

Special Report

## Achieving economy: keeping the costs of EU-financed rural development project grants under control



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**Special Report****Achieving economy:  
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grants under control**

(pursuant to Article 287(4), second subparagraph, TFEU)

## Paragraph

### I – IX **Executive summary**

### 1 – 15 **Introduction**

### 16 – 20 **Audit scope and approach**

### 21 – 100 **Observations**

#### 21 – 35 **Part I - Guidance, supervision and correction: the European Commission's responsibility for ensuring that EU rural development funds are spent well**

24 – 29 Once audits showed weaknesses in checks of project costs, the Commission responded by proposing financial corrections and by encouraging Member States to prepare action plans

30 – 31 Costs could have been better managed had the Commission issued guidance and detected weaknesses much earlier in the programming period

32 – 35 While the Commission's recent initiatives have produced some results, the action plans do not address in sufficient depth the risks to the reasonableness of costs

#### 36 – 55 **Part II - Guarding against over-specification: approaches to ensure that the items for which the grant is approved are reasonable**

38 – 42 Restricting grants to the costs of a standard specification is simple and effective where there are many similar projects or common types of expenditure

43 – 55 For other measures, where justified by the risk, proposed costs should be evaluated to ensure that specifications are reasonable

#### 56 – 87 **Part III - Getting the best price: approaches to ensure that the prices of the items approved are reasonable**

58 – 63 Where feasible, using simplified cost options (or using maximum costs in a similar way) effectively limits the risks of excessive prices – as long as they are set at the right level

64 – 74 Comparing the prices of the items applied for to independent price data can provide assurance that prices are reasonable but this approach can be difficult to implement

75 – 85 Comparison of offers received from different suppliers can be a straightforward method to establish market prices but safeguards are needed to guard against manipulation and fraud

86 – 87 Where judgement is required, an independent expert opinion or that of an evaluation panel can give valuable assurance and can be particularly cost-effective when targeted to higher-risk cases

88 – 92	<b>Part IV - Keeping the eye on the ball after project approval: approaches to ensure that the costs actually reimbursed are reasonable</b>
90 – 91	Control systems should detect and check any material changes to the project made after the grant has been approved to be sure that the costs to be reimbursed are still reasonable
92 – 94	Clear rules, explicit declarations and checks on samples of payments can deter the concealment of discounts, rebates or other advantages given by the supplier that lower the real cost
95 – 100	<b>Part V - Making it efficient: approaches to ensure that the level of requirements and checks is commensurate with the level of risk</b>
96 – 98	Where the likelihood and potential impact of the risks is low, control systems can be designed that minimise the administrative burden
99 – 100	High-value items, projects with high aid-rates and other risk factors warrant an increased level of checks
101 – 111	<b>Conclusions and recommendations</b>
Annex I	— Checklist developed by the ECA to assess the design of control systems in relation to the risks associated with rural development costs
Annex II	— Rural Development Programmes selected for desk review
Annex III	— Use of simplified cost options in the 88 Rural Development Programmes
Annex IV	— Overview of the approaches followed in the Rural Development Programmes selected for desk review

## Reply of the Commission

**Control systems:** The set of rules and procedures used to manage an organisation or a spending programme to achieve its objectives.

**Gold-plating:** Embellishment beyond what is necessary, or the incorporation of costly and unnecessary features or refinements. In this report the term 'gold-plating' refers to acquiring items (or services) that are of a higher quality or specification than necessary: buying a luxury car rather than an inexpensive utilitarian vehicle, for example.

**Measure:** An aid scheme for implementing a policy. A measure defines the rules for the projects that can be financed. **Investment measures** are those that provide financial support for the acquisition of machinery and equipment, for construction or for works such as replanting forests.

**Member State authorities:** Member States or their regions designate a **Managing Authority** responsible for the planning, implementation and evaluation of the rural development programme and a **Paying agency**, which may undertake some of these tasks and makes the payments to the grant beneficiaries.

**Outputs:** That which is produced or accomplished by implementing a 'project'.

**Programming period:** Period covered by the rural development programmes. This audit concerns the 2007 to 2013 period. Payments for projects financed in this period may continue until December 2015. Rural development programmes for the 2014 to 2020 period had not been adopted at the time of this audit.

**Project:** An investment, service or other activity for which grant finance is sought/obtained.

**Reference prices:** Prices for items of equipment, machinery, construction materials or building costs, labour costs, etc. against which the Member State authorities evaluate the project costs proposed in grant applications.

**Results:** The direct effects or changes that occur by implementing a project.

**Rural Development Programme (RDP):** A document prepared by a Member State and approved by the Commission to plan and implement the EU's rural development policy at regional or national level.

**Reimbursement of actual costs:** Grant based on eligible costs incurred. Usually, the beneficiary has to present paid invoices as evidence of this.

**Simplified cost options:** Grants that are independent of the costs actually incurred. The main forms of simplified costs are:

- o **Standard unit costs:** the grant amount is calculated on the basis of a unit cost defined in advance.  
Example: A land-owner is awarded a grant to establish a new-wildlife friendly hedge using native tree species. The standard unit cost per metre of hedge is 50 euro. If the land-owner creates a 100m long hedge, the grant paid will be 5 000 euro (50 euro x 100), regardless of the actual costs incurred in purchasing the plants and establishing the hedge.
- o **Flat rate financing:** the grant amount is determined for specific categories of eligible costs by applying a percentage to other categories of eligible costs.  
Example: A farmer is awarded a grant to construct a new cattle shed at a cost of 100 000 euro. The flat rate for architects and surveyors' fees is 10 %. The farmer will receive, on top of the grant for the construction itself, a grant of 10 000 euro for architects and surveyors' costs, whatever the actual fees paid are.
- o **Lump sums:** a fixed amount of grant is paid on completion of specific activities/outputs or results.  
Example: A municipality is awarded a grant for organising an event. The lump sum for such events is 10 000 euro. The municipality will receive that amount, independently of the actual costs it incurs, provided it meets the grant conditions for the number of people attending, and the duration of the event.

## I

This audit concerns the costs of the EU's rural development policy. It focuses on the grants given towards the costs of investments and other projects undertaken by farmers, businesses, local authorities and other organisations in rural areas. These grants, which make up around half of the 100 billion euro EU expenditure programmed for the 2007-2013 period, are managed by Member State authorities under Commission supervision.

## II

With such large amounts at stake, the EU and the Member States share an interest in ensuring that the costs of rural development grants are kept under control. This is a key element of the 'sound financial management' required by the EU's financial regulations, whereby all managers of the EU budget are expected to apply the principle of economy: giving support for the *right things* at the *best price*.

## III

The Court audits rural development expenditure every year and presents the findings in its annual and special reports. A recurring finding is that Member State authorities do not sufficiently ensure that the costs approved for rural development grants are reasonable. The need for improving financial management in this area is clear. This led the Court to examine in detail the risks and the approaches followed by the Commission and Member States to address these risks.

## IV

The Court found that the approaches followed were not the most effective for keeping rural development costs under control. The Commission reacted after problems emerged rather than ensuring that systems were sound in the first place. Member States' control systems addressed only some of the risks to economy or were flawed. More effective approaches were available but were not widely applied.

## V

The Commission did not offer guidance or spread good practice at the start of the 2007-2013 programming period: it did not ensure that Member States' systems were effective before they started approving large volumes of grants. By the time it took action, the bulk of the project grants had already been approved. But since 2012, the Commission has adopted a more active and coordinated approach. If followed-through with a greater focus on economy, this should lead to better financial management in the next programming period.

## VI

Regarding the Member States, by 2014 the 15 largest Rural Development Programmes all had in place the basic systems required by the regulations for checking rural development costs. However, all had weaknesses in relation to the main risks such that overall, the costs of rural development grants were not well controlled. Analysis of information from all 88 RDPs indicates that a similar situation prevails across the EU. In particular:

- (a) Member States' control systems focused on the *prices* of the items or works in the grant applications with much less attention to whether the items themselves were reasonable or if the grant was cost-effective in relation to the policy objectives. This leads to risks of gold-plating and poor value for money.
- (b) The main methods used to check grant applications for reasonable prices were to compare offers from different suppliers or to compare to reference prices. The Court found that the systems in some Member States gave little assurance that the costs were reasonable – using reference prices that were 30 % above real market prices, for example.



## Executive summary

- (c) Grants are approved in advance and paid once the applicant has purchased the items concerned or undertaken the works. Where changes to a project occurred after grant approval, loopholes in some Member State systems allowed costs to be reimbursed for which the reasonableness had not been checked.
- (d) The level of requirements and checks generally did not take account of the different levels of risk. Many Member State authorities had the same approach to checking a 10 000 euro grant as to a 1 million euro grant. Where the risks were limited, the possibilities for simplification were not widely followed.

### VII

This leads the Court to conclude that there is considerable scope for making real savings in rural development project grants in the 2014-2020 programming period by better approaches to controlling the costs. These funds could be made available to finance additional projects leading to greater outputs and results and achievement of objectives.

### VIII

The Court also found that there were workable and cost-effective approaches to the weaknesses identified – most of which are already implemented in one Member State or the other.

### IX

Consequently, the Court recommends that before expenditure is committed in the new programming period, the Commission and Member States ensure that the approaches followed for all RDPs address the risks described in this report. Criteria for assessing this are in the report annex. An *ex-ante* assessment by Member State authorities should be part of this process. The Court also recommends that the Commission and Member States check early in the new programming period that the systems operate efficiently and are effective.

## **Reasons for undertaking the audit: better control of rural development costs could generate real savings**

### **01**

This audit concerns the costs of the EU's rural development policy. It focuses on the grants given towards the costs of investments and other projects undertaken by farmers, businesses, local authorities and other organisations in rural areas. The grants are managed by Member State authorities under the Commission's supervision according to rules set in the EU regulations<sup>1</sup>. In general, these grants are approved on the basis of a project specification and prices proposed by the applicant and are paid once the applicant has purchased the items concerned or undertaken the works.

### **02**

In the 2007-2013 programming period, the EU planned to spend almost 100 billion euro on rural development. Member States also planned an additional 55 billion euro contribution from their own national and regional budgets. With such large amounts at stake, the EU and the Member States share an interest in ensuring that the costs of rural development grants are kept under control. This is a key element of the 'sound financial management' required by the EU's financial regulations, whereby all managers of the EU budget are expected to apply the principles of economy, effectiveness and efficiency.

### **03**

However, in its audits of the 2007-2013 rural development policy the Court has found that the national and regional authorities do not sufficiently ensure that the project costs for which these grants are given are reasonable. The Commission has come to similar conclusions following its own audit work. More details are given in paragraphs 24 to 26.

### **04**

This indicates that a better control of costs could generate significant savings in rural development project grants while still obtaining the same outputs and results and achieving the same objectives. In the Court's opinion substantial savings are achievable. Just a few hundred euros saved on each investment project could generate many millions of euros in savings. Each 1 % saving would amount to 500 million euros saved from the EU budget over the programming period<sup>2</sup>. These funds could be made available to finance additional projects leading to greater outputs and results and achievement of objectives.

1 Council Regulation (EC) No 1698/2005 of 20 September 2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) (OJ L 277, 21.10.2005, p. 1), Commission Regulation (EC) No 1974/2006 of 15 December 2006 laying down detailed rules for the application of Council Regulation (EC) No 1698/2005 on support for rural development by the European Agricultural Fund for Rural Development (EAFRD) (OJ L 368, 23.12.2006, p. 15) and Commission Regulation (EU) No 65/2011 of 27 January 2011 laying down detailed rules for the implementation of Council Regulation (EC) No 1698/2005, as regards the implementation of control procedures as well as cross-compliance in respect of rural development support measures (OJ L 25, 28.01.2011, p. 8) apply for the 2007-2013 programming period. This arrangement is known as 'shared management'. The Commission retains overall responsibility but does not itself approve grants or make payments to beneficiaries, such tasks being undertaken by the Member State authorities.

2 The investment measures make up approximately half of the programmed rural development expenditure.

## 05

A similar set of rural development measures is due to be implemented in the 2014-2020 programming period, with the approval of new grants expected to start during 2015. The Commission is working with the Member States to improve the effectiveness of their control systems to ensure that they comply better with the regulations. Given the prospects that improvements in financial management in this area could lead to real savings and better use of the EU budget, the Court decided to contribute to this process with an in-depth audit on the current approaches for controlling the costs of rural development<sup>3</sup>.

**The rural development policy: over a million individual grants paid out to farmers, small businesses, local authorities and other organisations in rural areas**

## 06

The 2007-2013 rural development policy was put into practice through 88 national or regional rural development programmes across the EU. These programmes consisted of a number of 'measures' (aid schemes), each of which targeted specific beneficiary groups and project types through a set of eligibility rules and project selection criteria. The Member State authorities decided the grant rates (within the limits set by the regulations), which varied from below 10 % up to 100 % of the eligible project costs, depending on the measure. Through these measures the EU aims to induce and support activity that helps achieve the objectives of the policy: improving the competitiveness of agriculture and forestry; improving the environment and countryside; improving the quality of life in rural areas and diversifying the rural economy<sup>4</sup>. Examples of the range of projects financed are shown in **Box 1**.

- 3 The Court's mission is to contribute to improving EU financial management, promote accountability and transparency, and act as the independent guardian of the financial interests of the citizens of the Union. The Court's role as the EU's independent external auditor is to check that EU funds are correctly accounted for, are raised and spent in accordance with the relevant rules and regulations and have achieved value for money. More at: <http://www.ea.europa.eu/en/Pages/MissionObjectives.aspx>
- 4 More information on the rural development policy can be found on the Commission's web site: [http://ec.europa.eu/agriculture/rurdev/index\\_en.htm](http://ec.europa.eu/agriculture/rurdev/index_en.htm)

## Examples of projects financed by rural development programmes

**Policy objective: improving the competitiveness of agriculture and forestry**



Training for farmers financed through the 'Training and information' measure (Bulgaria)



Spraying machine financed through the 'Farm modernisation' measure (Germany)



Cattle shed with straw-spreading equipment financed through the 'Farm modernisation' measure (Luxembourg)



Grain drying and storage facilities financed through the 'Adding value to agricultural and forestry products' measure (Lithuania)

**Policy objective: Improving the environment and countryside**



Drip irrigation system financed through the 'Infrastructure related to the development of agriculture and forestry' measure (Greece)



Maritime pine trees planted through the 'Restoring forestry potential' measure (France)

**Policy objective: Improving the quality of life in rural areas and diversifying the rural economy**



Flower shop financed through the 'Support for the creation and development of micro-enterprises' measure (Sweden)



Café at wildlife park financed through the 'Encouragement of tourism activities' measure (United Kingdom)

## 07

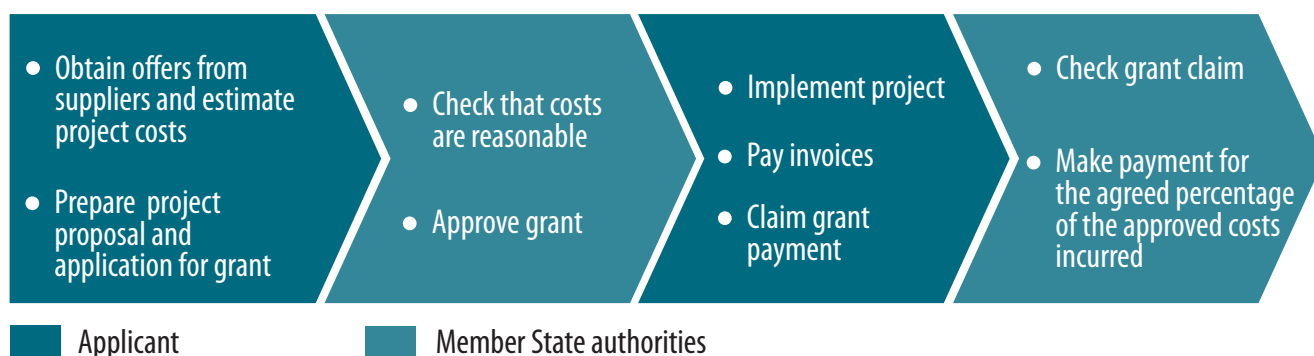
For most of the measures covered by this audit (see Audit Scope in paragraph 16), the applicant is reimbursed for the approved expenditure incurred. A typical process for obtaining a grant on a reimbursement basis is shown in **Figure 1**.

## 08

The main methods Member State authorities use to check the project costs in grant applications are illustrated in **Box 2**.

Figure 1

## Typical steps for requesting and obtaining a grant



Box 2

## Common approaches used to check that project costs in grant applications are reasonable



**Simplified example:** a farmer needs a new 75 hp tractor. He obtains offers from three suppliers: Offers A 44 000 euro; B 46 000 euro; and C 48 000 euro. He selects offer B and applies for a rural development grant of 50 % of the costs.

**Comparison of different offers:** the Member State authorities compare offers A, B and C and decide whether the costs applied for (Offer B: 46 000 euro) are reasonable.

**Market research:** the Member State authorities contact other suppliers or search on the internet for the costs of equivalent 75 hp tractors and compare these to Offer B.

**Expert opinion:** the Member State authorities ask an agricultural engineer to confirm that Offer B is reasonable. Alternatively they may consult an Evaluation committee for an opinion.

**Reference prices:** the authorities compare Offer B to a database of prices for different makes and models of tractors. If the reference price is 45 000 euro, they may nevertheless agree a grant of 23 000 euro based on Offer B if they consider the cost of 46 000 euro to be justified. Alternatively, they may apply the reference price as a ceiling and approve a grant of 22 500 euro.

**Simplified cost options:** instead of checking if Offer B is reasonable, the Member State authorities offer a lump sum grant of 20 000 euro for the purchase of a tractor. This is paid irrespective of the type of tractor or actual costs incurred. Alternatively, they may set a **Maximum cost** of 40 000 euro per tractor and reimburse 50 % of the actual costs incurred up to this amount.

## 09

For the main investment measures, the mean total project cost is around 125 000 euro. The amount of grant payable towards the project costs will depend on the aid rate but the measures are characterised by large numbers of relatively small grants – some of which can be for less than 1 000 euro – and a smaller number of large grants, which can exceed 1 million euro. Member State authorities expect to have approved around 1,4 million individual grants by the end of the programming period.

**Analysis of the risks: grant payments may be too high if given for unnecessary costs or based on uncompetitive prices**

## 10

As described above, the principle of economy applies to all grants or payments from the EU budget. According to this principle, subsidies should be given for the *right things* at the *best price*. In the context of rural development projects, this means that the items for which the grant is given should be of the type, quality and quantity needed to achieve the intended outputs and results. The grant for these items should be based on the lowest available price for the required specification.

## 11

In most cases, grants are given for only a proportion of total project costs and applicants must pay the balance from their own resources, giving the applicant an incentive to limit the project costs. Where aid rates are low, the incentive can be strong – but as aid rates increase the incentive diminishes.

## 12

Any subsidy distorts the real cost-benefit relationship, which may encourage the applicant to specify a higher-cost solution than necessary, from 'gold-plating' (see **Glossary**) through to investments that are disproportionate to the outputs or results expected to be achieved by undertaking the project. Consequently there is a risk that the quantity and quality of the items financed may be greater than appropriate (risk of '**over-specification**') representing an unnecessary cost to the EU and national budgets.

## 13

Subsidies also reduce the incentive for the applicant to search for the best prices. Applicants may prefer to favour a higher-cost supplier. At the extreme, there is the possibility that they or the suppliers may manipulate the process thereby inflating the costs. These all lead to the risk that the grant may be based on prices that exceed the lowest available in a competitive market for items of the required specification (risk of '**uncompetitive prices**').



### 14

It is important that the approaches followed by Member State authorities to address these risks are effective because poor value for money and fraud not only increase costs to the budget, they also tarnish the reputation of the EU. However, a balance has to be found between the costs of implementing the control systems and the benefits gained by mitigating the risks. Applicants incur costs in providing the information required to support their grant applications. Member States incur costs in checking and evaluating this information. These costs should be proportionate to the level of the risks: a 1 million euro grant could warrant several days of work if that was necessary to establish that the costs were reasonable. A 1 000 euro grant would not.

### 15

Finally, there is a risk that the Commission may not detect any deficiencies in Member States' control systems or may not take timely corrective action when weaknesses are identified.

## Audit Scope: the rural development measures implemented through grants

### 16

The risks identified above apply particularly to the rural development measures implemented by way of grants towards the costs incurred by the beneficiary. These measures, which represent around 50 % of the total rural development costs programmed for the 2007-2013 period<sup>5</sup>, are included in the scope of this audit (see **Figure 2**). The main measures concerned are:

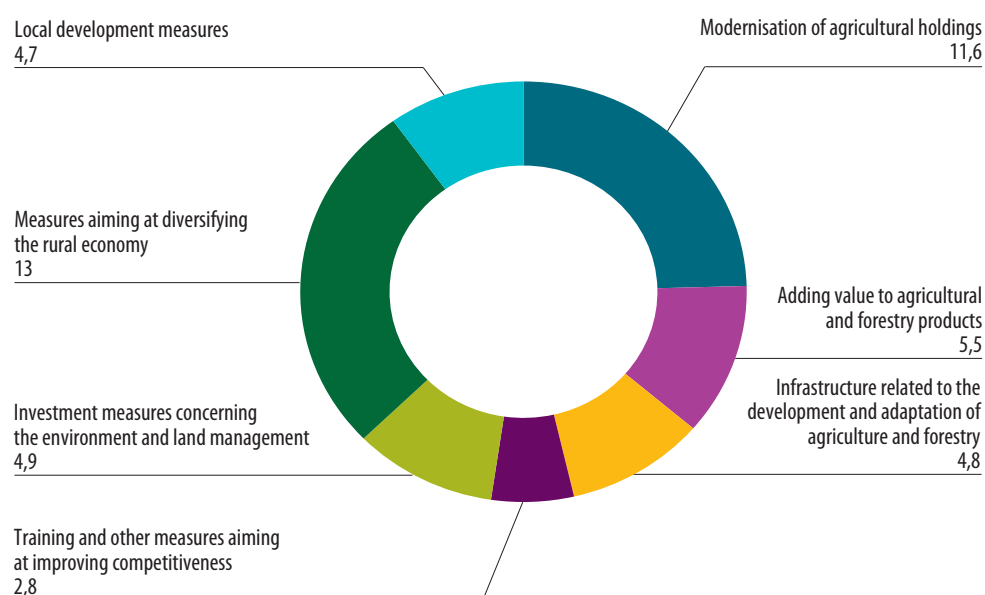
- Modernisation of agricultural holdings
- Adding value to agricultural and forestry products
- Infrastructure related to the development and adaptation of agriculture and forestry
- Training and other measures to improve the competitiveness of agriculture and forestry
- Investment measures related to land management and the environment
- Measures to diversify the rural economy and improve quality of life
- Local development measures using the LEADER approach.

<sup>5</sup> The other 50 % of rural development spending mostly comprises compensation payments to land owners calculated on a per hectare basis for activities such as protecting and enhancing the environment. The amounts payable are included in the RDPs and approved in advance by the Commission. The Court's Special Report 7/2011 covered 'agri-environmental payments', which is the main area-related measure (<http://eca.europa.eu>).

Figure 2

## Audit scope: the measures covered by this audit

Programmed expenditure 2007-2013 (billion euro)



Source: European Commission.



**Audit approach: focus on the design of control systems, obtaining a wide geographical coverage through questionnaires and desk reviews**

## 17

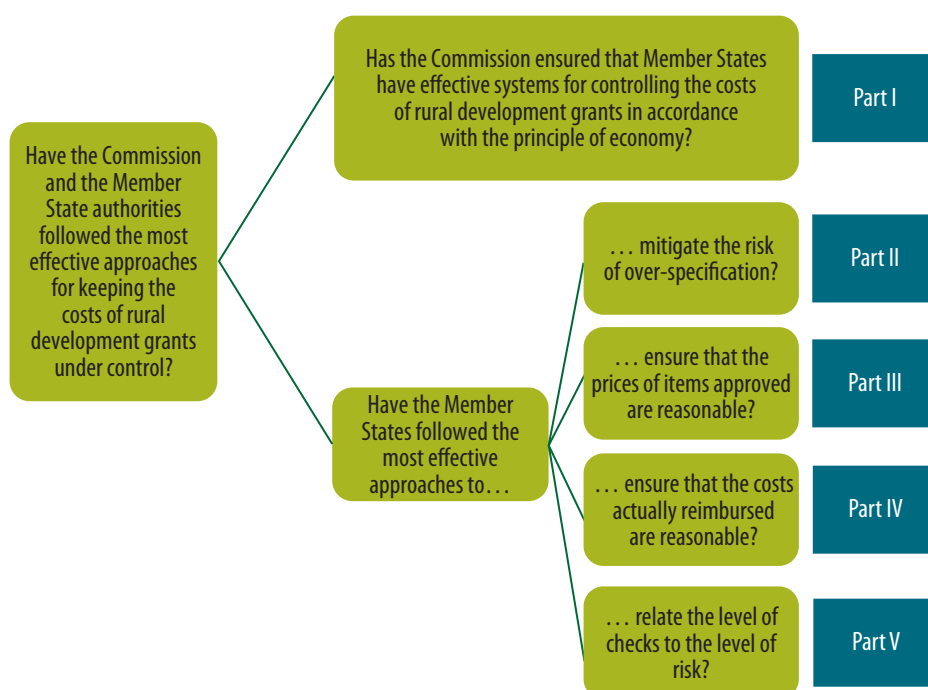
The Court's audits of rural development expenditure have repeatedly found that Member State authorities have not sufficiently ensured that the project costs approved are reasonable<sup>6</sup> (see paragraphs 24 to 25). The need for improving financial management in this area is clear. This led the Court to question whether the approaches followed by the Commission and Member States were the most effective in relation to the main risks. The audit placed a particular emphasis on identifying

good approaches that other Member States can apply, thereby raising the general level of performance. To examine the scope for this, the Court set the audit questions shown in **Figure 3**.

<sup>6</sup> Member States have to comply with Commission Regulation (EU) No 65/2011, Article 24(2)(d): Administrative checks on applications for support shall in particular include verification of [...] the reasonableness of the costs submitted, which shall be evaluated using a suitable evaluation system, such as reference costs, a comparison of different offers or an evaluation committee.

**Figure 3**

## Audit questions and structure of the report



## Audit scope and approach

### 18

This report follows the same structure as the audit sub-questions: Part I covers the supervisory role of the Commission. In Parts II to V, the Court examines the different approaches followed by the Member State authorities to mitigate the key risks.

### 19

A focus group of officials from the Commission and Member State authorities supported the Court's team in identifying elements key to the design of effective control systems. From this the Court developed a checklist to assess the design of control systems in relation to the risks (see **Annex I**). The Court's evidence collection consisted of a follow-up of previous audit findings<sup>7</sup>; a questionnaire addressed to the managers of all the EU's 88 RDPs and a desk review of the key procedures applied in the 15 RDPs with the greatest planned expenditure on the measures within the scope of this audit (see **Annex II**). These 15 represent 64 % of the total planned expenditure on these measures for the EU as a whole. Short audit visits were made to four of these Member States to complement the desk reviews. Interviews were held with Commission officials and relevant documentation analysed. The audit examined the systems in place from the end of 2013 and was concluded in mid-2014.

### Limits of the audit scope and approach

### 20

In this audit the Court has identified and assessed the *design of the control systems* put in place by the Managing Authorities that are intended to ensure that rural development costs are reasonable. Even the best-designed systems may not be effective if they are not implemented well. It was not the aim of this audit, however, to check how well the control systems were applied in practice. Such an approach would have duplicated the work done each year to prepare the Court's annual reports (see paragraphs 24 to 25).

<sup>7</sup> Where weaknesses had previously been identified, the Court examined whether the Member State authorities concerned had changed their approaches accordingly.

## Part I - Guidance, supervision and correction: the European Commission's responsibility for ensuring that EU rural development funds are spent well

### 21

While the rural development spending programmes are managed by the 88 Member State authorities, the Commission is ultimately responsible for implementing the EU budget. Specifically, the Commission is required<sup>8</sup> to check that management and control systems exist and function properly in the Member States, and that they observe the principles of 'sound financial management': economy, effectiveness and efficiency.

### 22

The legislation provides various means by which the Commission can exercise its supervisory functions: Member States should inform the Commission of their management and control measures; paying agencies must be accredited and national 'Certifying bodies' report annually on issues including the operation of control systems. The Commission meets periodically with Member State representatives and has contacts and formal annual meetings with the managing authority of each RDP. It adopts legislation with the detailed rules for implementing the policy and issues guidance. It also has its own audit department to check the operation of Member States' systems. Finally, if it finds that the Member State authorities are not complying with the regulations, it can recover improperly spent funds.

### 23

The Court assessed whether the Commission used these means to ensure that Member States' systems for controlling the costs of rural development grants are effective.

### Once audits showed weaknesses in checks of project costs, the Commission responded by proposing financial corrections and by encouraging Member States to prepare action plans

### 24

The Court examines a large randomly-selected sample of payments each year and checks the effectiveness of selected control systems. In each annual report since that for the year 2011 the Court has noted that the majority of the systems for checking the reasonableness of rural development costs were not sufficiently effective (see **Figure 4**). In 2013 all four systems audited were found to be ineffective in this respect.

### 25

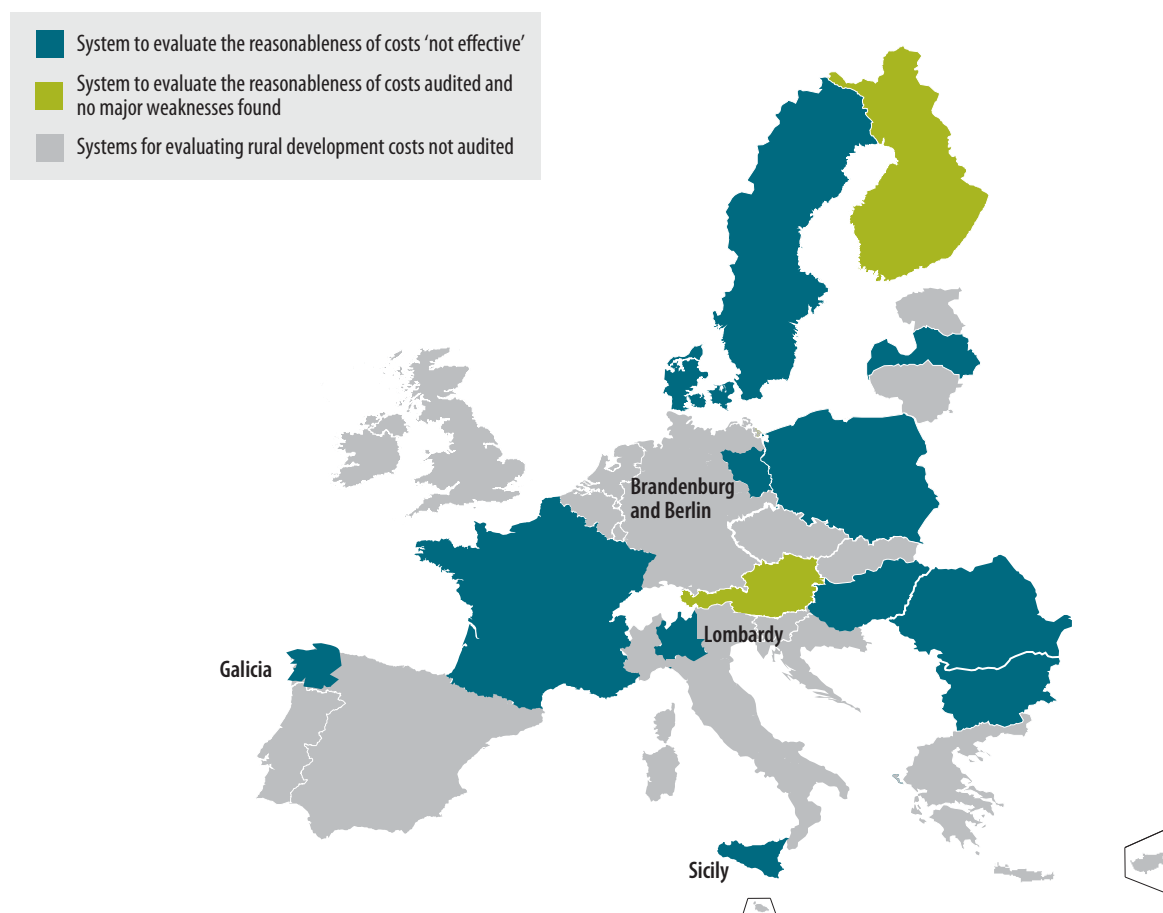
In the audits for the 2011, 2012 and 2013 annual reports, the Court found for the measures concerned by this audit that around a third of the rural development projects had not been sufficiently checked for the reasonableness of costs. Where the beneficiaries were public bodies, almost half of the payments were affected by non-compliance with public procurement rules<sup>9</sup>.

8 This requirement is in Article 9.2 of Council Regulation (EC) No 1290/2005 of 21 June 2005 on the financing of the common agricultural policy (OJ L 209, 11.08.2005, p. 1).

9 Public procurement rules are intended to ensure that public bodies obtain the best prices for the goods and services they buy, as well as promote fair competition and transparency. Non-compliance with these rules makes it less likely that the prices obtained are the best available.

Figure 4

### Effectiveness of the Member State or regional systems for assessing cost reasonableness



Source: ECA annual reports 2011, 2012, 2013.

## 26

The Commission also has its own programme of audit enquiries, which identified similar findings, as did the Court's performance audits of specific rural development measures<sup>10</sup>. While the Court and Commission audits are not designed to quantify the savings that could be made by better control of the costs, flaws in the systems and the high level of errors are strong indications that the potential savings could be considerable.

## 27

In response to the audit findings mentioned above, the Commission launched procedures for 'financial corrections', whereby EU funding for the Member State concerned is reduced to compensate for the shortcomings identified. Procedures underway with eight Member States stem at least partly from failings in their checking of rural development costs or non-compliance with public procurement rules.

10 Special Reports No 5/2010 'Implementation of the LEADER approach for rural development'; No 8/2012 'Targeting of aid for the modernisation of agricultural holdings'; No 1/2013 'Has the EU support to the food processing industry been effective and efficient in adding value to agricultural products?'; No 6/2013 'Have the Member States and the Commission achieved value for money with the measures for diversifying the rural economy?'; No 8/2013 'Support for the improvement of the economic value of forests from the European

### 28

Following the Court's 2011 Annual Report, the Commission asked the Member States to develop action plans to identify the causes of errors and define remedial actions. In 2012, 14 Member States set up such plans and all other Member States did so in 2013.

### 29

In parallel, at the request of the European Parliament, the Commission analysed the main reasons for the high error rate and presented the results in June 2013<sup>11</sup>. Two of the main reasons given were insufficient checks that the costs were reasonable, and non-compliance with public procurement rules.

### **Costs could have been better managed had the Commission issued guidance and detected weaknesses much earlier in the programming period**

### 30

There was no guidance by the Commission at the start of the 2007-2013 programming period on the design of control systems to verify costs or on the risks to be addressed by those systems. The managers of the 88 RDPs were expected to develop their own approaches without information from the Commission on the standards expected. The Commission did not sufficiently check that Member States had robust systems in place for checking grant applications before they approved large volumes of expenditure through the investment measures. The processes of accreditation and reports by Certifying Bodies did not alert the Commission in good time to the risks to the economy of the EU budget.

agricultural fund for rural development' (<http://eca.europa.eu>).

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

### 31

By the time the first Member States produced action plans towards the end of 2012, only one year of the seven-year programming period remained. Consequently, the action plans came too late to have any effect on the bulk of the expenditure. For example, by that time the Polish authorities had already approved grants representing 90 % of the budget for farm modernisation – the most important rural development measure financially – and several measures in other Member States had already been closed for new applications.

**While the Commission's recent initiatives have produced some results, the action plans do not address in sufficient depth the risks to the reasonableness of costs**

### 32

Audits and pressure from the Commission have already had some positive results: several Member States informed the Court that they introduced new procedures in 2013 and 2014 for checking rural development project costs. But Member State action plans did not cover all the regional RDPs or all the relevant measures and did not always propose changes even where audits had found specific weaknesses<sup>12</sup>. Moreover, several of the plans put off any action until the next programming period.

### 33

Since the beginning of 2013, the Commission has organised twice-yearly seminars to discuss some of the key issues and asked Member State authorities to further develop their action plans. In February 2014 it issued a guidance note on avoiding fraud and, in September 2014, guidance on the use of simplified costs. This guidance is aimed at the 2014-2020 programming period in which the Commission is encouraging Member States to make more use of simplified costs, which, it is hoped, will reduce the rate of errors<sup>13</sup>.

### 34

However, for the measures within the scope of this audit only around 5 % of the expenditure is currently based on simplified cost options. The Commission has not issued guidance on approaches applicable for the remaining 95 % of the expenditure, despite the evidence of shortcomings. This leads to the risk that except for using simplified costs, the 88 managing authorities may not all identify and implement effective approaches for controlling the costs of rural development grants.

12 Examples are shown in the Court's Annual Report for 2013.

13 However, Member State representatives have indicated their concern that the diversity of the rural development measures makes the use of simplified cost options difficult; that the administrative costs involved in defining standard costs can be high; that a lengthy preparation time may be needed to undertake studies; and that the Member States would run the risk of systematic errors and large financial corrections if auditors found that the standard costs had been set too high.

## 35

The Commission and Member States have focused the action plans on improving compliance with the implementing regulations, thereby reducing the rate of errors. Clearly, this is important and the Court has been calling for such action for many years. But compliance with the regulations is not an end in itself – a focus is also needed on the ‘sound financial management’ principle of economy that the legislation is intended to achieve (see paragraphs 2 and 10). In this respect even the best of the plans examined by the Court does not have a comprehensive response to the main risks to economy – grants based on higher-than-necessary specifications and uncompetitive prices; post-approval variations; and checks not related to the level of risk. The Court examines these and the possible approaches to them in Parts II to V of this report.

## Part II - Guarding against over-specification: approaches to ensure that the items for which the grant is approved are reasonable

## 36

Managers of EU spending programmes are expected to apply the principle of economy described in the introduction to this report. According to this principle, not only should project grants be based on reasonable prices but the project specification – the items financed – should also be reasonable. Subsidies change the cost-benefit relationship, leading to a risk that applicants may specify higher-cost project proposals than necessary, ranging from ‘gold-plating’ (see **Glossary**) through to investments that are disproportionate to the expected results. The Court assessed the approaches followed by Member State authorities to address this risk of over-specification.

## 37

While all Member State authorities made checks of *prices* (see Part III), few made explicit documented checks that project specifications were reasonable<sup>14</sup>. Some made indirect, implicit or undocumented checks, as shown in paragraphs 46, 48 and 53. However, many Member State authorities mitigated risks of over-specification for some types of projects by restricting the maximum eligible costs or by using simplified cost options, as shown below.

14 One good example was in UK-England, where an explicit check was made that the proposed building design or equipment specification are justified as being the most appropriate to the project.

### Restricting grants to the costs of a standard specification is simple and effective where there are many similar projects or common types of expenditure

#### 38

The risk of over-specification occurs where the grant is based on the costs of the items chosen by the applicant. The Court has observed that Member State authorities can largely avoid this risk by restricting the eligible costs to those of a 'standard' specification. With this approach the Member State authorities estimate the costs necessary for a typical project or category of expenditure and limit all grants to these typical costs. An example is given in **Box 3**.

#### 39

This approach has the advantages of being simple to implement and having a predictable outcome: it gives certainty. This allows Member State authorities to dispense with burdensome requirements and checks of whether the specifications are reasonable for individual project applications. It does not prevent applicants from implementing a higher-cost solution – but the grant payment will be based on the standard, so the costs to the EU budget will be reasonable.

#### 40

But rural development projects require varied and sometimes innovative solutions, involving a wide range of different types of expenditure. Defining a standard specification for all possible situations is hardly feasible. It is best applied where there are a large number of straightforward projects with similar types of expenditure.

#### 41

Many Member State authorities followed this approach to some extent by applying 'simplified costs' or 'maximum costs'. These approaches are described in **Box 2**. Simplified costs were applied in 54 of the 88 RDPs, mostly to investments in land-management measures designed to enhance the environment, or for planting and managing forests. A typical example is a standard payment per metre of hedge calculated on the basis of a standard specification (e.g. three hawthorn plants per metre). Several Member State authorities also set 'maximum costs' in relation to project outputs in a similar way. These differ from 'standard costs' in that the applicant is reimbursed the actual costs incurred. Examples of types of expenditure where Member State authorities have restricted grants to standard or maximum costs are shown in **Box 4**.

#### 42

While over half of the Member State authorities make use of simplified costs (and others use maximum unit costs in a similar way), the Court found that this is only for specific expenditure types within a limited number of measures (see **Annex III**) and amounts to only around 5 % of the budget. There is scope for wider application of these methods in other measures and in other RDPs.



## Box 3

**Example of restricting eligible costs in a way that limits the risk of over-specification: crop-spraying equipment in France**

In France, farmers applying for grants towards the costs of crop-sprayers frequently specified optional extra equipment that could reach 85 % of the total costs. Considering this to be unreasonable, in 2012 the French authorities placed a limit of 3 000 euro on the costs of such extras for which a grant would be payable.

## Box 4

**Types of expenditure where Member State authorities restricted grants to standard or maximum costs in a way that limits the risk of over-specification****Standard unit costs**

- per metre of hedging (e.g. in France under the measure 'Conservation and upgrading of the rural heritage')
- per hectare of land improvement (e.g. in Hungary under the measure 'First afforestation of agricultural land')

**Maximum costs per unit of output or result**

- per square metre of building constructed or renovated (e.g. in Bulgaria for buildings under the measure 'Village renewal and development')
- per animal place (e.g. in France for cattle sheds under the measure 'Farm modernisation')

**Maximum costs per category of expenditure**

- maximum amount for a type of agricultural equipment (e.g. in France for spraying equipment under the measure 'Farm modernisation')
- maximum amount for technical or feasibility studies (e.g. in the Czech Republic for preparation of plans for biogas projects under the measure 'Farm modernisation')
- maximum percentage for fees (e.g. in Spain-Andalucía for architect's fees under the measure 'Adding value to agricultural and forestry products')

**For other measures, where justified by the risk, proposed costs should be evaluated to ensure that specifications are reasonable**

### 43

Where the costs are not restricted to those of a standard specification, the risk of over-specification needs to be addressed. Member State authorities followed three main approaches to this:

- Standard checks to compare the proposed costs to benchmarks;
- Individual evaluation of project specifications;
- Expert opinions.

**Standard calculations and comparison to benchmarks can quickly identify applications that may be over-specified**

### 44

For all but the smaller projects, applicants have to provide physical and financial data on their businesses and on the project plans, which the Member State authorities use to check eligibility and select the best projects. This information ranges from just a few figures to full business plans. Member State authorities can also make use of this information to check that the costs of the proposed project are reasonable in relation to the expected outputs or results: the contribution that the project is likely to make towards achieving the RDP objectives. Examples include simple payback calculations or relating the capacity of agricultural equipment to the size and type of farm.

### 45

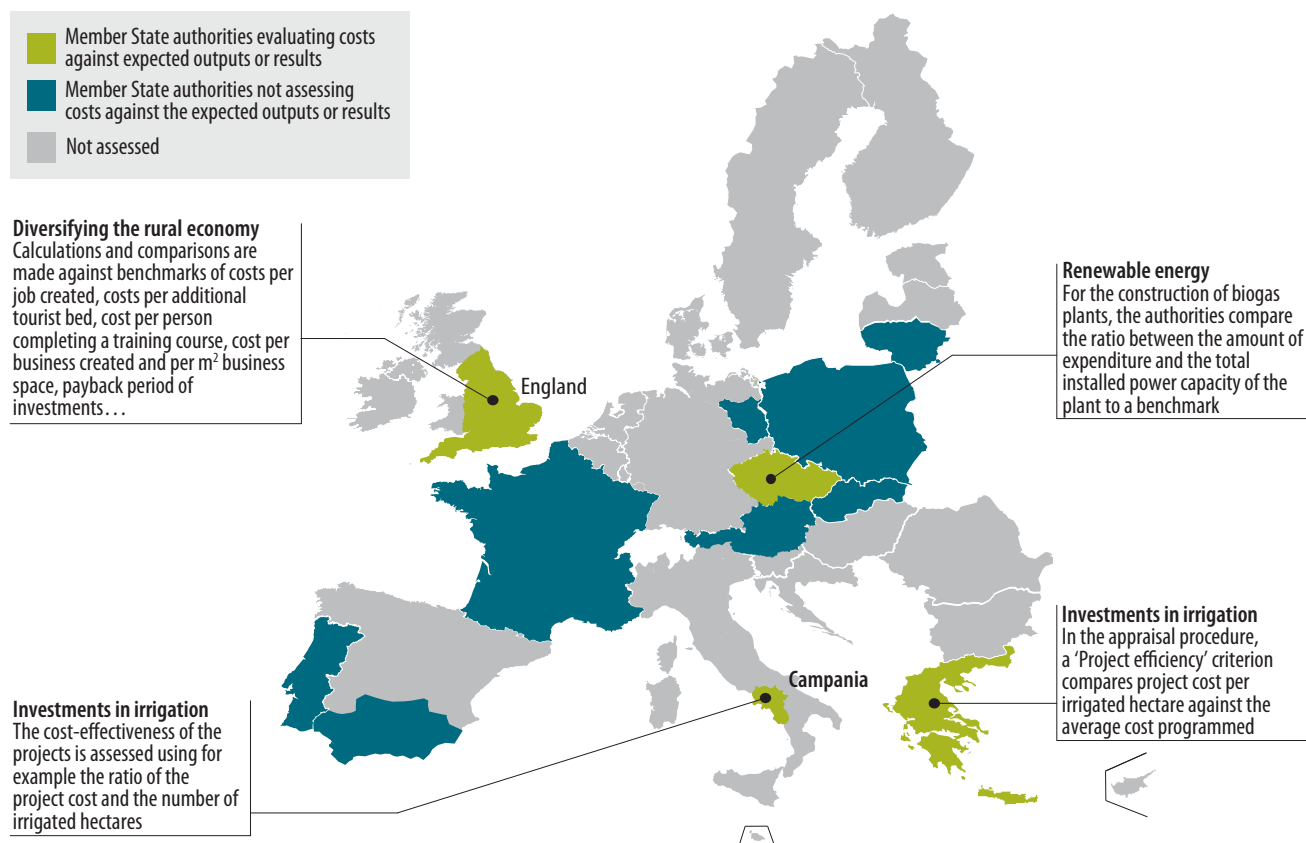
Member State authorities can establish standard calculations and spreadsheets that allow their staff to quickly calculate financial ratios or other indicators and compare them to benchmarks or warning levels. This can be done with little additional time or cost using templates for application forms to ensure the information is consistent. Applications that fall within the normal ranges can have a reduced level of scrutiny and those outside the range be investigated more thoroughly to ensure that the costs are reasonable.

### 46

These benchmarks can also be used as cost effectiveness or 'value for money' criteria for project selection. As an example, in UK-England the authorities set a target that on average, projects involving support for small rural businesses should generate one new job per GBP 30 000 of subsidy. If they considered that the proposed project costs were not reasonable (i.e. too high) in relation to that target, they did not approve the grant. For the main investment measures, only 4 of the 15 RDPs reviewed evaluated whether costs were reasonable in relation to the expected outputs or results (see **Annex IV** and **Figure 5**).

Figure 5

## Member State authorities evaluating against the expected outputs or results<sup>1</sup>



<sup>1</sup> Excluding the measure for training and information.

Source: ECA audit findings.

**Evaluation of individual project specifications can be difficult for non-technical administrative staff but common-sense checks and unambiguous rules can help prevent and detect over-specification**

### 47

In diverse programmes such as those for rural development, projects will not all have a standard set of outputs and results that allow costs to be readily evaluated through calculations of ratios or comparison with benchmarks. Furthermore, where specifications exceed the norm, Member State authorities have to consider whether the higher specifications are justified by the individual circumstances of the project or because they represent better value for money. Such evaluations of individual project specifications (including tender conditions and award criteria) can be difficult without specialist technical knowledge and can be time consuming but are worthwhile for larger amounts.

### 48

Some two-thirds of Member State authorities informed the Court that their staff make common-sense checks of project specifications, often using the experience they build up through processing a large number of projects. However, the Court has observed that the value of these checks is diminished if a record is not kept of what was checked and what standard was applied.

### 49

Unambiguous rules help non-technical staff to make consistent and fair decisions when evaluating project proposals. A particular – but common – situation occurs where the applicant presents several suppliers' offers for the project with differing specifications: different makes of equipment, different construction methods or materials, different time schedules or different after-sales service, etc. Applicants will normally choose the offer that represents the best value for their business in terms of quality and cost (although this choice will be influenced by the subsidy). Where applicants do not choose the lowest-cost offer, the Member State authorities have to evaluate if the additional quality or features of the higher offer also represent the best value for money in terms of the policy objectives, or whether it may be a case of gold-plating.

## Observations

### 50

For this, the staff evaluating the costs of project proposals need clear criteria that they can apply consistently to all cases. Here, the Court has found a general weakness as, instead of criteria, Member State authorities have just listed examples of the sort of justifications that *might* be acceptable. One example is in Germany, where almost any conceivable reason – quality, price, technical suitability, environmental qualities, operating and maintenance costs, profitability, customer service, technical assistance or delivery dates – can be taken into consideration. Others, such as the French and English authorities, follow a similar approach. In its previous audits the Court found that Member State authorities were satisfied if one of these reasons was given but rarely evaluated whether it was sufficient to justify the additional costs. A degree of judgement is required to assess the justifications given by the applicant but the project files lacked documentation to show the basis on which staff evaluating the application considered that the extra costs involved were reasonable.

### 51

An alternative approach, followed by around a quarter (21) of the 88 Member State authorities, is to always base the grant on the lowest valid offer. This has the advantages of simplicity – as it is unambiguous – and economy as the cost to the EU budget is the lowest. Such an approach does not prevent the applicant from choosing the ‘best value’ offer if that is higher – but the *amount of grant* will always be determined on the lowest offer. In effect, applicants pay for the ‘extras’ (such as higher quality or an extended warranty) themselves without grant support. The different approaches are illustrated in **Box 5**.

### 52

Of course, neither of the above approaches will be effective if the applicant manipulates the process of obtaining and presenting offers, for example by drafting the specifications in a way that excludes potential suppliers. This risk is covered in Part III: *Getting the best price*.

## Box 5

**Different approaches to establishing the grant amount: lowest valid offer or applicant's choice**

**Simplified example:** Farmers in Member States X and Y receive offers for 200 hp tractors from brands A, B and C for 80 000 euro; 90 000 euro and 100 000 euro respectively. The tractors are functionally equivalent but the farmers both prefer brand C. While it is the most expensive, it holds its value well and can be re-sold for 40 000 euro after 5 years. Taking the grant into account, this is better value than tractor A, which has a lower re-sale value.

Member States X and Y both approve grants for the purchase of tractor C but the amount of the grant is different. Member State X follows the 'lowest offer' principle and gives a 40 000 euro grant (50 % of the lowest valid offer). Member State Y checks that the farmer has justified the higher offer and gives a 50 % grant of 50 000 euro based on the applicant's choice.

	(euro)	
	Member State X: grant based on lowest offer	Member State Y: grant based on applicant's choice
Lowest valid offer	80 000	80 000
Applicant's chosen offer	100 000	100 000
Grant approved at 50 %	40 000	50 000

**Expert opinions can give good assurance that specifications are reasonable, provided that they are sufficiently independent**

## 53

Many RDP projects involve similar types of expenditure: agricultural machinery, agricultural installations, construction and rural infrastructure, for example. Several Member State authorities, including Hungary and Italy-Campania, employ staff with qualifications in these fields, such as agricultural engineers or quantity surveyors. These are able to understand the technical specifications and apply their professional qualifications and experience to make sound judgments on the project specifications proposed. Provided that the purpose and conclusion of the checks is clear and the work done is documented, the use of in-house expertise can give

reliable, independent assurance that the costs proposed are reasonable and allows the Member State authorities to identify any cases of gold-plating. The deterrent effect of this is also important: a farmer that knows that the grant application will be evaluated by an agricultural engineer, for example, is less likely to apply for an excessive specification.

## 54

However, it is not always feasible or cost-effective for Member State authorities to employ staff with such expertise, particularly when there are too few projects of a particular type to justify it. Some Member State authorities, such as those in Greece and Lithuania, contract experts to give opinions on the specifications and costs of selected projects, particularly for projects that present specific risks because of their size or specificities, or because they differ from the normal ranges of costs.

## 55

Other Member State authorities, such as those in Austria and Hungary, require applicants to provide a certificate or statement by a recognised expert such as a quantity surveyor on the project specifications. However, the reliance that can be placed on such statements is limited in practice. Most obviously, the experts will act in their clients' interest, which may conflict with the Member States' and EU's interests of achieving the policy objectives at the lowest possible cost. Secondly, the purpose of the expert's statement may be to confirm that the specification complies with building regulations or other technical requirements. This is not relevant or useful for identifying potential over-specification.

## Part III - Getting the best price: approaches to ensure that the prices of the items approved are reasonable

## 56

Following the principle of economy (see paragraphs 2 and 10), EU project funding should be based on prices that are the lowest available for the required project specification. However, subsidies reduce the incentive for the applicant to search for the best prices and applicants may prefer to favour a higher-cost supplier, leading to the risk that grant applications may be based on uncompetitive prices. The Court assessed the approaches followed by Member State authorities to address this risk.

## 57

By the end of 2013, all 15 of the Member State authorities had formal systems in place for checking that prices are reasonable. The main approaches followed (which are described in **Box 2**) were:

- Comparing the costs applied for with independent price information (obtained through market research or from price lists or databases);
- Comparing different offers obtained by the applicant (including through public procurement procedures);
- Consulting experts.

An alternative approach followed that mitigated the risk was to use simplified or maximum costs to establish or limit project costs.

**Where feasible, using simplified cost options (or using maximum costs in a similar way) effectively limits the risks of excessive prices – as long as they are set at the right level**

### 58

As described in paragraphs 38 to 42, grants can be based on simplified costs determined by the Member State authorities, an approach which limits the risk of over-specification. Maximum costs can be set for outputs, results or categories of expenditure in a similar way. Where these cost levels are set at or below the level of the best available market prices, it follows that the cost to the EU budget will be reasonable. In paragraphs 41 to 42 the Court found that over half the Member State authorities made some use of simplified costs and there was scope for more widespread use of these approaches.

### 59

Where a *maximum cost* is set, the applicant is reimbursed the lower of the grant applied for, the amount actually paid or the maximum amount. This potentially gives the best economy for the EU and national budgets. With the *simplified cost* methods, however, the applicant can theoretically receive a grant for more than the costs incurred. Provided that this occurs infrequently and is only for small amounts the extra cost can be justified by the gains from the additional simplification.

### 60

If 'maximum costs' are set at a level that exceeds the available market prices they would have little effect. If 'simplified costs' are set too high this would lead to unjustified costs being incurred as described below. This is illustrated in **Box 6**.



## Box 6

## The difference between maximum unit costs and standard unit costs



**Simplified example:** Based on a study, the average cost of replanting a forest is estimated by the Member State authorities to be over 4 000 euro per hectare.

With a system of 'maximum unit costs' an amount of 4 000 euro per hectare is set as a ceiling. The applicant has to submit details of the actual costs incurred and the Member State authorities have to check these. The payment made is based on the actual costs per hectare up to the maximum.

With a system of 'standard unit costs' the Member State authorities pay the same amount of 4 000 euro per hectare to all applicants, regardless of the costs incurred. This is a simplification for the applicant - who does not have to prove that their costs are reasonable or submit details of the actual costs – as well as for the Member State authorities.

If the maximum cost is set at 6 000 euro it has no effect. If the standard cost is set at 6 000 euro it results in over-payments, as illustrated in the following table:

(euro)

Actual costs incurred per hectare	Grant paid on basis of 4 000/ha maximum cost	Grant paid on basis of 4 000/ha standard cost	Grant paid on basis of 6 000/ha maximum cost	Grant paid on basis of 6 000/ha standard cost
3 000	3 000	4 000	3 000	6 000
4 000	4 000	4 000	4 000	6 000
5 000	4 000	4 000	5 000	6 000

**If simplified cost levels are set too high, they could affect the economy of the whole expenditure - for this reason Member State authorities should ensure they are soundly based and periodically review and adjust them**

The Commission has issued guidance for Member State authorities to ensure that these calculations are sound. These authorities can obtain additional assurance by having the calculations audited.

## 61

Simplified costs have to be set in advance as they are needed for preparing applications and approving the grant amount. Studies and projections are needed to establish the amounts, which will entail a number of assumptions.

## 62

The resulting amounts will apply for a standard situation and may understate the prices available to some applicants and overstate others. This could lead to overpayments, where the grant exceeds the real costs incurred. An example is shown in **Box 7**. Consequently, Member State authorities should ensure that overpayments are exceptional. To this end, Member State authorities should periodically test a sample of real cases to be sure that the simplified costs are set at or below the level of generally available market prices.

## 63

The Court did not identify any Member State authorities that kept simplified costs under review in this way. However, some did have methods to ensure that their *maximum unit costs* were reasonable, which could also be applied to simplified costs. For example, in Germany - Brandenburg and Berlin, the authorities adjusted each year the maximum cost per hectare for planting forests to 85 % of the average actual costs observed in the preceding year.

### Box 7

#### **Standard unit costs based on theoretical calculations can overstate the available market prices, resulting in overpayments**

The 2007 RDP for England included a standard cost of GBP 228 per hectare for management of scrub land under the measure for 'non-productive investments'. The English authorities based this amount on estimates of the typical costs of a farmer undertaking this work. A well-respected agricultural college checked the calculation. The Court's audit of a randomly selected 2012 payment found that the farmer concerned had employed a contractor to do the work at a cost of GBP 95 per hectare.

The English authorities did not have a process in place to periodically compare the standard unit costs with the actual costs incurred for a sample of projects, which could have detected that the standard costs were out of line with real costs.

## Observations

**Comparing the prices of the items applied for to independent price data can provide assurance that prices are reasonable but this approach can be difficult to implement**

**Market research can be used to get independent comparative price information for individual projects**

### 64

In 11 of the 15 RDPs subject to desk review (see **Annex IV**), the Member State authorities sometimes undertake market research or compare with other similar projects to verify that the prices given in the application are reasonable (this method is often combined with the 'comparison of offers' described in **Box 2** for added assurance). For example, in Poland, staff make internet searches for prices, confirm prices with suppliers or ask for counter-offers. As this information is independent – i.e. it is not provided by the applicant – it can provide good-quality evidence of the available prices.

### 65

Market research is used successfully in some Member States, in particular where there is an indication of risk, but it is time-consuming and it can be difficult to demonstrate that all applications have been evaluated consistently. This leads other Member State authorities to set up systems of reference prices instead (see below).

**Reference to price databases or listings can be efficient but an approach is needed that can cope with the huge variety of eligible items**

### 66

Most Member State authorities – 76 of the 88 – have established price databases for at least some types of expenditure (most commonly for agricultural machinery) or refer to commercial price databases or listings, such as for unit prices for construction materials or building costs. EU-wide, the costs of around a quarter of the rural development grant applications are evaluated against such reference prices. Two different approaches are followed. The majority – 63 of the Member State authorities – consider the reference prices as *ceilings* and limit the grant to the prices of the individual items listed in the database. In the second approach, the reference prices are considered as *indications*, so the authorities may approve grant applications with prices that exceed the reference if they consider the higher prices to be reasonable.

## 67

With the great diversity of possible expenditure on the wide range of potential rural development projects – which can range from basic inputs like concrete or labour to sophisticated computer-controlled equipment – comprehensive price databases can become costly to set up and manage and it can be difficult to ensure that the data is reliable, consistent and up to date. In Hungary, for example, the price database for machinery alone contains 230 000 items of different makes, models, options and qualities and has to be updated twice a year (construction-related costs are in another database).

## 68

Nevertheless, for the larger RDPs with sometimes thousands of similar project applications to process, the use of such databases can be an efficient way of checking prices, subject to the points made above. However, where the prices are listed for component items or inputs – such as construction materials – the work involved to check the prices can be considerable (see **Box 8**). This can also lead the Member State authority staff to focus on the prices of some easy-to-check items like the costs of concrete but to ignore more specialised finishings, for example, where the risks of excessive prices may be greater. Member States, such as Bulgaria, France and Greece, avoid these problems by establishing reference prices based on outputs such as the size or capacity of the construction as a whole (these may be implemented as ‘maximum costs’ – see paragraph 41).

### Box 8

#### **Comparison of approaches used to check the costs of construction projects for the farm modernisation measure: checking costs of component items (Lithuania) and checking costs of outputs (France)**

In Lithuania, the authorities subscribe to commercial listings of construction costs. These show, for a given type of building, construction method and choice of materials, the typical costs per linear metre of foundations, costs per square metre of roof, costs per square metre for walls, windows, decoration, tiling, etc. The staff evaluating project proposals take details of the proposed construction from the grant application and calculate the expected cost of each element using the price listings. The calculated costs of these elements are then compared with those in the grant application.

In France, typical construction costs have been established per animal or per square or cubic metre based on a study of past projects. For example, a shed for 40-60 cows is estimated at 2 920 euro per cow. A concrete slurry pit of up to 100 m<sup>3</sup> is estimated at 157 euro per m<sup>3</sup>. The authorities can quickly calculate the cost per cow or per m<sup>3</sup> of the project proposal and compare it with the expected cost.

## These databases and listings are only useful if the prices they contain are sufficiently close to the real market prices available

69

In 6 of the 10 RDPs where reference prices are used for machinery and equipment (see **Figure 6**), prices are provided to the Member State authorities by the manufacturers and distributors or taken from their price lists or catalogues. An example is shown in **Box 9**. However, it is normal commercial practice to negotiate discounts from list prices, which may be substantial (it is unusual to pay full list price for a new car, for example). This means that list prices are likely to overstate the real market prices available. Consequently, these are of little value as reference prices (or as ceilings) except to identify the unusual situation of the prices proposed in the grant application being above those offered by the manufacturer<sup>15</sup>.

Other Member State authorities compile reference prices by market surveys or collecting data from project approvals and payment claims.

- 15 It may, however, be easier to compile and maintain price databases from suppliers' list prices rather than market prices. If this is the case, Member State authorities can apply a coefficient to the list prices to obtain an approximation of market prices to be used as a reference or ceiling.

### Box 9

## Reference prices (or price ceilings) based on suppliers' list prices are of little use for establishing that costs are reasonable

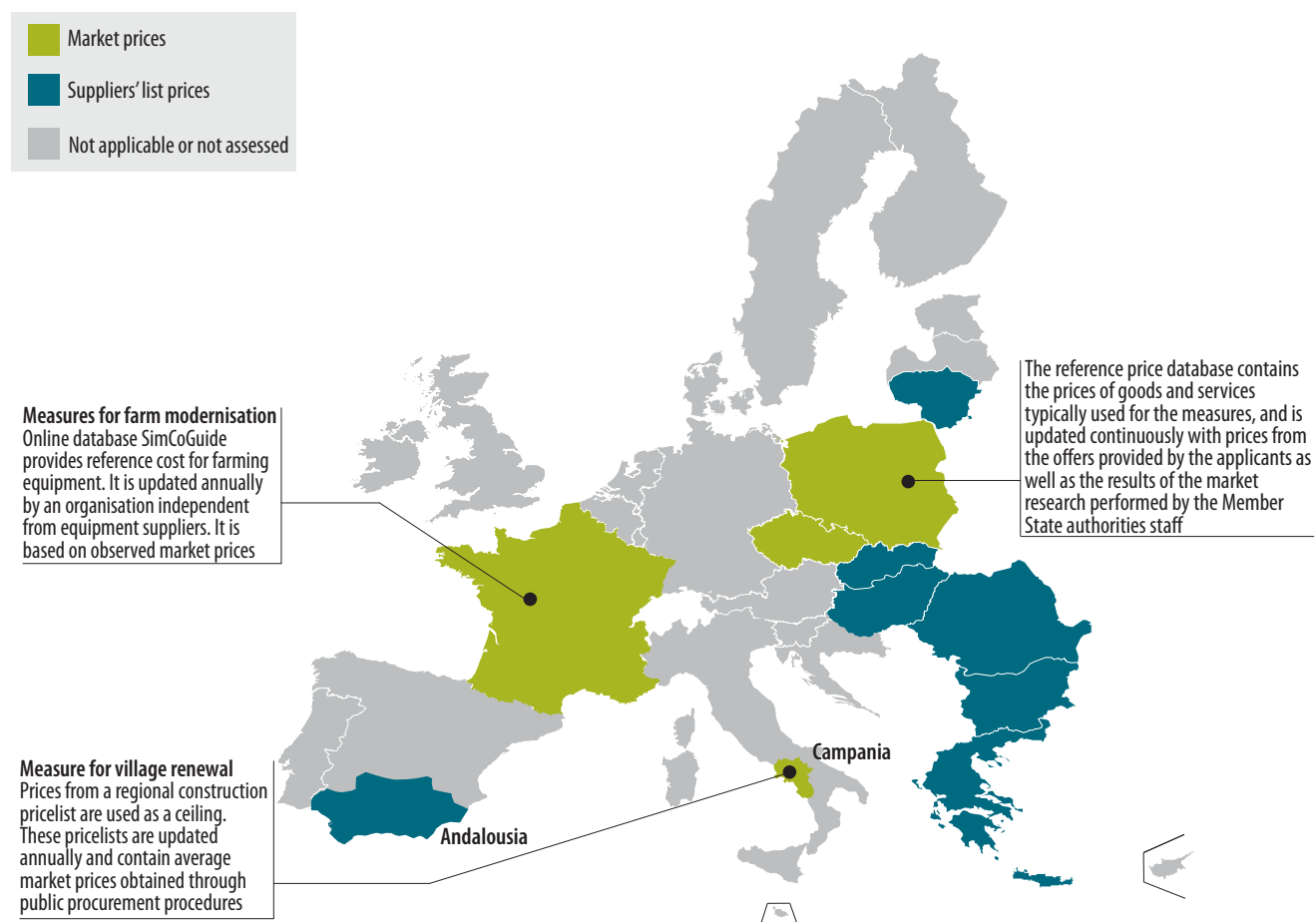
In Hungary, a database is maintained of prices for agricultural and forestry machinery, which are provided by distributors and manufacturers. The applicant does not have to provide offers from suppliers to support the grant application if the items concerned are listed in the database, which simplifies the process. The Hungarian authorities approve grant applications if the costs are equal to or below the prices in the database.

The Court compared prices actually offered to applicants by suppliers to the prices in the database. Twelve of the offers examined were for agricultural tractors. On average, these offers were 30 % lower than the price listed in the database. The Hungarian authorities replied to the Court that a difference of 25-30 % below the database prices was not unusual.

In this situation – which is not unique to Hungary – the comparison of the grant application to a price database may comply with the letter of the implementing regulation (see paragraph 17) but it demonstrates only that the prices do not exceed the distributors' and manufacturers' list prices. It does not show that the prices are reasonable.

Figure 6

## Sources used for establishing reference costs or price ceilings



Source: ECA audit findings.

## 70

If reference prices (or ceilings) are too high, this could also affect behaviour, encouraging applicants to propose prices up to the limit in order to maximise the amount of grant. This creates a disincentive to reduce costs and an incentive for collusion with suppliers to artificially inflate prices – such as by providing ineligible goods or services hidden within the inflated costs of the eligible item or by offering hidden rebates. It can also lead to uncompetitive behaviour by suppliers. To avoid this risk, Member States such as Bulgaria do not display the prices in the public version of their reference price database.

## 71

As with simplified costs, reference or maximum prices can go out of date and if based on construction costs in the capital city, for example, may not reflect those available in rural areas. Price databases should therefore be updated periodically and should reflect regional variations where these are significant.

**Where the prices of the items applied for exceed the reference price, judgment is needed to determine the level of grant that should be approved: clear rules and criteria are needed to support this**

## 72

By their nature, reference prices cannot always reflect the market prices available at the time and place of every individual project. Some differences in prices are inevitable – especially for equipment if the reference price database does not include the same make and model as the item applied for. Where the prices applied for exceed the reference prices, unless Member State authorities apply the reference as a ceiling, staff have to make a judgment on whether the higher prices are reasonable. As this can be difficult and time-consuming, small differences from reference prices can be accepted without further investigation as the potential cost saving would be low.

## 73

Where differences exceeded the tolerated variance from reference prices, Member State authorities generally required the applicants to provide a justification. But there was a lack of clarity on the criteria applied to evaluate these justifications and of documentation to show the basis on which costs above the reference prices were considered reasonable.

### 74

However, Member State authorities such as France and Lithuania automatically accepted differences of up to 30 or 40 % above the reference prices without requiring any justification from the applicant and without first having established that differences of such magnitude reflect the prices really paid in situations without subsidy. The Court would question whether a price 30 % above a reference price can be automatically considered as reasonable and whether this practice accords with the principle of economy. The costs of an average food-processing project, for example, are around 750 000 euro. If the reference price corresponded to this amount, the approach outlined above could allow an additional 300 000 euro of costs to be accepted without question. Where the reference prices themselves are based on list prices rather than real market prices (as is the case in Lithuania, for example), the risk that excessive prices may be approved is all the greater.

**Comparison of offers received from different suppliers can be a straightforward method to establish market prices but safeguards are needed to guard against manipulation and fraud**

### 75

A method commonly used in rural development, as in many other grant-based spending programmes, is to require the applicant to provide offers from suppliers to demonstrate that the grant application is based on reasonable prices. For larger amounts, particularly where public bodies are concerned, the offers may be obtained through a formal tendering process. The comparison of offers is a common commercial practice and often does not represent an additional burden for the applicant. Where there is genuine competition between suppliers, a comparison of offers can be effective in demonstrating that the best available price has been obtained. Member State authorities evaluate the costs of some two-thirds of rural development grant applications in this way.



**The ‘comparative offers’ method relies on there being genuine competition, so if only one offer is provided (or the offers provided are not comparable), alternative methods are needed to check that the prices are reasonable**

## 76

Member State authorities typically require the applicant to submit two or three supplier offers in support of the grant application. However, on occasions applicants only provide a single offer, which may be because an item is unique (there is only one possible supplier) or because other suppliers chose not to make an offer. It may also result from a manipulation of the call for offers by the applicant to favour a particular supplier.

## 77

A single offer does not demonstrate that the best price has been obtained for the item in question. However, the Court has observed that Member State authorities have accepted single offers without making alternative checks to establish that the prices are reasonable such as market research, comparison with other projects or expert estimations.

Examples from France and England are shown in **Box 10**). The English authorities have since introduced procedures requiring such alternative checks to be made in cases where only a single offer is provided.

**Measures are needed to deter, prevent, detect and correct any manipulation of the process to favour a particular supplier**

## 78

The vulnerability of the comparative offers method is that the price information is provided by the applicant, not obtained independently by the Member State authorities. This opens up the possibility that the process will be manipulated in order to favour a higher-cost supplier.

### Box 10

#### Single offers accepted by the authorities without making additional checks

In France, an applicant obtained two offers for the supply and installation of an automated fruit-processing line but presented only the most expensive offer to the authorities as this corresponded best to his needs. The French authorities accepted the single offer without performing any check that the costs were reasonable.

In England, an applicant provided only one supplier offer for wine-making equipment with the justification that the equipment was specific to the production of sparkling wines and there was only one supplier. This was accepted by the English authorities without question. However, the Court’s auditors were able to identify other suppliers of the same equipment.

### 79

This may be for motives that are understandable: an applicant may prefer a higher cost local supplier or contractor because the applicant has worked successfully with them in the past. Several Member State authorities explicitly accept such preferences as justification for accepting a higher-cost offer, such as in Hungary, or for one of the aid schemes in England. In the Court's view, such personal preferences are not sufficient justification for basing the grant on a higher offer.

### 80

There is also a risk that the applicant may manipulate the process by defining the specification in such a way that only one supplier could easily comply – or simply not asking other potential suppliers to make offers. At the extreme, an applicant may even collude with the supplier to falsify offers or be the victim of collusion and fraud by consultants or suppliers.

### 81

While fraud is an exception, there is sufficient evidence that it exists from the Court and Commission's audit work and from the EU's anti-fraud office (OLAF). Yet only 4 of the 15 RDPs reviewed for the audit had introduced anti-fraud measures in their management of rural development grants. The Commission's guidance suggests training staff to be aware of fraud, sharing information on cases detected, operating a system of 'red flags' and using checklists designed to identify possible manipulation.

One approach used in Member States such as Romania is to increase transparency and competition by requiring private grant applicants to publish their calls for offers to suppliers on a web site run by the paying agency.

**Public procurement rules make manipulation and fraud more difficult to conceal, but do not eliminate these risks or guarantee in all cases that costs will be reasonable**

### 82

Public bodies are required to follow procurement procedures designed to obtain the best price while ensuring fairness and transparency. Above certain thresholds EU directives apply<sup>16</sup>. Negotiated procedures with a single supplier can be followed in some situations but typically, for larger contracts, public bodies will obtain offers from different suppliers, which may be through an open invitation to tender. If properly applied, public procurement rules should reduce the opportunities for manipulation and fraud – although as shown in paragraph 25, public procurement rules are not always complied with.

### 83

In 9 of the 15 RDPs reviewed (see **Annex IV**), the Member State authorities did not make checks that the costs applied for were reasonable if a public procurement procedure had been followed. However, such procedures may not result in multiple comparable offers being received – which may be because of a genuine lack of competition; because the call for offers was not widely publicised or because the tender specifications or contract conditions excluded potential suppliers. If only one offer is received or the offers are not comparable, the fact that the procurement procedures

<sup>16</sup> Details can be found at: [http://ec.europa.eu/internal\\_market/publicprocurement/index\\_en.htm](http://ec.europa.eu/internal_market/publicprocurement/index_en.htm)

were followed does not demonstrate that the price of the selected offer is reasonable.

## 84

Moreover, a public procurement procedure does not in itself do anything to mitigate the risks of over-specification described in Part I. Court and Commission audits have found cases of public procurement where the specifications in the invitation to tender were excessive, or where the award criteria gave undue weight to qualitative aspects without taking proper account of the costs.

## 85

Consequently, if only one offer is received from a public procurement procedure, if there are risks of over-specification or if there are weaknesses in the process followed, Member State authorities should make additional checks to establish that the costs proposed are reasonable where this is justified by the amounts at stake.

**Where judgement is required, an independent expert opinion or that of an evaluation panel can give valuable assurance and can be particularly cost-effective when targeted to higher-risk cases**

## 86

Paragraphs 53 to 55 of this report describe the use of experts for evaluating project specifications. Experts can give similar assurance that prices are reasonable, and the same opinion can cover both the specification and the price. Using external experts can be costly, so is particularly relevant where there is a high financial risk or suspicion of manipulation. The Lithuanian example in **Box 11** shows that well-targeted use of experts can generate net savings to the national and EU budgets.

## 87

In 10 of the 15 RDPs reviewed (see **Annex IV**), Member State authorities referred at least the larger grant applications to an evaluation panel that may comprise technical experts and/or other individuals with relevant knowledge. Such panels can help reduce the subjectivity of assessments of whether the prices (and the specifications) are reasonable.

### Well-targeted use of experts can generate net savings to the national and EU budgets

Where grant applications concern larger amounts, if only one offer is provided or there are other risk characteristics, the Lithuanian authorities refer the project proposal to a firm of financial consultants for an expert review of the proposed costs. The Lithuanian authorities referred 214 cases to the consultants in 2012/13. The consultants concluded that the prices applied for exceeded the best available market prices in 27 cases. The Lithuanian authorities have calculated that every euro paid to the consultants resulted in a saving of over 4 euro of EU and national funds.

### Part IV - Keeping the eye on the ball after project approval: approaches to ensure that the costs actually reimbursed are reasonable

#### 88

As described above, Member State authorities are required to check that the grants they approve are based on reasonable costs. But some costs may still be uncertain at the grant application stage, particularly for large construction projects. It can take some Member State authorities several months to process applications, so the prices obtained at the time of the application may no longer be valid once the project starts, or the applicant's business plans may have changed. Consequently, it is not unusual that the costs incurred will differ from the costs approved: both the specification and the prices may change.

#### 89

Three types of risk appear when the applicant presents a grant payment claim for reimbursement of the costs incurred:

- (a) the costs are no longer reasonable in terms of the actual outputs and results: costs that were approved for a 100-animal capacity cattle shed may not be reasonable if the shed actually built has a capacity of only 50;
- (b) the project has been implemented in a different way, so the specifications and prices checked in the application are no longer applicable: instead of a slate roof for the cattle shed, for example, the farmer constructs a metal roof for the same amount;
- (c) savings made on elements of the project have been used for gold-plating, as project promoters tend to see the grant approval as a budget available to spend: if construction works come in under budget, for example, the saving may be spent on lavish fittings.

The Court assessed the approaches followed by Member State authorities to address these risks.

**Control systems should detect and check any material changes to the project made after the grant has been approved to be sure that the costs to be reimbursed are still reasonable**

**90**

Except where 'simplified costs' apply, applicants must normally submit paid invoices to support their grant payment claims. Member State authorities check these invoices to ensure that there is a correct basis for reimbursement. Where the actual project costs are exactly as detailed in the application, no further checks are needed to establish that the costs are reasonable. But Member State authorities need rules and control systems in place to detect significant changes from the approved project costs and check that the costs are still reasonable.

**91**

The Court found that all of the 15 Member State authorities had procedures to deal with changes to the approved project outputs or costs. Two alternative approaches were followed. In the first, the authorities specified the project costs in the grant agreement at the same level of detail as those that they had checked in the application: if the costs were checked item by item, the grant agreement specified the costs item by item. In the second approach, grant agreements were made for the total project cost or for broad categories of cost (such as construction, equipment and fees) even where the costs had been checked on an item by item basis. This second approach did not generally give good assurance that the three risks mentioned above were addressed and it allowed the reimbursement of costs for which the reasonableness had not been checked. An example is shown in **Box 12**.

**Box 12**

**Measure for supporting small rural businesses in England: changes made to the project allowed the reimbursement of costs for which the reasonableness had not been checked**

An applicant requested a grant for a project to renovate their premises and purchase specialised equipment. The applicant presented several offers for the building works, the equipment and other items including a new staff kitchen. These were checked and approved by the English authorities. When the applicant came to buy the specialised equipment they found a supplier offering a price well below the previous offers. They used the savings made on the equipment to do some works on the car park and to purchase a more expensive staff kitchen. As the total approved project costs were not exceeded, the English authorities did not check the reasonableness of these extra costs.

### Clear rules, explicit declarations and checks on samples of payments can deter the concealment of discounts, rebates or other advantages given by the supplier that lower the real cost

#### 92

In most RDPs, applicants are required to present their payment claims net of any discounts. This may be required by the general administrative law of the Member State or in the rules for implementing the aid measure. In 3 of the 15 RDPs examined (see **Annex IV**), the Member State authorities also required the applicant to make an explicit declaration in the payment claim (for example by ticking a box yes/no). Another good practice is to include examples in the aid scheme guidance to show how the applicant should deal with various types of discounts, rebates, or other advantages given by the supplier that lower the real cost. While these approaches would not prevent intentional fraud, they can have a deterrent effect. They also cover the cases where applicants do not think about whether a discount or rebate should be deducted from the claim, or where they are unsure.

#### 93

Beyond having clear rules and declarations, Member State authorities should check the invoices provided in support of the payment claims for any indications of discounts, rebates or other advantages and ensure that these are deducted. As these may not be shown on the invoice (for example, a supplier may give a rebate at the end of the year), Member State authorities should also make further checks for a sample of payments. Such checks are time-consuming and may require contacting the suppliers and/or visits to the applicant to check their accounting and bank records. An opportunity for this is the 'on the spot' and 'ex-post' checks on a sample of payments required under the EU legislation<sup>17</sup>. 6 of the 15 Member State authorities did this (see **Annex IV**).

#### 94

Undertaking such checks cannot detect and correct all instances of hidden discounts or other advantages but it serves two purposes. Firstly as a deterrent: applicants are less likely to hide discounts if they know that there is a chance it will be checked. Secondly, it provides feedback to the Member State authorities about the incidence of such practices so they can adjust their control systems appropriately.

<sup>17</sup> Commission Regulation (EU) No 65/2011.

## Part V - Making it efficient: approaches to ensure that the level of requirements and checks is commensurate with the level of risk

### 95

The potential financial impact of reimbursing unreasonable costs due to over-specification or excess price depends on how frequently it happens and the amounts involved. As the potential financial impact increases, so should the level of checks: they should be proportionate to the level of risk involved. To avoid an unnecessary administrative burden, the requirements applicants must comply with should be the minimum necessary to permit those checks. The Court assessed the approaches followed by Member State authorities to match the level of requirements and checks to the level of risks.

## Where the likelihood and potential impact of the risks is low, control systems can be designed that minimise the administrative burden

### 96

The lower the grant as a proportion of total project costs (the effective aid rate), the greater the amount that the applicant has to contribute from their own resources. This increases the applicant's incentive to get the best price and reduces the incentive to inflate the specification. However, none of the 15 Member State authorities reviewed reduced their requirements or checks to reflect the reduced risk associated with low effective aid rates.

### 97

Where the Member State authorities had independent information on the prices, notably in databases of reference prices, or where they set maximum costs, they mostly reduced the requirements on applicants to reflect the lower risk. For items in the database of machinery prices in Hungary, for example, applicants did not have to provide any offers to support their grant applications. Use of simplified costs removes the need to check costs, but this approach was not widely used (see paragraph 42).

### 98

Most Member State authorities reduced the requirements and checks for very low-cost items by requiring a reduced number of offers, accepting price lists or web site screen prints instead of offers, or excluding very small individual items from the eligible costs. They also reduced requirements for business plans and other information.

### High-value items, projects with high aid-rates and other risk factors warrant an increased level of checks

#### 99

Across the EU, the average rural development investment project costs around 125 000 euro. For project costs of this amount, all Member State authorities require two or three supplier offers or check the proposed costs against price databases. Some also check value for money, do market research on prices or consult experts, as described earlier in this report. But where the eligible project costs (and therefore the amount of grant) are much higher than the average amount, few authorities make additional or more extensive checks, despite the potential impact of the risks being higher<sup>18</sup>.

#### 100

But it is not only high-value projects that present higher risks. In particular, the higher the aid rate, the lower the applicant's incentive to limit the costs by searching for the best price or by more economical specifications. As aid rates approach 100 % the risk of over-specification and gold-plating becomes very high, whether the applicant is a public body or in the private sector<sup>19</sup>. Yet none of the 15 Member State authorities reviewed increased their requirements and checks to reflect the increased risks associated with high aid rates. This is a particular concern where the Member State authorities made no checks on the reasonableness of costs if the applicant followed public procurement procedures, as these do not in themselves give assurance that the project specifications are reasonable (see paragraphs 83 to 85).

18 Where the applicant is a public body, they are normally bound to follow additional procurement procedures for higher value contracts and the Member State authorities have to check that the procedures are correctly followed.

19 Public bodies and associations are often given grants of up to 100 %. This is much less frequent for private-sector projects but it does occur. For example in Italy-Campania 100 % grants were offered to private businesses for farm diversification and rural business development projects.



# Conclusions and recommendations

## 101

In this audit the Court questioned whether the approaches followed by the Commission and Member States were the most effective for keeping the costs of rural development grants under control.

## 102

The Court found that the approaches followed were not the most effective. The Commission reacted after problems emerged rather than ensuring that systems were sound in the first place. Member States' control systems addressed only some of the risks to economy or were flawed. More effective approaches were available but were not widely applied.

## 103

The Commission did not offer guidance or spread good practice at the start of the 2007-2013 programming period. It did not ensure that Member States' systems were effective before they started approving large volumes of grants. By the time it took action, the bulk of the project grants had already been approved. But since 2012, the Commission has adopted a more active and coordinated approach. If followed-through with a greater focus on economy, this should lead to better financial management in the next programming period.

## 104

Regarding the Member States, by 2014 the 15 largest Rural Development Programmes all had in place the basic systems required by the regulations for checking rural development costs. The methods used varied, and the Court identified some well-designed approaches to address certain risks. But, as shown by the overview in **Annex IV**, all had weaknesses in relation to the main risks such that overall, the costs of rural development grants were not well controlled. Analysis of information from all 88 RDPs indicates that a similar situation prevails across the EU. In particular:

- (a) Member States' control systems focused on the prices of the items or works in the grant applications with much less attention to the *specification*: whether the items themselves were reasonable or if the grant was cost-effective in relation to the policy objectives. This leads to risks of gold-plating and poor value for money.
- (b) The main methods used to check the prices in grant applications were to compare offers from different suppliers or to compare them to reference prices. The Court found that the systems in some Member States gave little assurance that the costs were reasonable – using reference prices that were 30 % above real market prices, for example.

- (c) Grants are approved in advance and paid once the applicant has purchased the items or undertaken the works concerned. Where changes to a project occurred after grant approval, loopholes in some Member State systems allowed costs to be reimbursed for which the reasonableness had not been checked.
- (d) The level of requirements and checks generally did not take account of different levels of risk. Many Member State authorities had the same approach to checking a 10 000 euro grant as to a 1 million euro grant. The possibilities for simplification where the risks were limited were not widely followed.

### 105

The main flaws or gaps in the approaches followed are summarised in **Box 13**.

### 106

This leads the Court to conclude that there is considerable scope for making real savings in rural development project grants in the 2014-2020 programming period by better approaches to controlling the costs. These savings could be made available to finance additional projects leading to greater outputs and results and achievement of objectives.

### 107

The Court also found that there were workable and cost-effective approaches to mitigate the risks identified – most of which are already implemented in some RDPs. These are described in the main body of the report. Where sufficient evidence could be obtained from the desk review of the 15 largest RDPs, an overview of some of these approaches is given in **Figure 7** below and summarised in **Annex IV**.

### 108

The Court welcomes the Commission's intention to issue guidance on simplified costs (although Member States have indicated that simplified cost options are unlikely to be widely applied due to the diverse nature of rural development grants). The Court also welcomes the Commission guidance on tackling fraud and the 'action plans' developed by the Member States at the initiative of the Commission. The plans seen by the Court show improvements in some of the basic systems but do not address many of the design weaknesses listed in paragraph 105 above.

### Main weaknesses observed in the design of control systems for rural development costs

#### Risk of over-specification:

- other than for land-management and training costs, limited use of the possibilities for restricting grants to 'standard' costs (see paragraphs 41 to 42);
- little consideration of whether costs were reasonable in relation to the expected outputs and results - few Member State authorities took into account the cost-effectiveness or value-for-money of the grant applications (see paragraph 46);
- a lack of reliable approaches to the risk of gold-plating (see paragraphs 48 to 50);

#### Risk of grant approvals being based on prices that are too high:

- standard unit costs not checked to see if they resulted in overpayments in practice (see paragraphs 62 to 63);
- reliance on checks against price databases containing list prices that were commonly 20-30 % above the real market prices (see paragraphs 69 and 71);
- acceptance of grant applications where the prices exceeded reference prices by as much as 30 or 40 % without requiring justification (see paragraph 74);
- insufficient safeguards when relying on the comparison of supplier offers (see paragraphs 77 to 81);
- reliance on checking compliance with public procurement procedures (where applicable) without also checking that the costs proposed were reasonable (see paragraphs 83 to 85);

#### Risk that the costs actually reimbursed may not be reasonable:

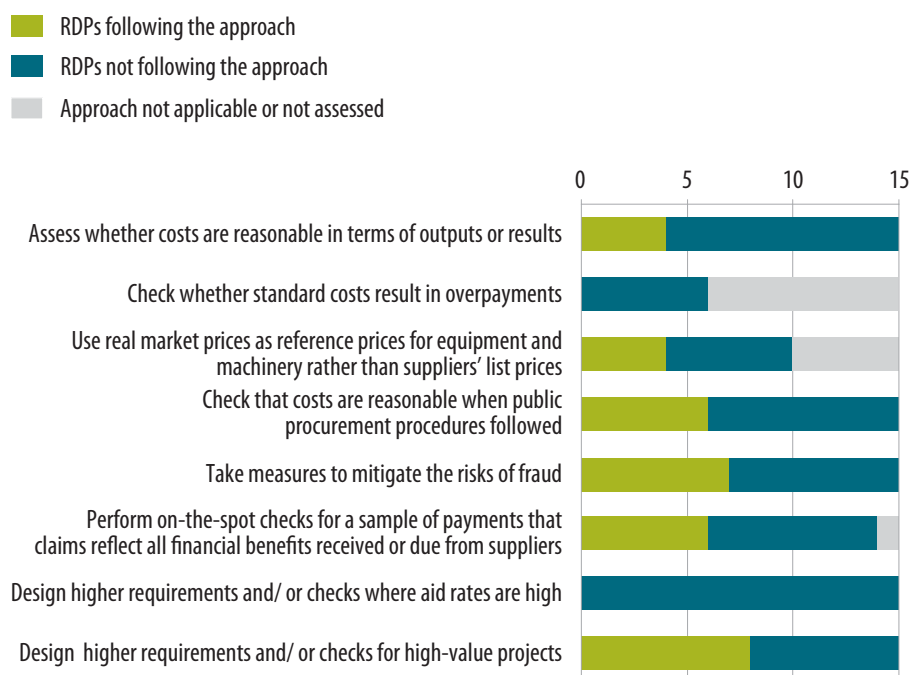
- loopholes in the procedures after approval of grant applications, which mean that the costs actually reimbursed may be different from those that have been accepted as reasonable (see paragraphs 91 to 92);

#### Risk that the level of requirements and checks is insufficiently related to the level of risks:

- requirements and checks not increased where aid rates are high (and the applicant has little incentive to limit the costs) or for very large grants (see paragraphs 99 to 100).

Figure 7

## Overview of approaches in the 15 RDPs audited



Source: ECA audit findings.

## Conclusions and recommendations

### 109

In many cases, Member State authorities will develop the detail of their control systems – the forms, the instructions, the procedures and checklists – once the RDPs for 2014-2020 have been approved. But unless these control systems address the risks identified in this report, the weaknesses are likely to persist. Approaches are available that do not involve adding more and more requirements and checks, but better target the effort to where the risks are greatest. The best control systems are not only effective - designed to achieve economy - but also efficient - appropriate to the level of risk.

### 110

The 'good-design' checklist presented in **Annex I** provides a comprehensive set of criteria for assessing whether control systems address the risks described in this report. The Court **recommends** that before expenditure is committed in the new programming period, the Commission and Member States cooperate to ensure that the approaches followed for all RDPs meet these criteria and target the areas of greatest risk. An ex-ante assessment of the control systems by Member State authorities' internal audit services (or by other inspection or audit bodies) should be part of this process.

### 111

Good systems design is only the first step. How the systems are implemented in practice is also key. The Court therefore **recommends** that the Commission and Member States check early in the new programming period that the systems operate efficiently and are effective in relation to the risks highlighted in this report.

This Report was adopted by Chamber I, headed by Ms Rasa BUDBERGYTĖ, Member of the Court of Auditors, in Luxembourg at its meeting of 26 November 2014.

*For the Court of Auditors*



Vítor Manuel da SILVA CALDEIRA  
*President*

### Checklist developed by the ECA to assess the design of control systems in relation to the risks associated with rural development costs

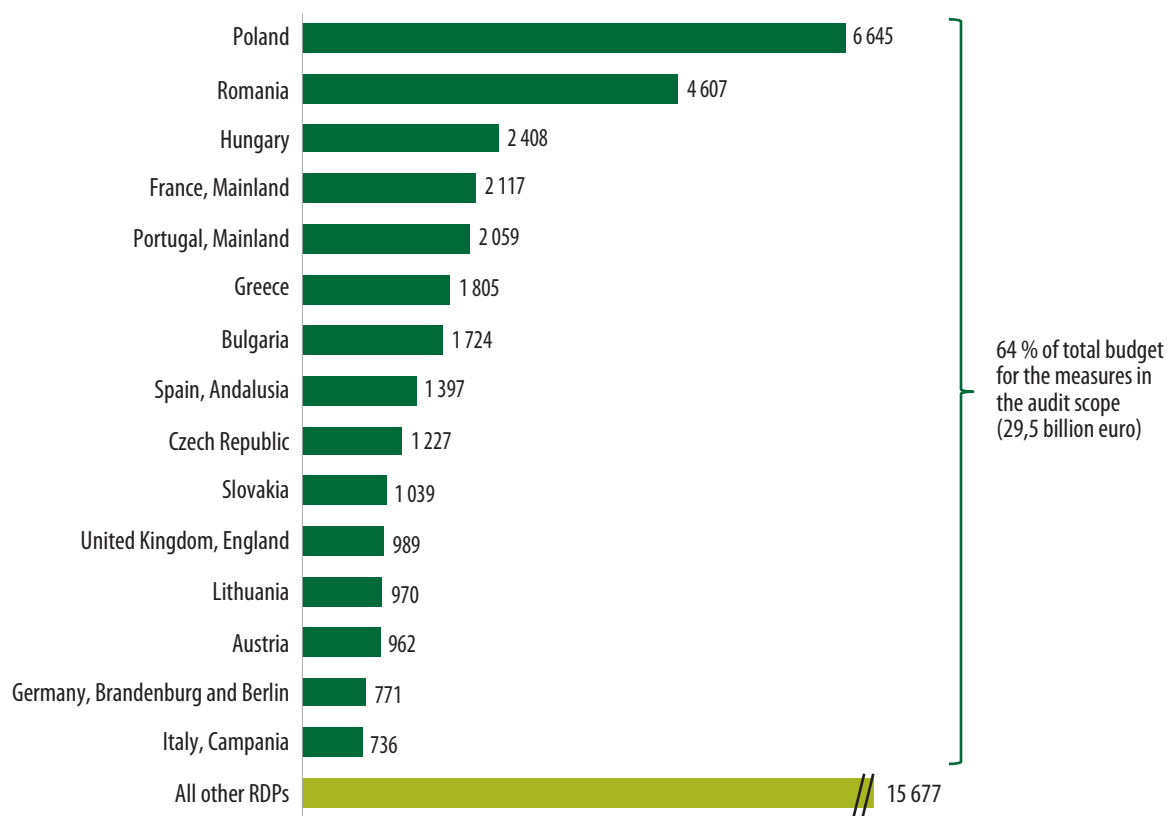
Risk	Design feature	See paragraphs
Over-specification	<b>1. Restrict the eligibility to the costs of a standard specification where there are many similar projects or common types of expenditures</b>	38 - 42
	<b>2. Evaluate the proposed costs to ensure that specifications are reasonable</b>	
	(a) Make standard calculations and compare to benchmarks to quickly identify applications that are over-specified	44 - 45
	(b) Evaluate if costs are reasonable against cost-effectiveness or value-for-money criteria	46
	(c) Document assessments of whether specifications are reasonable and the basis for this, whether comparison with other projects, technical evaluation, or common-sense judgment	47 - 48
	(d) If grants are not based on the lowest valid offer, establish clear criteria for establishing whether the costs of the higher offers are reasonable; document the evaluation of the extra costs involved	49 - 51
Uncompetitive prices	(e) Use independent expert opinions for assurance that specifications are reasonable, particularly where projects present risks because of their size, technical complexity or lack of comparative information	53 - 55
	<b>3. Where feasible, set maximum costs or use simplified cost options and periodically check that they do not exceed generally available market prices</b>	58 - 63
	<b>4. Compare the prices of the items applied for to independent data</b>	
	(a) Where justified by the risk, use market research to get independent comparative price information for individual projects	64 - 65
	(b) When using reference price databases, use real market prices (or apply a coefficient to suppliers' list prices); update prices periodically and ensure they reflect any large regional differences	66 - 71
	(c) Define clear rules and criteria for when the price applied for exceeds the reference to establish whether the higher costs are reasonable; document the evaluation of the extra costs involved; if a percentage variation from reference prices is automatically accepted, ensure that the percentage used can be justified in relation to real market prices	72 - 74
	<b>5. Design safeguards against manipulation and fraud when evaluating offers from suppliers</b>	
	(a) If only one offer is received or if the offers received are not comparable, use alternative methods to check that the prices are reasonable	75 - 77
	(b) Design measures to deter, prevent, detect and correct any manipulation to favour a particular supplier	78 - 80
	(c) Follow the Commission's guidance to prevent and detect fraud	81
	(d) When public procurement does not result in several competitive offers, or if the procedures followed are flawed take additional steps to ensure that the costs are reasonable	82 - 85
	<b>6. Use independent expert opinions to get valuable assurance where this is cost-effective</b>	
	(a) When judgement on the reasonableness of costs is required, use expert opinion or that of an evaluation panel to get additional certainty that the decision is well-founded	86 - 87
	(b) Refer higher-risk cases to internal or external experts	86 - 87

## Annex I

Risk	Design feature	See paragraphs
Project changes	<b>7. Design control systems to detect and check significant changes to the project made after the grant has been approved to ensure that the costs are still reasonable</b>	
	(a) Require a clear breakdown of costs both in the grant application and payment claim; specify costs in the grant agreement at the same level of detail at which they were checked	90 - 91
	(b) Set clear rules and procedures to check that the costs of material changes from the approved project costs are reasonable and that any savings are not used for gold-plating	90 - 91
	<b>8. Design rules to deter concealment of discounts, rebates or other advantages given by the supplier that lower the real cost</b>	
Relation-ship to the risks	(a) Require explicit declaration in payment claims of discounts, rebates or other advantages	92
	(b) Make additional on-the-spot checks for a sample of payments to detect hidden discounts, rebates or other advantages	93 - 94
	<b>9. Where the likelihood and potential impact of risks is low, design control systems that minimise the administrative burden</b>	96 - 98
	<b>10. Increased the requirements and checks for high-value items, projects with high aid-rates and other risk factors</b>	99 - 100

## Rural Development Programmes selected for desk review

Programmed expenditure (2007-2013) for the 15 largest RDPs<sup>1</sup> (million euro)



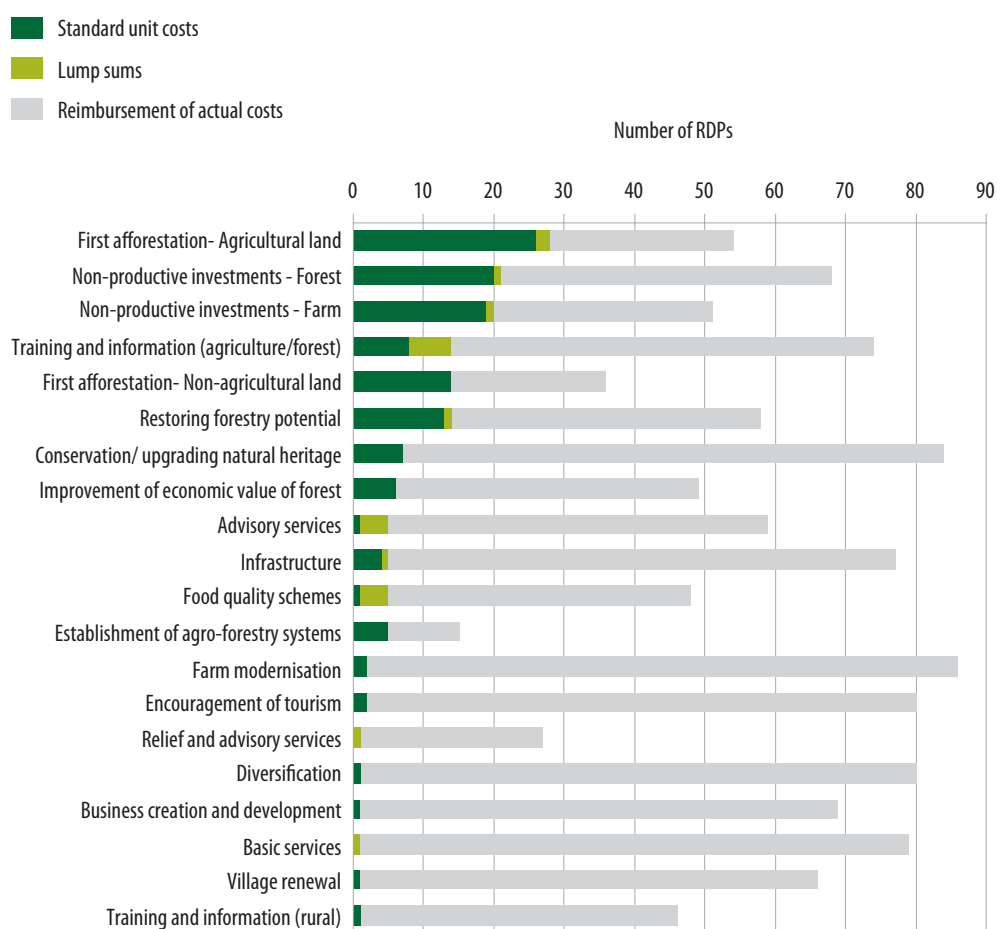
<sup>1</sup> For the measures in the scope of this audit, as of 31.12.2013.

Source: ENRD.



## Use of simplified cost options in the 88 Rural Development Programmes

RDPs using standard unit costs or lump sums as one of the methods, by measure



Source: ECA Questionnaire.

## Overview of the approaches followed in the Rural Development Programmes selected for desk review

	Bulgaria	Czech Republic	Germany - Brandenburg	Greece	Spain - Andalusia	France - Mainland	Italy - Campania	Lithuania	Hungary	Austria	Poland	Portugal - Mainland	Romania	Slovakia	UK - England
Assess costs against the expected outputs or results		√		√			√								√
Check whether standard costs result in overpayments	N/A		N/A	N/A			N/A					N/A		N/A	
Use market research where necessary to get independent comparative price information for unusual or complex projects		√			√	√		√	√	√	√	√	√	√	√
Use real market prices as reference prices for equipment and machinery etc. and not suppliers' list prices		√	N/A			√	√			N/A	√		<sup>1</sup>		N/A
Take measures to mitigate the risks of fraud regarding supplier offers and procurement	√							√	√		√		√	√	√
Check that the costs are reasonable even when public procurement procedures have been followed	√	√						√			√			√	
Use evaluation committees or experts to assess specifications and / or prices	√	√	√	√	√		√	√	√	√	√				√
Require applicants to explicitly declare in their payment claims all financial benefits (discounts, rebates, etc.) received or due from suppliers			√											√	√
On-the-spot checks that all financial benefits received or due from suppliers are taken into account for the final payment			√		√						√	√	√		√
Higher requirements and / or checks for measures with high aid rates															
Lower requirements and / or checks for low-value items	√	√	√	√	√	√		√		√	√		√	√	√
Higher requirements and / or checks for very large projects	√	√	√	√	√	√		√		√	√		√	√	√

### Key

√ Included in the procedures for the main measures where it is relevant

Not included in the procedures for the main measures

Not assessed

N/A Not applicable

<sup>1</sup> The equipment price database has not been updated since 2006. The Romanian authorities informed the Court that a new database is being established based on suppliers' list prices.

## Executive summary

### II

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

### III

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

### IV

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

### V

Initially, the provisions on the evaluation of the reasonableness of costs submitted were regarded as self-explanatory.<sup>1</sup> Indeed, at the time of recasting the previous legal framework which took place in spring 2010<sup>2</sup>, no major difficulties had been brought to the attention of the Commission on this point. In the approval process of the recast, only one question (whether maximum costs were a suitable method) was presented and answered.

### VI (a) - (d)

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

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

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

### VIII

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

### IX

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

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

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

<sup>1</sup> Article 24(2)(d) of Commission Regulation (EU) No 65/2011.

<sup>2</sup> Regulation (EC) No 1975/2006.

### Introduction

#### 03

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

On 19.12.2013 the Commission adopted guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement. According to these guidelines, the non-respect of procurement rules is to be judged based on the principle of proportionality.

#### 04

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

#### 05

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

#### 15

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

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

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

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

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

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

### Observations

#### 21

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

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

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

#### 22

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

#### 24 - 28

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

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

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

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

<sup>3</sup> European Court of Auditors' Annual Report 2013, paragraph 4.8.

### 29

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

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

### 30

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

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

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

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

In addition, on 19.12.2013 the Commission adopted guidelines for determining financial corrections to be made by the Commission to expenditure financed by the Union under shared management, for non-compliance with the rules on public procurement.

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

### 32

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

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

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

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

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

## Reply of the Commission

### 33

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

### 34

In the 2007-2013 period for the majority of the rural development investment measures, there was no specific legal basis for the use of simplified cost options. Regulation (EU) No 1303/2013 (Article 67-68) has included the possibility for all European Structural and Investment Funds to implement these options and, therefore, it is expected that, with the help of enhanced guidance by the Commission, a bigger share of the expenditure will be based on simplified cost options in the new programming period. Of course it is ultimately up to Member States to decide whether they want to make use of simplified cost options.

### 35

The action plans are focused on identification and correction of main sources of irregularities in the expenditure, including weaknesses in checking the reasonableness of costs. In fact, the Staff Working Document presented in June 2013 by the Commission<sup>4</sup> included the poor assessment of the reasonableness of costs as one of the main roots of errors (RC10). Since then, Member States have progressively identified shortcomings in this field and have launched preventive and corrective actions.

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

### 42

See reply to paragraph 34.

### 44 - 49

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

### 52

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

See reply to paragraph 33 for further details.

### 54

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

### 61

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

### 62

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

### Box 7

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

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

### 71

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

### 78 - 79

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

### 80

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

### 81

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

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

### 86

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

### 90

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

## Conclusions and recommendations

### 103

Initially, the provisions on the evaluation of the reasonableness of costs submitted were regarded as self-explanatory<sup>5</sup>. Indeed, at the time of recasting the previous legal framework which took place in spring 2010<sup>6</sup>, no major difficulties had been brought to the attention of the Commission on this point. In the approval process of the recast, only one question (whether maximum costs were a suitable method) was presented and answered.

<sup>5</sup> Article 24(2)(d) of Commission Regulation (EU) No 65/2011.

<sup>6</sup> Regulation (EC) No 1975/2006.



## Reply of the Commission

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

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

### 110

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

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

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

### 111

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

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

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

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

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Member States implement a large part of the EU's rural development policy by providing grants towards the costs of investments and other projects undertaken by farmers, rural businesses, associations and local authorities.

The Court found that some Member States had poorly-designed systems for checking that the costs of these grants were reasonable. Workable and cost-effective approaches existed but were not widely followed. The Court outlines good practices found in the course of its audit, and concludes that there is considerable scope for making real savings in rural development project grants in the 2014-2020 period by applying these good practices.



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