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Delegations will find attached Commission document COM(261) final.

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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE COURT OF AUDITORS

More or less controls? Striking the right balance between the administrative costs of control and the risk of error

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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE COURT OF AUDITORS

More or less controls? Striking the right balance between the administrative costs of control and the risk of error

1. BACKGROUND AND OBJECTIVE OF THE PRESENT COMMUNICATION

The Commission is responsible for the execution of the budget, paying each year some €130 billion to beneficiaries in the Member States and throughout the world across a wide range of policy areas. While the Commission directly manages around one fifth of the budget, the remainder is executed in conjunction with partner bodies, including the Member States, through which some 75% of the budget passes.

The risk profiles of these activities differ according to the complexity of the legislation, the length and complexity of the control chain, the types of beneficiaries and other factors. To ensure compliance with rules and the achievement of policy objectives, control strategies need to be tailored to the risks and specificities of each policy area, setting out the nature and timing of controls to be exercised (preventive, detective and corrective) taking into account the different risks profiles of beneficiaries.

For expenditure managed centrally, the Commission made over 500,000 individual payments in 2009 to a total of 85,000 different entities or individuals (including staff). Typically, grant expenditure comprises pre-financing followed by cost claims which "clear" the pre-financing, mainly on the basis of costs actually incurred. In many cases, the final control by the Commission on the eligibility of costs is carried out at the time of or after the final payment - in some areas this may be several years after the initial pre-financing. This control is often executed on a sample basis and may comprise desk-based and/or on-the-spot controls.

For expenditure in shared management, the Commission makes payments to Member State authorities which manage and disburse funds to beneficiaries. The Member States are responsible for the control of these numerous final beneficiaries (both administrative for 100% of beneficiaries and on-the-spot normally of at least 5% annually). For rural development alone (Pillar 2 of the Common Agricultural Policy) the total number of beneficiaries in 2008 was some 3.6 million, receiving some €13.7 billion of public expenditure, € 8.5 billion in EU contributions.

Each grant scheme is governed by the Financial Regulation and in most cases by specific sectorial legislation setting eligibility conditions for reimbursement of expenditure. Sectorial legislation is designed to target the achievement of often highly-specific policy objectives. It often has a certain level of complexity. This complexity can result in erroneous financial claims by beneficiaries who may misunderstand or misinterpret eligibility conditions: such financial errors are for the overwhelming majority involuntary and are not fraudulent.

Legal complexity, coupled with the potentially long gap between pre-financing and the final cost claim, increases the risk of error. Such errors occur for a variety of reasons and take different forms depending on the specific rule or contractual requirement broken and the nature of the breach. The guiding principle in the public sector has traditionally been compliance with rules with "zero risk taking" and no explicit recognition of the level of error which controls do not correct or cannot correct in a timely fashion. The responsibility of the manager of funds is to put in place a credible control strategy which directs control resources to the best effect, focusing on high-value and high-risk beneficiaries while not neglecting the rest. Such a strategy aims to provide reasonable assurance that money has been used for the intended purposes while ensuring an appropriate balance between the costs and the benefits of control (principally error-reduction/ recovery and the deterrent effect). In practice a certain amount of risk will be justified or "tolerable" as reducing error to "zero" is too costly or quite simply impossible.

Until now, this acceptance of a justified risk of error has not been explicit. The Court applies a standard 2% materiality level for the legality and regularity of underlying transactions (a "green light"). Above this, if the error rate calculated by the Court is between 2% and 5% it gives a "yellow" assessment and if it is over 5% a "red" assessment. The Commission has received discharge each year although error rates have exceeded 2% in some areas. The outcome of the Court's annual assessment of the Commission's management of EU funds has improved in recent years: however the level of error is still above the 2% threshold in some areas. The Commission will continue improving control systems, including those of its implementation partners, to ensure "the right control at the right time". Nevertheless as risk varies between the activities managed, the Commission considers it important to set reasonable and challenging benchmarks against which to judge its management of risk in line with a cost-benefit analysis. The Discharge Authority has also recognised this and invited the Commission to present tolerable risk proposals for all areas of the budget[1].

This Communication follows a 2008 Communication *Towards a common understanding of the concept of tolerable risk of error (COM(2008)866)* and aims to fulfil commitments there-in and the expectations of the Parliament and the Council. It presents the Commission's proposals for levels of tolerable risk of error (TRE) for the policies "Research, energy and transport" and "Rural development". Proposals for TRE in other areas will follow by the end of 2011.

This communication is presented along with the Commission's proposal for the triennial revision of the Financial Regulation, which includes an article on the concept of tolerable risk of error. Two staff working documents are annexed to the present communication providing technical detail on the methodologies and the results of the analysis underlying the proposals. They present detailed information on costs of control and on error rates and examine the link between the amount of control carried out and the level of error which may remain undetected.

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1 European Parliament resolution of 23 April 2009 (P6_TA(2009)0289) with observations forming an integral part of the Decisions on the discharge for implementation of the European Union general budget for the financial year 2007, Section III – Commission and executive agencies, point 48 *"[...]expects the Commission to take this work further when preparing its proposal on tolerable level of risk by budgetary area [...]"*

European Parliament resolution of 5 May 2010 (P7_TA(2010)0134) with observations forming an integral part of the Decisions on the discharge for implementation of the European Union general budget for the financial year 2008, Section III – Commission and executive agencies, points 59-60.

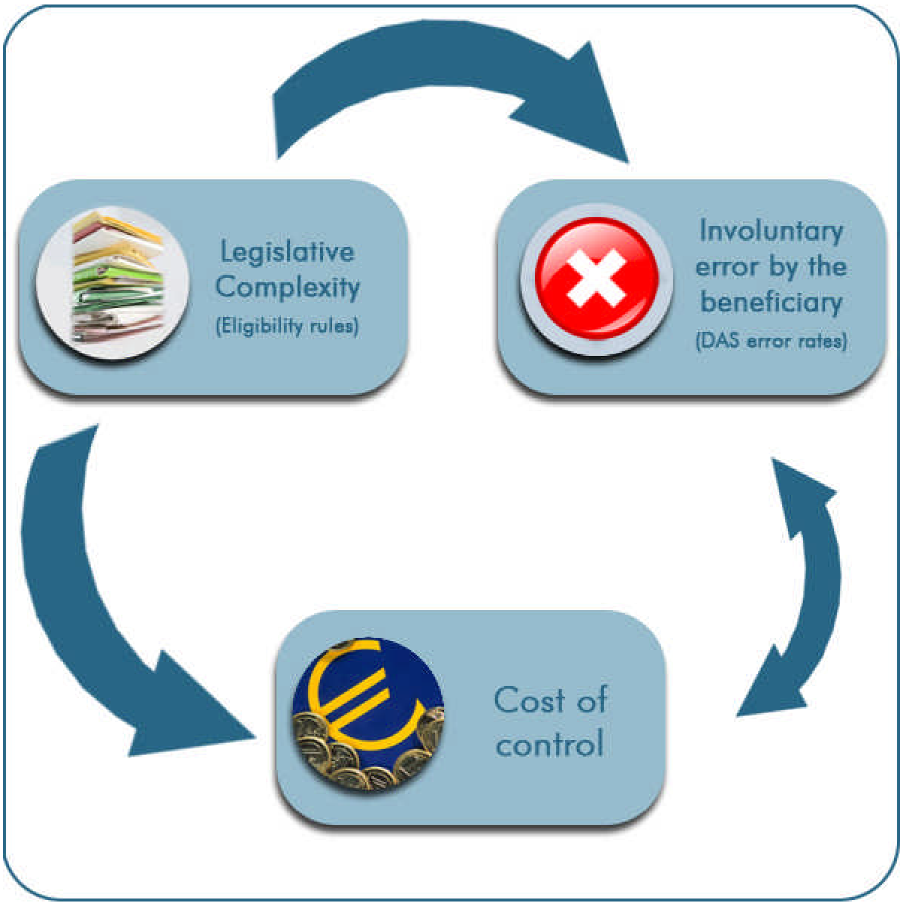
2. WHY DECIDE A TOLERABLE RISK OF ERROR?

At the time 2007-13 legislation was adopted, neither the costs of verifying the respect of eligibility conditions nor the risk of error were explicitly considered. For this period, the Commission has already implemented simplifications in the Common Agricultural Policy, including rural development, and will continue to do so in future. However, any such further simplification will not be enough to reduce the error rate in rural development below the Court's 2% threshold without the risk of jeopardising policy objectives.

In the area of Research the Commission has recently issued a communication on simplification aimed at launching an inter-institutional discussion on the issue[2]. However, the scope for further simplification of current legislation is limited given the time needed for this to be debated, adopted and to enter into force. Adoption of a TRE would allow the Commission to optimise control in FP7 (striking the right balance between control costs and recoveries and minimising the reputational risk) prior to the implementation of simplification which it is determined to propose for FP8.

TRE would recognise that in some areas, complex rules, extended control chains and control costs do not permit a 2% error level to be attained without incurring higher than justified costs (Figure 1 shows this relationship).

Figure 1: there is an interdependency between legislative complexity, error rates and cost of controls



[2] Simplifying the implementation of the research framework programmes: (COM(2010)187).

The Commission is committed to implementing sound and efficient control strategies, targeting risk and high-value activities without neglecting the rest. A decision on TRE will not result in a given rate of error being tolerated at beneficiary level: all errors detected will be corrected. TRE makes explicit a judgement which is already implicit by recognising the relationship between legislative complexity and error rates as well as the fact that controls cannot systematically be carried out on the spot, all meaning that some errors will remain undetected.

A tolerable risk approach gives a clear view of the balance between the financial impact of errors, the costs of control and related recoveries, and sound and efficient stewardship of EU funds. TRE levels per policy area, or significant parts thereof, should be based on a detailed review by all institutional stakeholders of the cost of control and the results of these controls and those of the Court. The added value obtained from expenditure (the right policy results at the right cost) is however at least as important in this context, since expenditure which does not achieve its objectives has limited value, even if perfectly controlled. As a result, political imperatives form part of the TRE discussion, notably the benefits of a policy and reputational aspects.

3. How TRE levels could be decided

To establish a legal framework for the adoption of TRE levels, the concept of TRE is included in the proposal for the triennial revision of the Financial Regulation. Following inter-institutional discussion on the content of this Communication, TRE levels could be adopted by the co-legislator (the Parliament and the Council) after having consulted the Court of Auditors, on the basis of legislative proposals made by the Commission. The Commission would then take account of the co-legislator's decision in executing the budget and controlling expenditure. It would propose revisions to the TRE levels in the light of any major changes in the control environment (for example simplification of eligibility rules reducing the risk of error).

Decisions on control levels and TRE go beyond a pure financial analysis. Controls are often considered burdensome by beneficiaries and may reach levels which discourage participation in programmes, thus jeopardising the objective of attracting the most appropriate beneficiaries and consequently the achievement of policy objectives. The tolerable error rate may also be influenced by political imperatives or by the level of reputational risk.

Once TRE levels are decided, the Commission will continue to apply effective control strategies, to minimise error rates on the basis of a cost-benefit analysis and will be alert to the need to feed results back into the control cycle to ensure key risks are addressed. To reduce the risk of error it will propose further simplification for the post-2013 period. Simplification is however a responsibility the Commission shares with the co-legislator and Member States.

4. Commission proposals

The Commission will progressively propose TRE levels for each policy area, or significant part thereof. This Communication covers "Research, energy and transport" and "Rural development" based on an analysis of the costs and benefits of controls and the link between a given management and control cost[3] and the residual error. Compared to the 2008 Communication, the methodology and quality of underlying data have improved. However, any model necessarily includes assumptions, as set out in the detailed Commission working documents.

4.1. Research, energy and transport

This policy area is mainly implemented in centralised direct management. Payments in 2008 were some €7.2 billion. Some 76% of this was on research projects in multi-annual framework programmes and around 12% was for energy and transport projects, notably trans-European networks. This Commission proposal is based on an analysis of costs of control data collected by Commission services, payment data for 2008 and errors detected by the Court of Auditors (DAS 2008). Based on the DAS data, the Commission estimated an error rate of 3% (yellow light) for this chapter in 2008. The cost of Commission control activities in this area is some €267 million (3.6% of 2008 payments).

The analysis, explained in detail in the annexed working document, shows that the cost of attaining a 2% error level could be prohibitive: an extra €150 million would virtually guarantee an error rate below 2% and even attaining a reasonable probability of achieving 2% (most likely error) could cost an extra €90 million (model 1). The 1% reduction in error rate that such a level of control would entail is some €72 million, assuming all error is fully recovered. A further analysis (model 2ab) shows that decreasing the error rate from the current 3% to 2.5% would still be costly: €55 million assuming that errors are removed randomly from the population. A third analysis was carried out to examine the impact on the error rate of reducing the number (and cost) of on the spot controls (model 2c). The results showed that accepting a higher error rate of 3.5%, the control costs would decrease more rapidly than the amount of expected recoveries from controls. For a 4% error rate this reduction could be almost one-third of current costs. The results of the analysis are presented in the figure below.

Figure 2: Summary of the estimated impact of attaining a given error rate

Error rate changed to	Change in estimated control costs (€million)	Estimated possible change in recovered amounts (€million)
4% (model 2c)	- €15.5	-€3.1
3.5% (model 2c)	- €8.0	-€1.5
2.5% (model 2ab)	+ €0.9 to €55 – median €28	+€36
2% (model 1)	+ €90 to + €150	+€72

The figures above show that the cost of reducing the error rate to 2% could be more than the value of that reduction (€72 million). Reducing the rate to 2.5% could be cost-effective, but this could involve some 500 additional audits. Increasing the error rate could result in a

[3] Such costs include the administration of programmes **and** financial control activities.

reduction in control costs in excess of the associated reduction in the value of errors recovered.

All statistical models imply a level of uncertainty as they are founded on sample-based estimates and can be expected to vary to a limited extent over time. To cater for this potential variation, the Commission's proposal is based on a range: the co-legislator may set an upper limit in this range. Using a range is even more important as the DAS 2008 was based essentially on FP6 payments, while FP7 will be predominant from 2010. Information currently available suggests FP7 expenditure will continue to be affected by error rates above 2% and comparable to, or slightly higher than, those in FP6 as:

- grants will continue to be based on beneficiaries' actual costs: overstatement is likely to remain the main cause of error; and
- the reduction of the number of required audit certificates, as a result of simplification efforts, and the relative low number of beneficiaries opting for ex-ante certification of their cost methodology are likely to increase the risk of error.

For FP6, the Commission significantly exceeded the number of audits originally planned. These additional controls placed a heavy burden on beneficiaries and on Commission services but have still not brought multi-annual error levels below 2%.

If the co-legislator sets a higher level of TRE, the Commission could review its control strategy and focus on targeted risk-based audits and fraud prevention. This would create a solid accountability framework, with appropriate emphasis on prevention and the timing of controls, while maintaining an appropriate deterrent to irregular use of funds.

The Commission proposes a TRE level in the yellow range (2%-5%). A DAS error rate around the middle of this range would be acceptable and justified. Beyond this level, additional action would be taken to reduce the error rate through increased controls addressing the major causes of error and taking into account the multi-annual nature of the expenditure. This rate should cover all Research Framework Programmes irrespective of the Chapter of the Court's annual report in which they are included as well as all activities included in this analysis even if they are reallocated to other Chapters of the Court's annual report in future.

This level could be revised in the light of major changes in the control environment that would have an effect on the DAS error rate.

4.2. European Agricultural Fund for Rural Development

The European Agricultural Fund for Rural Development (EAFRD) is implemented by the Member States in shared management and is part of Chapter 5 of the Court's annual report. Given the different management mode and data available (controls at beneficiary level are carried out mainly by Member States), the analysis for this area is different to that used for Research, energy and transport. Payments in 2008 were some €13.7 billion total public expenditure, of which € 8.5 billion from the EU (including advances). The area accounted for some 16% of total agricultural expenditure. The Court concluded in its annual report 2008 that the error rate for rural development exceeded 2%, while that for the European Agricultural Guarantee Fund (EAGF) was below 2%.

This Commission proposal is based on error rates and costs of control reported by Member States for 2008, which essentially impact on 2009 expenditure. The analysis was based on Member States' error rates because the Court's DAS sample, while representative for the whole Chapter, is not representative for EAFRD alone. Member States' statistics, covering some 300.000 on the spot controls, are sufficiently extensive to give a reasonable approximation of the situation in the whole population. To a very large extent they have been verified and validated by Member State certification bodies.

The analysis, explained in detail in the annexed working document, shows that the relative cost of control for EAFRD is nearly three times as high as for EAGF (7.3 % of the programme budget for the year compared to 2.7 %). Despite this high control cost, the cumulative error rate reported by Member States is 2.8 % for EAFRD. This is explained by complex rules and eligibility conditions, set to achieve environmental and other policy impacts which are challenging to verify.

Given the high cost of control, any increase of the level of on-the-spot controls beyond current levels would not be cost-effective – the costs of these controls would be five times higher than the recovery which on average can be expected (average error rate multiplied by the average amount received per beneficiary).

The EU's rural development policy recognises the need to pursue economic, environmental and social progress as three cords of a rope which reinforce each other. It aims to boost the competitiveness of the agricultural sector, care for the environment and preserve natural resources, and develop rural areas economically and socially. However, any further simplification of eligibility rules in rural development will not be enough to reduce the error rate in rural development below the 2% threshold presently used by the Court without the risk of jeopardising policy objectives.

While the Commission and Member States need to maximise the effectiveness of management and control systems to prevent, detect and correct errors, the Commission considers it would be uneconomic to increase controls in EAFRD. Member States' data support the Court's conclusion that the error rate in this area is higher than 2%.

The Commission proposes, for EAFRD expenditure, a TRE level in the yellow range (2%-5%). A DAS error rate around the middle of this range would be acceptable and justified. Above this level, additional action would be taken to reduce the error rate through increased controls and addressing the major causes of error. The target for the first pillar of the CAP would remain in the green zone (2%).

5. CONCLUSION

When the Court introduced the 2% materiality threshold the Commission did not have reliable information on the cost of controls. The threshold was decided by the Court in the absence of any indication to the contrary at political level. However, information on cost of controls is now available which allows a concrete discussion between stakeholders on the cost-effectiveness of controls.

Significant progress was made by the Commission and the 2008 DAS was the best ever. This improvement was secured by improving control systems and by doing more controls, increasing costs and the burden on beneficiaries (DG Research alone carried out 20% more on the spot controls of beneficiaries than originally planned in the period 2007-2009 for FP6). The Commission will continue to develop and implement credible control strategies, providing for efficient and timely control, focusing on risk and feeding back results into the control cycle. The current levels of control are high, including in rural development, and in the two areas covered above, the DAS error rate may have been reduced towards the minimum cost-effective level.

Commission services need to continue to demonstrate the effectiveness of their control strategies in their AARs, tailoring strategies to the risks and specificities of each policy area, ensuring that these are refined to reflect real risks and experiences and allowing for informed decisions on the cost/benefits of controls. However, once such due diligence has been demonstrated, tolerable risk is a sound investment and the co-legislator may set a TRE threshold higher than the current error rate in this light. This would provide a firm basis for the Discharge Authority to judge the Commission's management of risk**.**

While TRE would be an annual benchmark (in line with the DAS) where the Commission operates multi-annual control systems, the error rates at the end of a programme will be lower than the DAS due to financial corrections and recovery of unduly paid amounts. The Commission will work to identify such residual error rates as appropriate and will continue to correct all errors detected. However, the large number of beneficiaries means that controls cannot systematically be carried out on the spot and that errors will remain undetected. The Commission considers that:

– a TRE level for both policy areas covered by this Communication should be fixed in the yellow zone: 2% to 5%;

– a DAS error rate around the middle of this range in both areas would be acceptable and justified. Beyond this level, additional action would be taken to reduce the error rate through increased controls and addressing the major causes of error; and

– in parallel to the adoption of a justified annual TRE level, it should monitor multi-annual error rates and report to the Budgetary Authority at appropriate times in programme lifecycles.

The Commission has proposed to enshrine the concept of TRE in its proposal for the triennial revision of the Financial Regulation. Given the time necessary for the inter-institutional discussions on the latter prior to its entry into force, and following discussion of this Communication with the co-legislator, the Commission will put forward legislative proposals in view of formalising the TRE levels for "Research, energy and transport" and "Rural development". The Commission will present concrete proposals for TRE for "Administrative expenditure" and "External aid, development and enlargement" before the end of 2010 and progressively for the remaining sectors in 2011. It will propose simplification of sectorial legislation for the next round of basic acts to reduce the risk of error in the post 2013 period.

The Commission is committed to demonstrate the effective functioning of its control systems and will advise its Services for the next AAR round to enhance the reporting on systems effectiveness.