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**COMMUNICATION TO THE COMMISSION FROM MR POTOČNIK IN  
AGREEMENT WITH VICE-PRESIDENT KALLAS**

**Simplification of the recovery process in the framework of the implementation of the  
audit strategy under the Framework Programmes (EC, Euratom) for research**

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## Simplification of the recovery process in the framework of the implementation of the audit strategy under the Framework Programmes (EC, Euratom) for research

### 1. OBJECTIVE OF THE INITIATIVE

This Communication is about introducing elements of simplification into the recovery process, applied by the directorates-general of the research family in the context of the audit strategy for the Sixth Framework Programmes (EC and Euratom) for research (FP6).

The audit strategy includes the so-called extrapolation, i.e. an approach by which errors of a systematic nature found in audited contracts are presumed to be equally present in non-audited contracts of the same beneficiary within FP6.

The action proposed in this Communication is based on the experience gathered so far as regards the implementation of the FP6 audit strategy and aims at keeping the cost benefit ratio and resources devoted to this issue both by the Commission and the beneficiaries to a reasonable level while ensuring sound financial management and in particular the reduction of the residual error rate in the research area as far as possible. In parallel, some elements of simplification and rationalisation are introduced regarding the use of human resources in the process of the establishment and recovery of debts from beneficiaries of FP6 funding.

### 2. BACKGROUND

Responding to criticism from the European Court of Auditors<sup>1</sup> (ECA) and the European Parliament<sup>2</sup> (EP) as regards the relatively high number of errors identified in beneficiaries' claims for reimbursement, and as regards the control of research expenditure by the directorates-general of the research family, an ambitious audit strategy for FP6 was established in 2007, which included the extrapolation of audit findings to non-audited contracts<sup>3</sup>.

The purpose of this audit strategy is to reduce the residual error rate at the end of the FP6 period, if possible, below the 2% materiality threshold established by the ECA. This strategy has been endorsed by the ECA, the EP, the Commission's Audit Progress Committee (APC) and the Commission's Activity Based Management Steering Group (ABM).

The audit strategy is based on the following three main pillars:

- audit of the top beneficiaries that receive 50% of the research expenditure. Systematic material errors detected in this population are corrected through extrapolation, thereby addressing a large proportion of the corrections to be carried out;

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<sup>1</sup> European Court of Auditors, Annual reports concerning the financial year 2005, chapt. 7.19.

<sup>2</sup> Report concerning Discharge 2005 - Commission - Section III- P6\_TA-PROV(2007)0132 (137-142).

<sup>3</sup> Ex-post Audit Strategy of FP6 common to the Research DGs – 14/02/2007 - D(2007)3094.

- audit of the remainder of the population on the basis of a statistically representative sample, and
- risk-based audits of potentially high risk contractors.

In application of this audit strategy, the number of audits has been considerably increased and extrapolation of audit findings takes place if errors detected are systematic. As an example for DG Research (DG RTD), to date extrapolation has been proposed in 95 out of 738 audits (13%). The extrapolation concerns 4 376 FP6 participations corresponding to 8% of all participations managed by DG RTD. In most cases extrapolation is proposed for several deficiencies. The most common deficiencies are over declarations regarding personnel costs (35%) and overheads (38%). The exact amount to be recovered following extrapolation cannot be established yet. According to a first, very tentative assessment, the amounts at stake would be about €72 million as regards contracts managed by DG RTD.

The process of extrapolation and related recovery, particularly in the case of projects for which the financial statements have already been finalised and reimbursed, is very resource intensive for both the Commission services and the beneficiaries. On the basis of the audit findings, the beneficiaries have to go back to each project and its corresponding accountancy, and recalculate, for each period, the cost categories concerned by correcting the systematic error(s). Consequently, the procedure to establish debts and carry out recovery<sup>4</sup> following extrapolation is very time consuming and criticism of the ECA regarding low recovery rates in the research area might in the future further increase. Moreover, the eligibility rules for charges related to personnel are perceived as very complex and have been criticised as being subject to divergent interpretations.

Increased numbers and extent of audits, application of extrapolation (both to open and closed contracts), and related increased recoveries have also led to criticism from members of the EP, stakeholders and Member States.

In the framework of the Discharge procedure for 2007, the European Parliament addressed a recommendation (resolution §120) which reads as follows:

*"The European Parliament calls on the Commission, as a requirement for legal certainty, to refrain from re-calculating the financial statements of projects under the 6th Framework Programme that it has already approved and settled, by applying new interpretations to the eligibility criteria for costs established in the General Conditions (Annex II) of the FP6 model contract."*

The comment put forward by the EP in its discharge resolution concurs with the uneasiness expressed by the research community as regards the application of the FP6 audit strategy, pointing to the good faith of the contractors committing errors, the complexity of the rules, alleged new interpretations of rules through Commission's audits, high administrative burden to establish the actual debts in case of extrapolation.

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<sup>4</sup> Amounts due to the Union/Community are recovered by adjustments to future amounts due or by means of recovery orders.

### 3. THE COMMISSION'S RESPONSE

- The proposals presented below would be a response to address the concerns expressed on FP6. They would introduce elements of **simplification in the recovery process** and would lead to a **more cost efficient use of human resources** both at the level of the Commission services and the beneficiaries while safeguarding the principle of sound financial management.
- In this context it should be noted that the Seventh Framework Programmes (FP7) have already introduced several elements of simplification and the interim evaluation of this programme in 2010 provides an opportunity to consider further simplification. A communication that highlights the possibilities of further simplification in the research area is currently under preparation, based in part upon a public consultation of stakeholders, and should be adopted by the Commission in spring 2010.
- As regards the future of research funding in general, further simplification should aim to ensure an appropriate balance between sound financial management and administrative burden<sup>5</sup>.

### 4. COMPONENTS OF THE INITIATIVE

#### 4.1. Establishment of debts following extrapolation of systematic errors in audit findings to non-audited contracts on a flat rate basis

##### Objective

The calculation of the actual debts following the extrapolation of systematic errors to non-audited projects is very labour intensive and time consuming both for the Commission services and the beneficiaries as the costs claimed (and to be accepted) in each individual project have to be re-calculated. This process could be much simplified by the use of flat rate corrections, while safeguarding the respect of the principle of sound financial management in accordance with the principles of economy, efficiency and effectiveness.

##### Possible approaches

- The calculation of the actual debt can be made on the basis of one of the following methods:
  - Method 1: where the audit has identified the existence of a systematic error, the beneficiary shall **precisely recalculate the costs affected by the systematic error** in each of the non-audited projects and report the corresponding adjustments to the Commission in due form.
  - Method 2: however, with the aim to **simplify extrapolation** for the beneficiary and the Commission, the former may choose to adjust the individual cost category affected by a systematic error by the application of a **flat rate correction**. The flat rate corresponds to the average of the **individual systematic errors** in a given cost category identified in the audited projects. The beneficiary shall apply this

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<sup>5</sup> Communication from the Commission , "Towards a common understanding of the concept of tolerable risk of error" - SEC(2008) 3054.

average rate to recalculate the cost category in question in each of the non-audited projects. Where the audit has revealed the existence of several systematic errors affecting different cost categories, different flat rate corrections may be applicable to different categories.

- Method 3: the beneficiary may also opt to apply an **overall flat rate** correction to the total project costs of each of the non-audited projects. In these cases, the flat rate corresponds to the average rate of the individual systematic errors identified in the audited projects in relation to the total project costs.
- The beneficiary may engage an external, independent auditor to carry out further audits, which must be according to the Commission's own approach as regards the definition and treatment of errors. The Commission may take into account an average rate resulting from such audits in applying method 2 or 3 should they provide reasonable assurance based on the method used, without prejudice to the possibility of the Commission to carry out further, targeted, audits to corroborate the average error rate.
- It is understood that within one and the same extrapolation procedure only one of the extrapolation methods above may be employed.
- The Commission reserves the right to verify that extrapolation has been carried out in compliance with one of the methods described above. Agreement between the Commission and the beneficiary on flat rate corrections closes the Commission's audit exercise with regard to the systematic errors in the contracts and payments covered by the extrapolation. In such a case, adjustments following from the extrapolation methods mentioned above shall not be the subject to the application of liquidated damages or financial sanctions.
- The beneficiary may communicate the individual cost adjustments by project to the Commission in writing by means of revised cost declaration forms (forms C) or in another model format approved by the Commission. The implementation of the financial adjustments is made by compensation within the budget of the current project or via recovery order for closed contracts. Recovery orders for closed contracts may also be implemented by means of offsetting against other outstanding balances or advance payments to be made by the Commission to the same participant (as foreseen in the Financial Regulation and its implementing rules). For closed contracts, a global recovery order can be used.

#### **4.2. Treatment of charges related to personnel (direct taxes and social charges)**

##### The issues at stake

Audits performed under FP6 have revealed differences of interpretation of the contractual provisions between the Commission and certain beneficiaries. These differences often concern the eligibility of certain direct taxes or social charges relating to personnel costs. The recurring discussions about the eligibility of these types of costs are complex, contentious and time consuming.

The eligibility criteria are established in the FP6 Rules for Participation<sup>6</sup> and the FP6 model contract. Costs must be actual, necessary for the implementation of the project and determined in accordance with the usual accounting principles and explicitly exclude certain costs, in particular indirect taxes (e.g. VAT), duties and interests, provisions for possible future losses or charges.

It results from these provisions that direct taxes or social charges are not explicitly excluded; therefore, their eligibility as part of the remuneration of personnel (whether as a direct or indirect cost) must be decided on a case by case basis by applying the general eligibility criteria. Since legislation related to this type of taxes or social charges differs in each Member State, Associated Country, and the other countries whose entities participate and receive a financial contribution from the EU budget, this case by case analysis is difficult and very burdensome.

According to the Commission's interpretation of the rules, **social charges** are normally considered eligible costs when specifically attributable to the project. **Direct taxes and certain other charges related to personnel**, however, are in general not considered to be eligible when deemed not to be incurred specifically for the implementation of a project, unless they are calculated on the basis of the individual salaries of the persons working on the project.

However, beneficiaries tend to consider that all direct taxes and social charges linked to the remuneration of personnel are eligible, independently of the way they are calculated, as they are part of the full cost of employment related to research. In support of their view, some beneficiaries refer to the fact that these direct taxes or charges are not explicitly excluded by the contract, that their calculations were made – as required by another eligibility criterion – in accordance with their usual accounting principles<sup>7</sup> under which these costs formed an integral part of the remuneration and that under FP5 all expenses for taking on the personnel, including their remuneration and related charges, were explicitly considered eligible as a part of the personnel costs.

In addition, beneficiaries point out that when they had to make assumptions on eligibility to prepare their cost statements, they had not been aware of the Commission's diverging interpretation. This interpretation became explicit only during ex post audits, i.e. after most projects were finished and after the cost claims had already been reimbursed. As the submitted cost statements do not contain detailed information about the nature of the costs declared, the Commission is typically confronted with this issue for the first time during an on the spot audit. Moreover, under FP6 cost claims had to be certified by external auditors and the fact that these auditors in most cases never challenged the eligibility of these costs strengthened the beneficiaries' expectation that these costs would be considered eligible.

Beneficiaries could also claim that legitimate expectations were created in cases where these issues were not detected following earlier audits by the Commission's services or auditors mandated by the Commission due to the difficulties to identify and analyse such costs.

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<sup>6</sup> Regulation (EC) No 2321/2002 of the European Parliament and the Council of 16 December 2002 (OJ L 355, 30.12.2002). The principles applicable to the Euratom rules are the same.

<sup>7</sup> One of the major simplification offered by Commission in FP6 was the possibility to declare their costs according the usual accounting principles of the beneficiary.

### The approach to follow

In order to address this issue, the Commission considers that beneficiaries may rely on the principle of legitimate expectation as regards the eligibility of certain charges related to personnel (direct taxes and social charges). It is proposed that they are recognised as being eligible if and to the extent they fulfil all of the following criteria:

- the charges are mandatory under the applicable legislation or sector agreements, or resulting from measures based on such legislation or agreements
- they can be directly or indirectly<sup>8</sup> linked to the remuneration of personnel
- they are recorded according to the usual accounting principles of the beneficiary concerned
- they are effectively incurred during the duration of the project and have been paid or will be paid obligatorily at a later date and reflected in the accounts of the beneficiary.

These principles will not be applied in cases of fraudulent claims for such costs.

#### **The Commission is invited to:**

- adopt the present Communication;
- mandate the Commissioner responsible for Research and the Vice-President responsible for Administrative Affairs, Audit and Anti-Fraud to present it to the European Parliament, the Council and the Court of Auditors;
- instruct the directorates-general of the research family to apply the principles set forth in this Communication and to regularly report to the ABM Steering Group the results achieved in terms of amounts recovered;
- apply the principles under point 4.1 for extrapolation to FP7;
- instruct the directorates-general of the research family to examine the opportunity to apply the principles of point 4.2 as regards treatment of charges related to personnel to FP7.

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<sup>8</sup> This means that in order to satisfy this criterion the charges are not necessarily incurred for the specific individuals working on the projects funded under the contracts/grant agreements nor do they necessarily explicitly appear on the related payslip. Indeed, the related charges can be computed on the basis of specific accounting procedures, such as a pro rata charge on the overall employment costs of a legal entity and are fairly apportioned to the project. Taxes and charges for which the beneficiary is indebted for as a business entity, and having the nature of a business tax, calculated on the "masse salariale" of the beneficiary, are not considered linked to the remuneration of personnel, in the sense of this paragraph.