 2008 risk analysis.

63. The Commission considers that the use of flat rates is fully in line with the objective of the conformity clearance and the most effective and efficient way of achieving this objective, notably if the deficiencies found concern only the Member State's management and control system. It takes account of the fact that it is not possible to take a statistically valid sample in the context of each of the around 150 conformity missions carried out by DG AGRI each year. The Commission estimates that such substantive testing would, in fact, require on average some 100 individual files to be audited in each case, thus amounting to more than 15 000 files per year.

The use of flat rate corrections has been upheld by the Court of Justice as being in conformity with the legal rules governing the conformity work.,

64. For all the 32 conformity decisions adopted from 1996 to the end of 2009, slightly less than 70% of the total amount of financial corrections were determined by using flat rates. However, the Commission considers it to be pertinent to look at the *number* of cases rather than the amounts involved because each conformity audit is equally important within the overall annual audit programme. Here, flat rates were used in only 45% of all cases and, if the past ten decisions are taken, this percentage decreases further to 37%. This demonstrates the Commission's continuous efforts to calculate or extrapolate the financial loss for the EU budget whenever this is possible.

As part of this effort, the Commission recently set out to Member States the conditions under which it is prepared to limit the amount of any financial correction to the error rate found by the Member State, in the transactions at final beneficiary level and reported in its control statistics for the aid scheme concerned.

65. The Commission considers that by focusing on the functioning of Member States' management and control systems, the system based audit approach is the most effective and efficient way of achieving this objective. To supplement this work by a substantive testing of a representative sample of individual payments in the context of each of the around 150 on-the-spot conformity audits carried out by DG AGRI each year would require a substantial (more than twofold) increase in the current audit resources which would not be in line with any cost-benefit analysis. The increase would be even higher (fivefold) if the Commission had to carry out such substantive testing on all audit fields over, say, a three year period.

Nor would it take account of the fact that independent audit bodies are certifying the PAs' accounts and the functioning of their internal control procedures and are verifying and validating their control statistics, an element covering the legality and regularity of the underlying transactions which is currently being further reinforced.

Nor would it be possible to limit such substantive testing to cases where the "consequences are quantifiable and significant" as those conclusions cannot be drawn at the time of the audit and, if it were implemented towards the end of the procedure such substantive testing may well be irrelevant and/or impossible.

66. Flat rate corrections reflect the degree of financial risk for the EU budget which results from the deficiencies in the Member States' management and control systems. Therefore, the Commission considers that there is a correlation between the flat rate used and the level of irregular payments to final beneficiaries. The guidelines in working document VI/5330/97 have established a clear, objective and stable system for the application of the flat-rate corrections, avoiding subjectivity as well as unequal treatment.

The Commission's operational handbook explicitly states that the system of flat rate corrections is used to link the weaknesses identified to the risk for the EU budget and that this risk is the overriding element in the assessment of the level of financial corrections. Therefore, the auditors are required to assess whether there are any factors which would mitigate, or amplify the risk. The conformity decisions provide ample examples that this assessment is taking place and, where justified, leads to a reduction or increase of the level of financial corrections.

Moreover, as agricultural expenditure is implemented under shared management, the Member States are better placed than the Commission to assess and provide evidence of the real financial loss or risk for the EU budget. The operational handbook explicitly recognises this and requires the Commission to take such evidence, if reliable, into account. A more precise calculation of the financial loss for the EU budget therefore requires the active co-operation of the Member State concerned at all levels of the conformity clearance procedure because only the Member State has all the necessary information to make such a calculation. Unfortunately, however, despite the Commission's requests, Member States often do not avail themselves of this possibility. The Court of Justice has confirmed that it is not up to the Commission to undertake the checks necessary to put a precise figure to the losses incurred, but rather it is for the Member State to show that the Commission's estimate was excessive.

In this context, the Commission has recently set out to Member States the conditions under which it is prepared to limit the amount of any financial correction to the error rate found by the Member States in the transactions at final beneficiary level and reported in its control statistics for the aid scheme concerned.

BOX 5

In the case in hand, the testing of representative sample of files, suggested by the Court would have potentially treated the UK differently to other Member States. In order to treat Member States equally, such substantive testing would have to be carried out systematically, at least in all cases where there is a potential financial correction. Such an approach would require a significant increase in audit resources and is not in line with a cost-benefit analysis. This is why the Commission has decided on a system based audit approach with a hierarchy of corrections of which the flat rate approach is but one and which has been upheld by the Court of Justice. Furthermore, Member States are in all cases invited to calculate more precisely the financial loss for the EU budget but they do not always avail themselves of this possibility. Nevertheless, the Commission developed an alternative method in order to better determine

the real residual risk and has set this out to Member States (see point 104 e final subparagraph).

See also replies in 65 and 66.

67. In its 2007 discharge resolution, the Parliament explicitly requested that "flat-rate corrections are applied to those Member States which fail to meet their obligations"⁶.

To date the percentage of financial correction (by value) determined on the basis of flat rates amounts to slightly less than 70%.

Moreover, in December 2009, the Commission set out to Member States the conditions under which it is prepared to limit the amount of any financial correction to the error rate found by the Member State, in the transactions at final beneficiary level and reported in its control statistics for the aid scheme concerned.

68. The 1996 reform introduced an annual financial clearance to be completed by 30 April of the year $n + 1$ and the 24 month rule for conformity clearance. By doing so, a major contribution was made to the discharge procedure (and now the AAR) taking into account their timing. To conclude the conformity clearance work within such a timetable would impair the conformity clearance process.

69. The time needed for completing the conformity procedure depends on a number of factors, some of which are outside the Commission's responsibility and control. Such factors include, for example, the complexity of the case, requiring additional work or even additional missions, the respect of deadlines by the Member States, translation requirements and the follow-up of the recommendations of the Conciliation Body. Furthermore, quite often the target is exceeded in order to fully respect the Member State's right of defence, which is a fundamental principle of the conformity clearance procedure and explicitly required by Article 42(2)(c) of the Implementing Rules to the Financial Regulation.

71. Member States are aware of any deficiencies found shortly after the mission and can immediately take corrective action. The audit results are known and taken into account for the AAR for the year concerned. The length of time to determine the amount of the financial correction is a secondary issue if the deficiencies have already been notified and corrected.

Shortening the deadlines for the conformity clearance procedure would impact negatively on the Commission's ability to carry out the necessary audit work which would be neither in the interests of the EU nor of the Member States. The Commission will nevertheless continue to work at reducing the time needed to complete conformity clearance procedures.

72. None of the parties involved in the legislative procedure proposed any changes to the conciliation procedure in their opinions on the Commission's proposal for a Council Regulation on financing of the common agricultural policy, which was subsequently adopted as Regulation (EC) No 1290/2005.

In 2006, the Commission adopted measures to reduce the number of cases going to conciliation by doubling the threshold above which cases are considered admissible. The Conciliation Body has not seen the increase in cases which would be commensurate with the increase in size of the EU.

⁶ See paragraph 83 of the European Parliament resolution of 23 April 2009 on the discharge for implementation of the European Union general budget for the financial year 2007, Section III – Commission (P6_TA(2009)0289).

The Commission considers the conciliation procedure to be a useful element in the conformity procedure. This is demonstrated by the Conciliation Body's impact on the financial corrections proposed. In 28% of cases a reduction of more than 10% in the amount of financial correction resulted from the procedure, in 13% of cases, there was a reduction of less than 10% while in 3.5% of cases the Commission decided to withdraw its correction.

73. Whether the time-target can be met in a given case depends on a number of factors, some of which are outside the Commission's responsibility and control. Such factors include, for example, the complexity of the case, requiring additional work or even additional missions, the respect of deadlines by the Member States and the follow-up of the recommendations of the Conciliation Body. Quite often, the target is exceeded in order to fully respect the Member State's right of defence, which is a fundamental principle of the conformity clearance procedure.

At the end of 2009, only 10 audits carried out in the years 2004 and before, allowing financial corrections of expenditure from the period prior to 2003, had not been closed. The financial corrections related to these audits as regards expenditure from the period prior to 2003 are estimated to be around EUR 15 million. This means that the conformity work on expenditure incurred in the years prior to 2003 had largely been completed.

PART III – THE CLEARANCE OF ACCOUNTS PROCEDURE AS A WHOLE

76-77.

The financial clearance decision is taken around six months after the end of the financial year in question. Through this decision, the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. The fact that the decision is without prejudice to subsequent conformity decisions imposing financial corrections on Member States is explicitly provided for in Article 30 of Regulation (EC) No 1290/2005 which has the same legal status as the Financial Regulation. Moreover, in substance, it is fully compatible with the Financial Regulation, which for any other expenditure provides that the Commission can make ex-post checks up to 5 years after the discharge decision on the year in which the final payment was made. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the 5-year period has lapsed.

The amount of expenditure which is likely to be excluded from financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements. Together with the financial clearance decision, this disclosure provides the European Parliament and the Council with the information they require for the discharge procedure.

This role of the financial clearance decision was already set out explicitly in the memorandum of March 1993 by which the Commission approved the guidelines for the reform of the clearance of accounts system which became applicable in 1996 (SEC (93) 306) and was not called into question by any of the parties involved in the adoption of the subsequent legislation.

78.

(a) Each financial correction included in a conformity decision is linked to a specific financial year which is identified in the Annex to this decision.

(b) As already indicated in the reply to point 73, by the end of 2009, the conformity work on expenditure incurred prior to 2003 had largely been completed.

The financial statements include the pertinent information concerning the financial corrections of the year.

See also reply to points 76-77.

79. What the Court describes as limitations are, rather, positive features inherent to a system which has proven its value in safeguarding the financial interests of the EU.

80. Conformity clearance decisions disclose the amounts excluded from EU financing per year of expenditure and per Member State. The amounts per Member State are disclosed in note 6 to the financial statements 2009 of the Commission.

Annex 36 to the Commission Staff Working Document accompanying the financial report on the EAGF 2008 financial year provides information on the financial corrections made on expenditure from each financial year. Information on the distribution of these corrections between Member States and between sectors is provided in the Commission's fact sheet "Managing the agricultural budget wisely", which is published under the following internet address:

http://ec.europa.eu/agriculture/publi/fact/index_en.htm.

81. The financial clearance decision is taken around six months after the end of the financial year in question. Through this decision, the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. The fact that the decision is without prejudice to subsequent conformity decisions imposing financial corrections on Member States is explicitly provided for in Article 30 of Regulation (EC) No 1290/2005 which has the same legal status as the Financial Regulation. Moreover, in substance, it is fully compatible with the Financial Regulation, which for any other expenditure provides that the Commission can make ex-post checks up to 5 years after the discharge decision on the year in which the final payment was made. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the 5-year period has lapsed. The amount of expenditure which is likely to be excluded from financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements. Together with the financial clearance decision, this disclosure provides the European Parliament and the Council with the information they require for the discharge procedure.

The financial statements already include all the information required by the Financial Regulation and the accounting rules. See also reply to paragraph 76-77.

82. Under the reformed system, the financial clearance decision is adopted by 30 April of the year following the financial year concerned. Thus the reformed clearance of accounts procedure has significantly accelerated the timescale for clearing the PAs' accounts.

83. With the adoption of the annual financial clearance decision, the Commission accepts the accounts of the accredited paying agencies and the corresponding expenditure therefore becomes definitive. This acceptance is not called into question by the possibility of subsequent financial corrections under the conformity clearance process. The amount of expenditure which is likely to be excluded from EU financing by such future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and disclosed in a note to the financial statements of the Commission.

The financial statements give all the information required by the Financial Regulation and the accounting rules. In particular they include as a contingent asset an estimate of future financial corrections.

84. The Financial Regulation and the sectoral regulations regarding agriculture give the Commission the right to make checks on all expenditure for some years after it is incurred. The accounts should not imply that, because of this right, all the expenditure concerned

remains to be accepted. Where the amounts of potential recoveries are quantifiable, they are disclosed in notes 5.3 and 5.4 to the consolidated accounts.

These conformity clearance decisions disclose the amounts excluded from EU financing per year of expenditure and per Member State. The amounts per Member State are disclosed in note 6 to the financial statements 2009 of the Commission.

85. The purpose of recording the contingent assets in the Commission's accounts is to disclose the (potential) receivables, based on the results of its audits, and has not been intended to provide any assurance as to the legality and regularity of the underlying transactions.

The amount included in the contingent asset corresponds to the best estimation of the expenditure which is likely to be excluded from EU financing by future conformity decisions. This amount is disclosed in a note to the financial statements of the Commission, divided into EAGF and EAFRD.

88. The annual accounts present all information required by the accounting rules and financial regulation. In particular, the amount of expenditure which is likely to be excluded from EU financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements of the Commission. The accounts are not amended by subsequent conformity decisions. The financial effect of a conformity decision falls in the financial year in which the decision is executed and does, thus, not amend the accounts of previous financial years.

89. The conformity clearance is designed to exclude expenditure from EU financing which has not been executed in compliance with EU rules, thus shielding the EU budget from expenditure that should not be charged to it. In contrast, it is not a mechanism by which irregular payments to beneficiaries are recovered, which according to the principle of shared management is the sole responsibility of Member States, as referred to in Article 9(1)(a)(iii) of Council Regulation (EC) No 1290/2005 and Article 53b(2)(c) of the Financial Regulation.

The Commission considers that the conformity clearance has over the years proven to be a strong incentive for Member States to improve their management and control systems and, thus, to prevent or detect and recover irregular payments to final beneficiaries as reflected by the decreasing error rates at the final beneficiary level.

90.

(a) The conformity clearance is not a mechanism by which irregular payments to beneficiaries are recovered, which according to the principle of shared management and the rules of Article 9(1)(a)(iii) of Council Regulation (EC) No 1290/2005 and Article 53b(2)(c) of the Financial Regulation is the sole responsibility of Member States. Where irregular payments to individual beneficiaries are or can be identified as a result of the conformity clearance procedures, Member States are required to follow them up by recovery actions against these beneficiaries.

(b) Even where financial corrections only relate to deficiencies in the Member States' management and control and not to irregular payments, these corrections are an important means to improve the Member States' management and control systems and, thus, to prevent or detect and recover irregular payments to final beneficiaries. The conformity clearance thereby contributes to the legality and regularity of the transactions at the level of the final beneficiaries. Moreover, agricultural legislation provides for effective, dissuasive and proportional sanctions to be imposed on beneficiaries who have received irregular payments.

91. Financial corrections are not sanctions on Member States as the Commission said already in the memorandum of March 1993 by which it approved the guidelines for the reform of the

clearance of accounts system which became applicable in 1996 (SEC(93) 306). The current conformity clearance mechanism, including the use of flat-rate corrections, has been upheld by the Court of Justice, which implies that it is not a sanction mechanism as sanctions on Member States are the prerogative of the Court of Justice.

CONCLUSIONS AND RECOMMENDATIONS

93. The Commission welcomes the Court's conclusion that the clearance of accounts procedure, as regards the reliability of the accounts, provides reasonable assurance and sufficient information for the Commission to take its annual financial clearance decision

94. The Commission acknowledges the shortcomings identified by the Court concerning financial years 2007 and 2008 and has raised these issues with Member States. As a result, for financial year 2009, the situation has improved for all the new elements of assurance mentioned.

In the view of the Commission, an opinion on the internal control procedures would not require specific testing and assessment of the reliability of each key and ancillary control (conformity aspects). The CB is only to check that the PA has an administrative organisation and a system of internal control complying with the criteria set out in Annex I to Regulation (EC) No 885/2006.

For the reasons set out in its reply to point 34, the Commission considers that the control statistics are sufficiently reliable to be used for assurance purposes.

For the reasons set out under point 51 above, the Commission is of the view that the CBs' opinions on the SoA do provide added value.

95. The Commission does not consider that significant shortcomings affect the implementation of the conformity clearance procedure. The Court's criticism essentially relates to the design of the procedure as such and not to its implementation which, as the Commission has set out in its replies to points 76-77, 78b, and 81, is fully in line with the current rules, as acknowledged by the Court of Justice, and has over the past 15 years demonstrated its value in excluding non-conform expenditure from EU financing.

96. For financial year 2009, the part of the expenditure covered by the Commission's conformity audits increased to 61%⁷. The Commission considers this to be a sufficient coverage and, therefore, that the risk analysis results in an adequate number of measures and PAs identified as priorities for conformity audits.

The Commission considers that a complete coverage of all audit areas over, say, a three year period would not be possible even with significantly increased resources, and would go against the single audit concept. It would be disproportionate to devote human and financial resources to the audit of audit field/paying agency pairs with limited expenditure and a low risk. Therefore, the Commission carries out its conformity audit work on the basis of a central risk analysis, which incorporates all the necessary risk factors and is in line with internationally accepted auditing standards.

Moreover, for direct aids, which in financial year 2009 accounted for 72% of total agricultural expenditure and are covered by the IACS, all Member States with the exception of Luxembourg were audited over the past three years.

⁷ 26.5% for "Intervention on agricultural markets", 70.9% for "Direct aid" and 43.6% for "Rural development".

The 24 month rule is a deliberate choice of the EU legislator with a view to ensuring legal certainty for Member States. It is inherent in the application of this rule that certain expenditure cannot be subject to financial corrections although it may be affected by deficiencies. The Commission has repeatedly proposed an extension of this time limit, but these proposals were turned down by both the Council and the European Parliament.

97. The Commission considers that by focusing on the functioning of Member States' management and control systems, the system based audit approach is the most effective and efficient way of achieving its objective of sound financial management. To supplement this work by a substantive testing of a representative sample of individual payments in the context of each of the around 150 on-the-spot conformity audits carried out by DG AGRI each year would require a substantial (more than twofold) increase in the current audit resources which would not be in line with any cost-benefit analysis. The increase would be even higher (fivefold) if the Commission had to carry out such substantive testing on all audit fields over, say, a three year period.

Nor would it be possible to limit such substantive testing to cases where the consequences are quantifiable and significant as those conclusions cannot be drawn at the time of the audit and, if it were implemented towards the end of the procedure such substantive testing may well be irrelevant and/or impossible. (See reply to paragraph 65).

Flat rate corrections reflect the degree of financial risk for the EU budget which results from the deficiencies in the Member States' management and control systems. Therefore, the Commission considers that there is a correlation between the flat rate used and the level of irregular payments to final beneficiaries. Conformity clearance includes cases where the deficiencies found are limited to the control system in place and cannot be linked to individual irregular payments to beneficiaries but, because of the flat rate approach taken for control deficiencies, the risk to the EU budget is covered, e.g. when a Member State does not accomplish the minimum number of controls.

98. The main objective of the 1996 reform of the clearance of accounts procedure was to enforce the effectiveness and efficiency in achieving the general aims of the CAP and the Financial Regulation.

At the end of 2009, the conformity work on expenditure incurred in the years prior to 2003 had largely been completed.

99. Each financial correction included in a conformity decision is linked to a specific financial year which is identified in the Annex to this decision.

100. The financial clearance decision is taken around six months after the end of the financial year in question. Through this decision, the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. The fact that the decision is without prejudice to subsequent conformity decisions imposing financial corrections on Member States is explicitly provided for in Article 30 of Regulation (EC) No 1290/2005 which has the same legal status as the Financial Regulation. Moreover, in substance, it is fully compatible with the Financial Regulation, which for any other expenditure provides that the Commission can make ex-post checks up to 5 years after the discharge decision on the year in which the final payment was made. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the 5-year period has lapsed.

The amount of expenditure which is likely to be excluded from financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements. Together with the financial clearance decision, this

disclosure provides the European Parliament and the Council with the information they require for the discharge procedure. See replies to paragraphs 76-77.

101. With the adoption of the annual financial clearance decision, the Commission accepts the accounts of the accredited paying agencies and the corresponding expenditure therefore becomes definitive. This acceptance is not called into question by the possibility of subsequent financial corrections under the conformity clearance process. The amount of expenditure which is likely to be excluded from EU financing by such future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and disclosed in a note to the financial statements of the Commission.

102. Financial corrections are not sanctions but an exclusion from EU financing of expenditure which has not been effected in conformity with EU rules. These financial corrections are not "negotiable", but are determined by the Commission on the basis of the principles set out in its working document VI/5330/97 and the information received in the course of the administrative procedure leading to the conformity decision. The Member State's participation in this procedure is part of the principle "audi et alteram partem", allowing the Member State to give its opinion and to present its point of view, and the Commission is and should be willing to listen to the Member State's arguments and to take these into account. The number of financial corrections upheld by the Court of Justice demonstrate that the amounts are, in general, clear and indisputable.

103. The conformity clearance is not a mechanism by which irregular payments to beneficiaries are recovered which, according to the principle of shared management and the rules of Article 9(1)(a)(iii) of Council Regulation (EC) No 1290/2005 and Article 53b(2)(c) of the Financial Regulation, is the sole responsibility of Member States. However, where such irregular payments are, or can be, identified as a result of the conformity clearance procedure, Member States are required to follow them up by recovery actions against the beneficiaries.

104. The Commission considers the current system to function well and to achieve its overall objectives. It will, however, continue to improve its operations in practice and, where necessary, submit appropriate proposals for further improvements to the European Parliament and the Council for the post-2013 period.

(a) The Commission considers that, in general, the rules and responsibilities of the different parties are sufficiently clearly defined in the existing regulations while taking account of the need to maintain the necessary flexibility. It will, however, consider whether to define in more detail the role of the CBs in the rules for the post-2013 period.

(b) The existing rules already provide for a time limit for the adoption of the annual financial clearance decision. Time limits for the conclusion of conformity clearance procedures would go against the objective of protecting the EU's financial interests as they would exclude financial correction after the deadline has elapsed. Therefore, the Commission does not intend to propose the introduction of such additional time limits.

(c) The financial clearance decision is taken around six months after the end of the financial year in question. Through this decision, the Commission establishes the amount of expenditure recognised as chargeable to the EU budget for that year. The fact that the decision is without prejudice to subsequent conformity decisions imposing financial corrections on Member States is explicitly provided for in Article 30 of Regulation (EC) No 1290/2005 which has the same legal status as the Financial Regulation. Moreover, in substance, it is fully compatible with the Financial Regulation, which for any other expenditure provides that the Commission can make ex-post checks up to 5 years after the discharge decision on the year in

which the final payment was made. Otherwise, all budgetary expenditure would be considered provisional until an ex-post check is made or the 5-year period has lapsed.

The amount of expenditure which is likely to be excluded from financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and in a note to the financial statements. Together with the financial clearance decision, this disclosure provides the European Parliament and the Council with the information they require for the discharge procedure.

This role of the financial clearance decision was already set out explicitly in the memorandum of March 1993 by which the Commission approved the guidelines for the reform of the clearance of accounts system which became applicable in 1996 (SEC (93) 306) and was not called into question by any of the parties involved in the adoption of the subsequent legislation.

See also reply to paragraph 97.

(d) The estimated amount of expenditure which is likely to be excluded from EU financing by future conformity decisions is disclosed as a contingent asset in the Commission's accounting system and disclosed in the note to the financial statements of the Commission. It would not be appropriate to make an assessment by Member State or by budget area of these amounts, which are at present a best estimate and may change when a final decision is taken, nor to include such detailed information in the financial statements.

The conformity clearance decisions identify the amounts excluded from EU financing per year of expenditure and per Member State. The amounts per Member State are disclosed in note 6 to the financial statements 2009 of the Commission.

(e) Under the reformed system, the financial clearance decision is adopted by 30 April of the year following the financial year concerned. Thus the reformed clearance of accounts procedure has significantly accelerated the timescale for clearing the PAs' accounts.

The time needed for completing the conformity procedure depends on a number of factors, some of which are outside the Commission's responsibility and control. Such factors include, for example, the complexity of the case, requiring additional work or even additional missions, the respect of deadlines by the Member States and the follow-up of the recommendations of the Conciliation Body. Furthermore, quite often the target is exceeded in order to fully respect the Member State's right of defence, which is a fundamental principle of the conformity clearance procedure and explicitly required by Article 42(2)(c) of the Implementing Rules to the Financial Regulation.

The use of flat rates is fully in line with the objective of the conformity clearance and the most effective and efficient way of achieving this objective. It takes account of the fact that it is not possible to take a statistically valid sample in the context of each of the around 150 conformity missions carried out by DG AGRI each year. Nor would it be possible to limit such substantive testing to cases where the "consequences are quantifiable and significant" as those conclusions cannot be drawn at the time of the audit and, if it were implemented towards the end of the procedure such substantive testing may well be irrelevant and/or impossible.

Furthermore, as agricultural expenditure is implemented under shared management, the Member States are better placed than the Commission to assess and provide evidence of the real financial loss or risk for the EU budget. The operational handbook explicitly recognises this and requires the Commission to take such evidence, if reliable, into account. A more precise calculation of the financial loss for the EU budget therefore requires the active co-operation of the Member State concerned at all levels of the conformity clearance procedure

because only the Member State has all the necessary information to make such a calculation. Unfortunately, however, despite the Commission's requests, Member States often do not avail themselves of this possibility.

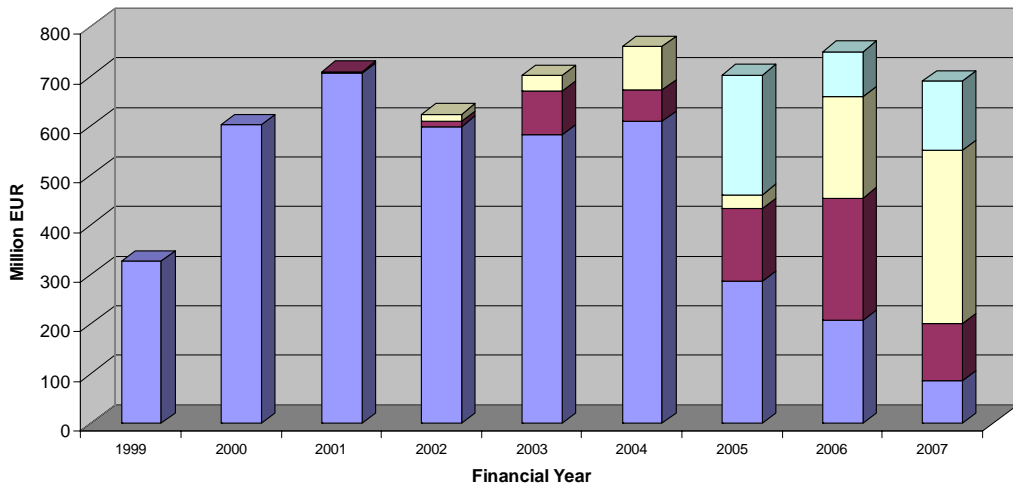
Moreover, the flat rate methodology has been accepted by the Court of Justice as being in conformity with the legal rules governing the conformity work.. In particular, the Court of Justice has confirmed that it is not up to the Commission to undertake the checks necessary to put a precise figure to the losses incurred, but rather it is for the Member State to show that the Commission's estimate was excessive.

The Commission has recently put forward a system by which Member States can, from 2010, reinforce the overall framework for gaining reasonable assurance on legality and regularity of transactions at the level of final beneficiaries. To this end, CBs should extend their work beyond the present requirements by fully re-performing, for a given expenditure population, a representative sample of transactions which the PA in question has checked on-the-spot. The work would cover the entire handling of the file, from receipt of the aid application to the calculation and execution of the final payment.

(f) Financial corrections imposed on Member States through conformity clearance decisions are not sanctions but an exclusion from EU financing of expenditure which has not been effected in conformity with EU rules. This is also confirmed by the jurisprudence of the Court of Justice.

(g) The Commission will continue to supervise the work of the certification bodies through specific audit visits.

Graph 1 - Amounts excluded in respect of each financial year
 (incl. estimates of future corrections)



- Estimated on basis of historic average
- Corrections under preparation
- Decisions 30-32
- Decisions 1-29