



STATE AUDIT
OFFICE OF HUNGARY

SUMMARY

of the Audit on the Processes of Managing Irregularities, Debts
and Financial Claims relevant to the Utilization of EU Funds

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SUMMARY

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Pursuant to EU legislation¹: 'irregularity' shall mean any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure.

The EU definition of the concept of 'irregularity' provided a broad framework for national regulation. This influenced the evaluation of the cases of irregularities in individual Member States as well as the content and quality of providing information towards the European Commission (hereinafter: Commission).

According to the 2008 report of the Commission², the practices of Member States vary in terms of reporting the irregularities in a timely manner, the assessments regarding the financial impact and the classification of irregularities.

The Commission was responsible for the implementation of the budget of the Union, but, to an extent depending on the mode of financial implementation, this devolved upon the Member States as well that is the responsibility was shared.

In Hungary, the importance of the systems related to the subject of irregularity, debt and claims management was demonstrated by the fact that a total amount of HUF 3,745 billion of EU and related domestic subsidies was spent in the period under review (2004-2009).

At the time of our audit, 7 chapters contained the subject of EU subsidies. Of the organisations managing the subsidies, the National Development Agency and within the Ministry of Agriculture and Rural Development chapter the Agricultural and Rural Development Agency managed approximately 90% of all the EU programmes, therefore, our audit extended to these two organisations.

¹ Council Regulation (EC, EURATOM) No. 2988/95 of 18 December 1995.

² Commission Report to the European Parliament and to the Council 'Protection of the Communities' financial interests: fight against fraud' – Annual Report 2008 (COM (2009) 372, Brussels, 15.7.2009).

The European Council determined the framework regulation on the protection of the financial interests of the European Community, and then the general rules for each fund. Based on the general rules, the Commission regulated the implementation in a regulation, and issued Guidelines for the management of irregularities, debts and claims. Member States had to formulate their own regulation and practice based on EU rules and guidelines.

The irregularity and claims management developed in Hungary depended on the type of legal relationship between the sponsor and the beneficiary. Different rules prevailed regarding legal relationships at the National Development Agency concerning civil law and at the Agricultural and Rural Development Agency concerning administrative law.

The **irregularity management of the programmes managed by the National Development Agency** (structural, cohesion and other structural programmes) was defined by government decree level regulation for the 2007-2013 programming period, designating the organisations responsible for irregularity management, the individual steps of the irregularity procedure with the relevant time limits, the recording method applied and the order of compiling the irregularity reports. Lawsuit initiated at the civil court was the applicable legal remedy against an irregularity decision.

The most typical irregularities committed by beneficiaries included breaches of the Act on Public Procurement, failure to implement the project in full or inadequate implementation of the project, accounting for ineligible costs and payment of unauthorised items.

The Intermediate Bodies, the National Development Agency and the National Authorising Officer's Office of the Ministry of Finance, relying on one another and in line with EU legislation, reported the irregularities to the Hungarian organisation of OLAF on a quarterly basis. In addition, the National Development Agency sent an annual statement on the amounts withdrawn within the framework of the projects of the operational programme as well as on the amounts collected and to be collected to the Certifying Authority, and the Certifying Authority had to be informed about the modes of reuse of the amounts collected, while the Authority informed the Commission before 31 March of the year following the year under review. Repayment obligations (debts) vis-à-vis the Commission were/are settled by the National Authorising Officer's Office of the Ministry of Finance (during requests for funds as well as upon the closing of projects).

The **processes under review** and the order of reporting **of the** (agrarian and rural development as well as other agricultural) **subsidies managed by the Agricultural and Rural Development Agency** were regulated by the implementation regulations of the Commission and the relevant domestic legislation. When providing EU subsidies, the procedure of the Agricultural and Rural Development Agency was based on the rules of the administrative proceeding, and the management of irregularities was embedded in the process of administration. No separate records of irregularities were kept. The Agricultural and Rural Development Agency considered only those cases as

irregularities, where final, enforceable decisions reclaiming the repayment of the subsidy were taken as a result of the irregularity.

With the exception of the SAPARD and the Agricultural and Rural Development Operational Programme (ARDOP), the Agricultural and Rural Development Agency reported about the irregularities using its Integrated Administration and Control System (IACS) to the Hungarian organisation of OLAF and to the Commission about the debts to be collected as a result of the irregularities, in a different way for each fund. A manual record system was developed for the SAPARD as a pre-accession tool. Similarly to the other operational programmes of the structural funds, the irregularities and accounts receivable of the ARDOP had to be kept on record in the Single Monitoring Information System (EMIR), considering that the ARDOP constituted a part of the structural policy. The financial settlement vis-à-vis the Commission and, within this framework, the accounting of liabilities (debts) were performed by the Paying Agency of the Agricultural and Rural Development Agency.

Typical cases of irregularities were: unauthorised procurement of machines, withdrawal of the beneficiaries before the deadline because of non-compliance with agricultural-environmental management conditions, accounting for ineligible costs, payment of unauthorised items as well as irregularities related to intervention storage and ones resulting from differences between the requested and actual area in the case of the area-based subsidy.

The Hungarian organisation of OLAF operated within the organisation of the Directorate General of the Hungarian Customs and Finance Guard, directly subordinated to the Commander, but operating independently within its scope of duties. It ensured the co-operation between OLAF and the EU institutions of Hungary in compliance with the relevant provisions of law, and it participates in the domestic implementation of the legal, administrative and operational obligations related to the protection of the financial interests of the EU.

The financial settlement between the directorate generals of the Commission and domestic institutions was based on cost statements and reports, although the structure and content of the reports varied according to financing fund and type of grant. Data collection for the audit was further hindered by the fact that cumulative data for the various programmes were not available, with the exception of the National Development Plan.

The irregularity management system was a part of the management and audit system, the compliance audit of which was conducted, as designated by law, by the Government Audit Office as an Audit Authority in the case of the subsidies managed by the National Development Agency. In 2008 and 2009, the Commission approved the so-called 'non-qualified opinions' submitted by the Government Audit Office. After 16 October 2007, the certifying body's tasks regarding the European Agricultural Guarantee Fund (EAGF) and the European Agricultural Rural Development Fund (EARDF) managed by the Agricultural and Rural Development Agency were attended to by KPMG Hungária Ltd.,

and it considered the accreditation criteria as fulfilled for the 2007-2013 programming period.

The subject matter of the audit covered the evaluation of the effectiveness of the irregularity, debt and claims management processes, and it did not affect the Audit Authority's compliance audit and the Certifying Body's accreditation audit. The processes started when the irregularity or the suspicion of irregularity arose. The audit did not cover the review of the prevention of irregularities and the procedures conducted and decisions taken by the institutions.

With regard to the assessment of the irregularity, debt and claims management processes, **the term of the audit** covered three years, from 2007 to 2009, of the 2007-2013 programming period. In addition, with regard to both the 2004-2006 and the 2007-2013 programming periods, we carried out a comprehensive evaluation of the results attained by the domestic EU institutions in irregularity, debt and claims management.

We conducted the audit by applying the methodology of performance audit, and within that concerning the aspect of effectiveness. The evaluation was carried out on the basis of the relevant regulation, and the processes were tested by sampling.

The aim of the audit was to assess whether the irregularity, debt and claims management processes applied in spending the EU subsidies effectively served the protection of the financial interests of the EU and Hungary, and whether they provided sufficient and adequate information for the Commission and domestic decision-makers.

Findings

In the 2004-2009 period under review, in compliance with EU requirements, domestic institutions reported to the Commission on the irregularities and the developments in the related claims and liabilities by programmes and legal title of measures, but it was a shortcoming that no comprehensive, programme based report covering all EU programmes and containing financial corrections (reallocations, withdrawals by the Commission, etc.) as well was prepared and published.

Both the Agricultural and Rural Development Agency and the National Development Agency intended to arrange the settlement of the claims against the beneficiaries primarily through deductions from forthcoming payments (so-called compensation). Collection of debts was applied as general collateral, but in view of the legal harmonisation with the Acquis Communautaire, as of 1 November 2009, the possibility of statutory collection ceased to exist for the National Development Agency and the Agricultural and Rural Development Agency, which managed the funding. Subsequently, based on the relevant Government Decree, the National Development Agency had the possibility to issue collection orders based on the authorisation of the beneficiary. Following the change in legislation, the Agricultural and Rural Development Agency applied the official transfer order, which works the same way as collection, through the Hungarian Tax and Financial Control Administration.

The importance of collaterals, prompt collection orders and implementation increased in the current economic situation, as based on the experiences of our audit, liquidation could be considered the primary reason for bad debts. Consequently, the development of the system of collaterals and the time factor became the most important elements in the avoidance of bad debts. This was emphasised by the relevant EU regulation as well.

The total number of irregularities reported to OLAF in connection with the structural, cohesion, agricultural and rural development as well as other EU subsidies amounted to 78 (HUF 636 million) in 2005, 116 (HUF 1.8 billion) in 2006, 57 (HUF 1.6 billion) in 2007, 72 (HUF 1.7 billion) in 2008 and 147 (HUF 8.4 billion) in 2009.

Compared to 2008, the amount affected by irregularity quintupled in 2009, while the amount to be collected grew by more than eightfold. One of the reasons for this was that the possibility of paying the amount to be collected through so-called 'compensation' (deduction from the next payment) ceased to exist because of the closure of the projects of the 2004-2006 programming period. Moreover, according to the organisations under review, in 2009, the amount to be collected also increased as a consequence of the economic crisis.

Irregularity and claims management required different practices in the civil law procedure applied by the National Development Agency and the administrative proceeding applied by the Agricultural and Rural Development Agency; therefore, we evaluated the effectiveness of the two organisations separately. The data in the report of the National Development Agency are preliminary, because at the time of our audit, the compilation of the financial statements for 2009 and other assessments was underway.

The irregularity and claims management procedure of the National Development Agency was fundamentally regulated and in time for the 2007-2013 period, but the regulation did not yet present a sufficient basis for the management of the processes.

In line with its internal statutes, every year, the National Development Agency prepared an evaluation and analysis of the irregularities, liabilities resulting from the irregularities and their reasons, and on this basis decided on a comprehensive review of the relevant domestic regulations. Starting from mid-2009, the review had been conducted within the framework of internal works, before the involvement of external experts was initiated in December 2009. The review with the involvement of external experts was underway when we were conducting our on-site audit.

In matters of dispute between the National Development Agency and the beneficiary, the legal remedy procedures in civil lawsuits regarding decisions on irregularities were protracted. In the audited period, there were 27 civil lawsuits, out of which the plaintiff was a Managing Authority or Intermediate Body in 6 cases (according to information collected by the SAO). Most of the lawsuits (25) were not closed; the ones that were

already closed had lasted for three years, and one of the lawsuits, which was still not closed, had been going on for four years at the end of 2009.

The effectiveness of irregularity management was adversely affected by the time-consuming nature of the irregularity procedure. The total time requirement from the receipt of the suspicion until the date of decision-making varied between 4 and 509 days; the average was 65 days, as opposed to the 45 calendar days required by law. In some cases, the detected time requirement also includes the period of suspending the irregularity procedure due to contacting other authorities, which is not included in the settlement deadline, but this cannot be inquired from the data recorded in the Single Monitoring Information System.

In practice, mainly, cancellation of the agreement was applied, and firms were rarely sanctioned with exclusion from tendering, because there was uncertainty in the application of the relevant provision of law, and procedural issues were not clarified (the issuance of the rules of procedure was in progress).

In the course of claims management, the National Development Agency determined the sequence of having receivables reimbursed and collected in its internal regulation. The Agency complied with this sequence during the procedures, although this did not always facilitate the effectiveness of collection. The Act on Judicial Enforcement did not determine the sequence of the acts of enforcement precisely because the sequence in itself may hinder effectiveness.

Between 2004 and 2009, a Member State liability of HUF 4.79 billion (EU fund) was incurred at the National Development Agency because of the procedures and provisions of law it applied (not attributable to the beneficiary) and that were classified by the Commission as deviating from EU regulation. This amount was a financial correction because of expenditures that are related to structural subsidies and cannot be accounted for (VAT, procurement of equipment), which had to be paid from budget resources.

In the period between 2004 and 2009, the amount of the receivables of the National Development Agency, due to irregularities concerning beneficiaries, was HUF 25.6 billion (EU fund), HUF 6.5 billion of which was related to structural subsidies and HUF 19.1 billion to ISPA/Cohesion Fund subsidies. No data on the refund of the HUF 19.1 billion receivable were available at the time of our on-site audit.

Approximately, HUF 2.8 billion of the receivables related to structural subsidies and amounting to HUF 6.5 billion were repaid before the end of 2009 that is the average recovery rate was 43.1%. This rate corresponded to EU level³, and varied by programme. For example, it remained somewhat below the average in the case of National Development Plan I (35.9%), while it amounted to 62.5% in the case of the PHARE.

³ According to the Commission Report to the European Parliament and to the Council (COM (2009) 372, Brussels, 15.7.2009), at EU level, 'over the last decade, the recovery rate has ranged between 40% and 55%'.

The National Development Agency did not write off any receivables; complete regulation and rules of procedure necessary for its qualification and writing off were not available before the completion of our on-site audit. At the time of our on-site audit, regulations were issued mainly regarding the closing of projects and settlement with the Commission, in accordance with Commission directions.

Loss sharing **with the Commission** as a result of writing off bad debts has not yet taken place in connection with the programmes of the National Development Agency co-financed by structural and cohesion funds, as no receivables have been written off, while the settlement within the framework of the financial closing of operational programmes was carried out after our audit.

Until the end of 2008, the National Development Agency continuously settled the reimbursed receivables with the Commission through the National Authorising Officer's Office of the Ministry of Finance as a Certifying Authority. The amounts received from beneficiaries and repaid by the Managing Authorities of the National Development Agency to the Certifying Authority in 2009 were not settled with the Commission, as transfer requests could no longer be submitted in 2009.

The irregularity and claims management process of the Agricultural and Rural Development Agency was regulated in a timely manner compared to the launching of the programmes and legal title of measures of the 2007-2013 period. The procedures were based on the rules of administrative proceeding; deviations from it were regulated at an adequate level. In the event that the client disagreed with the decision taken by the authority, the client was entitled to lodge an appeal against it in any phase of the procedure.

Following from the administrative proceeding, the Agricultural and Rural Development Agency considered the cases as irregularities when the decision establishing the fact of irregularity became effective. However, in the case of certain legal titles,⁴ the first administrative or legal conclusion of facts took place already before the final, enforceable decision. Pursuant to EU legislation, in these cases, the calculation of the starting date of the measures taken must be the first conclusion of facts. A procedure deviating from this is financially disadvantageous for the Member State.

In spite of the relevant domestic statutory requirement, there was no Irregularity Officer at the Agricultural and Rural Development Agency. At the same time, the issue of responsibility for irregularity reports, and especially the harmonisation among the data in various types of reports, was not resolved.

⁴ Cases like this included when the audit had to be conducted in an enclosed area, and the beneficiary was also present, who took notice of the facts established (deviation or irregularity, if any), which, following from EU definition, already qualified as the first administrative conclusion of facts.

Between 2004 and 2009, a Commission withdrawal and Member State liability of HUF 3.64 billion (EU fund) was incurred at the Agricultural and Rural Development Agency because of the procedures it applied and that were classified by the Commission as deviating from the EU regulation.

The receivables of the Agricultural and Rural Development Agency from beneficiaries amounted to HUF 7.5 billion (EU fund) between 2004 and 2009. HUF 2.7 billion of the receivables of HUF 7.5 billion were reimbursed before the end of 2009 that is the collection rate was 36% in the case of agricultural and rural development subsidies. This was close to the rate corresponding to the EU level in 2008 (37.5%), but fell short of the EU values of the last ten years (values between 40-55%). The collection rate related to the SAPARD and Intervention subsidies was even lower than the average of the Agricultural and Rural Development Agency.

Bad debts were written off in an amount of HUF 1.1 billion (EU fund), equalling 14.6% of receivables. The amount of recovered and written-off receivables was settled with the Commission.

The high (80%) amount of receivables of the intervention measure consisted of 141 items of debt of 49 companies. The total debt (EU + domestic) is HUF 6.8 billion, of which the EU part amounts to HUF 2.1 billion. According to the analysis conducted by our audit, the high amount of receivables is partly attributable to the fact that half of the companies were in liquidation as of 15 October 2009. The other reason is that the amount of the average debt per firm was high, HUF 42.9 million (only considering the EU fund).

In the case of a delay in the procedure (payment), the Agricultural and Rural Development Agency does not pay any interest to the beneficiaries, but it has had a duty payment obligation towards the budget since 1 October 2009, although no such payment has been effected. The client was not obliged to pay duty either (for example when lodging an appeal), but had to pay interest on debts paid with a delay.

Liabilities (debts) vis-à-vis the Commission were settled according to programme and financial fund, within the framework of statements, on which the relevant financial accounts are based, and during transfer requests. In the case of the National Rural Development Plan and the SAPARD programme, the financial closing was implemented, thus in these cases debt settlement was carried out upon the financial closing and subsequently as well. Cumulative data of various years for all programmes and financial funds were not available.

According to the documents handed over for the audit, the Agricultural and Rural Development Agency conducted limited analyses of the irregularities, the emergence of receivables due to the irregularities and their reasons. It was not required by regulation, and written analysis was only prepared upon managerial request with regard to the National Rural Development Subsidies and only for 2008. Discussions and exchanges of experience took place with regard to this subject.

Our recommendations included, inter alia, that:

the Minister of National Development shall

1. Initiate unambiguous regulation of the legal relationship established between the National Development Agency and the beneficiary upon providing the subsidy and during the irregularity and claims management, at an appropriate level, in line with the area of law it belongs to, thus providing adequate support for conducting the procedures and for the clarification of the opportunities of the beneficiaries for legal remedy. In the course of the preparation of the regulation, the Minister shall take into account the time requirement of the subsidy contract and its amendment as well as the experiences of claims management and legal remedy.
2. Take measures to ensure that the regulation of the irregularity management of the National Development Agency provides an adequate basis for the assessment of irregularities, and also take measures to reduce the duration of irregularity procedures within the institutional system.
3. Arrange for the reasonable, rational organisation of claims management in order to increase the effectiveness of the procedures.

the Minister of Rural Development shall

1. Have the list of documents that can be considered as first administrative conclusion of facts outlined, in order to make the starting date of verifiable claims management in line with EU legislation.
2. Have regular analyses prepared about the reasons for the emergence of irregularities and claims as well as about the experiences of their management, and take steps to utilise the analyses in order to prevent irregularities and to improve the effectiveness of the collection of debt.