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COMMUNICATION ON PRE-FINANCING

Situation as at 30/6/2008

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1. INTRODUCTION: OBJECTIVES OF THIS REPORT

In its resolution on the 2005 discharge, in paragraph 8 of chapter 1 'Statement of Assurance', the European Parliament "expresses concern at the fact that the Court of Auditors notes errors in the pre-financing amounts recorded, and calls on the Commission to take urgent steps to remedy these shortcomings with a view to ensuring that the accounts reflect the Community's financial position as accurately as possible";

At the same time, the European Parliament requested the Commission "to provide the budgetary authority with six-monthly reports on the management of pre-financing operations".

The Commission undertook to provide such reports on the pre-financing operations.

It clarifies the way the management of pre-financing is part of the Commission's follow-up of the use of EC funds by beneficiaries.

It explains how the Commission accounts for this asset in the financial statements in accordance with the accounting rules decided by the Accounting Officer, based on the generally accepted International Public Sector Accounting Standards (IPSAS).

The present report is based on the figures in the accounting system of the European Commission as of 30 June 2008.

2. BASIC PRINCIPLES OF PRE-FINANCING ACCOUNTING

2.1. Definition: cash advance

The Financial Regulation¹ introduced the concept of pre-financing and the implementing rules² give a definition and determine the supporting documents needed.

Pre-financing is a payment intended to provide the beneficiary with a cash advance, i.e. a float. Pre-financing is paid, in some procurement contracts and in most grant agreements, before the goods or services are delivered and before the occurrence of eligible costs by beneficiaries.

It may be split into a number of payments over a period defined in the particular pre-financing agreement.

The float or advance is either used for the purpose for which it was provided during the period defined in the agreement or it is repaid – if the beneficiary does not incur eligible expenditures he has the obligation to return the pre-financing advance to the European Communities. Thus pre-financing paid is not a definitive expense until the relevant contractual conditions are met and so is recorded as an asset on the balance sheet when the initial payment is made. Pre-financing constitutes a significant part of the European Communities' assets.

[Article 81³ of the Financial Regulation and Articles 104 and 105 of the implementing rules⁴].

2.2. Acceptance of eligible cost and pre-financing "clearing"

In the budgetary accounts, the pre-financing is treated as a charge to the budget when it is paid.

¹ COUNCIL REGULATION (EC, Euratom) N° 1995/2006 of 13 December 2006 amending Regulation N° 1605/2002 on the Financial regulation applicable to the general budget of the European Communities (OJ L 390/2006 of 30 December 2006. Hereinafter FR.

² COMMISSION REGULATION (EC, Euratom) No 478/2007 of 23 April 2007 (OJ L 111 of 28.04.2007). Hereinafter IR.

³ Art 81 FR

1. "Payment shall be made on production of proof that the relevant action is in accordance with the provisions of the basic act or the contract and shall cover one or more of the following operations:

(b) payment of the amount due in any of the following ways:

(i) pre-financing, which may be divided into a number of payments;"

⁴ Art 104 IR

1. Pre-financing, including in cases where it is split into a number of payments, shall be paid either on the basis of the contract, the decision, the agreement or the basic act, or on the basis of supporting documents which make it possible to check the conformity of the actions financed with the terms of the contract, decision or agreement in question. If a date of payment for pre-financing is determined in those instruments, payment of the due amount shall not be dependent upon further demand.

Art 105 IR

1. Pre-financing is intended to provide the beneficiary with a float. It may be split into a number of payments.

In the general accounts, the payment of pre-financing is treated as an asset. The amount of the pre-financing asset is reduced (wholly or partially) by the acceptance of eligible costs and by amounts returned to the EC. When a pre-financing amount is fully or partially accepted by the Communities as having been properly used, following analysis of the eligibility of a cost claim received, then the accepted amount of eligible expenditure is removed from the balance sheet and taken as an expense in the economic outturn account. This may clear the pre-financing amount in whole or in part. If at the end of the project the use of the pre-financing is not justified, it is necessary to recover it by a recovery order.

Since the introduction of accrual-based accounts in 2005, the central accounting system enables the granting, clearing and recovery of pre-financing to be recorded and tracked by the Commission's authorising services. The following-up of the timely clearing of pre-financing is one of the major tasks of these services. All pre-financing should normally be cleared by the end-date of the financial commitment. That contributes to a better follow up of the financial management of the projects.

[Article 105 of the implementing rules⁵]

2.3. Estimation at recoverable amount

Pre-financing is valued at its estimated recoverable amount, taking into consideration the risk, amongst others, of the financial capability of the beneficiaries and of the existence of a related guarantee attached. The amount of any irrecoverable pre-financing is recognised as a charge in the economic outturn account and as a decrease in the pre-financing carrying value in the balance sheet.

[Accounting rule n°5 on Pre-financing, article IV.2.3 "value reduction" – Decision of the Accounting Officer of 18/10/2006]

2.4. Accrued charges against pre-financing

At the end of each financial year, accrued charges for each project are deducted from the relevant pre-financing still outstanding. Accrued charges represent the amount of eligible costs that were estimated to have been incurred by the beneficiaries (i.e. the work in progress) of the pre-financing amounts outstanding at year-end, but not yet reported to the Communities. These amounts are taken as expenses in the economic outturn account.

Due to the complex and time-consuming nature of this exercise, it should be pointed out that the estimates of accrued charges are performed only during the year-end closure process. During the year, only gross figures of pre-financing amounts are available and presented.

⁵ Art 105 IR

2. An interim payment, which may be repeated, is intended to reimburse expenditure incurred by the beneficiary on the basis of a statement of expenditure when the action is in progress. It may clear pre-financing in whole or in part, without prejudice to the provisions of the basic act.

3. The closure of the expenditure shall take the form of the payment of the balance, which may not be repeated and clears all preceding payments, or a recovery order.

2.5. Long-term and short-term pre-financing

In accordance with international accounting standards, pre-financing which is not due to be used within the next financial year (as is notably the case for structural funds) must be disclosed as a long-term asset, and is thus distinguished from pre-financing which may be used within the following year.

The timing of the recoverability or utilization of the pre-financing governs whether the pre-financing is disclosed as a current or long-term pre-financing asset. The recoverability or utilization is defined by the project's grant agreement. Where information is not available from the beneficiary on the current period's utilization, an estimate should be made in accordance with the planned project budget, which will define the repayment or utilization profile of the pre-financing. All repayments or utilization due after twelve months of the reporting date should be classified as long-term pre-financing and recorded as non-current assets in the balance sheet. The outstanding balance of pre-financing (due within one year) is disclosed as current asset.

[Accounting rule n°5 on Pre-financing, article V "disclosure requirements" – Decision of the Accounting Officer of 18/10/2006]

Due to the complex and time-consuming nature of this exercise, it should be pointed out that the split between long- and short-term is performed only during the year-end closure process. During the year, long- and short-term pre-financing amounts are presented together.

2.6. Interest generated on pre-financing

Interest is generally earned on pre-financing paid out (notable exceptions include amounts paid to Member States or as pre-accession aid). The ownership of this interest designates the two categories of pre-financing existing – European Communities (EC) and Third Party (TP). The difference between the two categories is that the interest generated by "European Communities" pre-financing amounts remains the property of the Communities and so must be returned to the Communities, while that earned on "Third Party" pre-financing is the property of the beneficiary.

[Article 5a of the Financial Regulation⁶]

⁶ Article 5a RF

1. Interest generated by pre-financing payments shall be assigned to the programme or the action concerned and deducted from the payment of the balance of the amounts due to the beneficiary.

The Regulation laying down the rules for implementing this Regulation, hereinafter 'the implementing rules', shall specify the cases in which the authorising officer responsible shall, by way of exception, recover annually such interest. That interest shall be entered in the budget as miscellaneous revenue.

2. Interest shall not be due to the Communities in the following cases:

- (a) pre-financing which does not represent a significant amount, as determined in the implementing rules;*
- (b) pre-financing paid under a procurement contract within the meaning of Article 88;*
- (c) pre-financing paid to Member States;*
- (d) pre-financing paid under the pre-accession aid;*
- (e) advances paid to members of the institutions and to staff in accordance with the Staff Regulations of Officials of the European Communities and the Conditions of employment of other servants of the European Communities, hereinafter 'the Staff Regulations';*
- (f) pre-financing paid in the framework of joint management as referred to in point (c) of Article 53(1).*

2.7. Pre-financing by Budget Management types

The European Communities' operating expenditure covers the various headings of the financial perspective and takes different forms, depending on how the money is paid out and managed. In accordance with the Financial Regulation [Articles 53⁷ of the FR], the Communities implement the general budget using the following methods:

Direct centralised management: this is where the implementation of the budget is undertaken directly by the responsible Communities' Institution or body.

Indirect centralised management: this refers to cases where the Communities entrust the task of managing a portion of the budget to a Communities or Member States body.

[Article 53a⁸ of the IR]

Decentralised management: these are the cases where the Communities delegate certain tasks for implementation of the budget to third countries.

[Article 53c⁹ of the FR]

Shared management: similarly, under this method of management, the Communities delegate certain tasks for implementation of the budget to Member States.

[Article 53b¹⁰ of the FR]

Joint management: under this method, the Communities entrust certain implementation tasks to an international organisation.

[Article 53d¹¹ of the FR]

⁷ Article 53 RF

The Commission shall implement the budget in accordance with the provisions set out in Articles 53a to 53d in any of the following ways:

- (a) on a centralised basis;*
- (b) by shared or decentralised management;*
- (c) by joint management with international organisations.*

⁸ Article 53a RF

Where the Commission implements the budget on a centralised basis, implementation tasks shall be performed either directly by its departments or indirectly, in accordance with Articles 54 to 57.

⁹ Article 53c FR

Where the Commission implements the budget by decentralised management, implementation tasks shall be delegated to third countries in accordance with Article 56 and Title IV of Part Two, without prejudice to delegation of residual tasks to bodies referred in Article 54(2).

¹⁰ ¹⁰Article 53b FR

1. Where the Commission implements the budget by shared management, implementation tasks shall be delegated to Member States. That method shall apply in particular to the actions referred to in Titles I and II of Part Two.

2. Without prejudice to complementary provisions included in relevant sector-specific regulations, and in order to ensure in shared management that the funds are used in accordance with the applicable rules and principles, the Member States shall take all the legislative, regulatory and administrative or other measures necessary for protecting the Communities' financial interests.

3. FOLLOWING-UP OF PRE-FINANCING

Day to day and control procedures are put in place in all services paying pre-financing to beneficiaries. Also the accounting service implements following-up and reviews procedures. Those include control covering the complete pre-financing cycle from the request for pre-financing to the final clearing in the general accounts. The control measures and their frequency are based on a risk analysis.

The main objective of the ex-ante control or ex-post reviews is to avoid errors and inconsistencies or to ensure that they are discovered and corrected in a timely way. They aim at ensuring the quality of the accounting data. But the data collected during the control activity help also inform both the management and the operational services of the progress which is being made in disbursing the pre-financing and alert them to possible problems.

In short: the rules put in place in the Commission since the introduction of accrual accounting and the implementation of an adequate control system, including the quality of pre-financing data in the information systems and the management reporting, aim to support the assurance on the legality and regularity of underlying transactions on the one hand and to guarantee a sound financial management, that is to say the best use of available resources to reach the Commission's objectives, on the other hand.

4. ANALYSIS OF GROSS AMOUNTS OF PRE-FINANCING (PRESENTED EACH HALF-YEAR)

As already explained above, due to the complex and time-consuming nature of the cut-off exercise, it should be pointed out that the accrued charges estimates are performed only during the year-end closure process. **During the year and therefore in the present report, only gross figures of pre-financing amounts are available and presented.**

¹¹ Article 53d FR

1. Where the Commission implements the budget by joint management, certain implementation tasks shall be delegated to international organisations.

4.1. General overview of pre-financing amounts

The table below shows an overview of the pre-financing figures:

Table 1

EUR millions		
PRE-FINANCING AMOUNTS		
Management type	Balance at 30.06.2008	Balance at 31.12.2007
Pre-financing European Communities gross amounts (generating interest for the European Communities):		
Direct centralised management	12 916	10 678
Indirect centralised management	2 771	2 854
Decentralised management	605	576
Other	564	627
Unallocated pre-financing balances	1 610	2 128
Total Gross Pre-financing European Communities	18 466	16 863
Pre-financing Third parties gross amounts (not generating interest):		
Direct centralised management	1 371	1 136
Indirect centralised management	33	32
Decentralised management	688	768
Shared management	28 246	16 104
Joint management	1 750	1 460
Unallocated pre-financing balances	18 316	19 278
Total Gross Pre-financing Third parties:	50 404	38 778
Total Gross pre-financing	68 870	55 641
<i>Less Accrued Charges (for 31/12 only)</i>	-	(21 053)
<i>Total NET pre-financing (for 31/12 only)</i>	-	34 588

NB:

- The unallocated pre-financing amounts are those first included in the opening balance sheet of 2005 and are shown separately on a single line when no information on the split by budget management type was available on transactions before 31/12/2004. The split of amounts outstanding between management types is available for the pre-financing payments made since 2005.
- At the end of each financial year, accrued charges for each project are deducted from the relevant pre-financing still outstanding. Accrued charges represent the amount of eligible costs that were estimated to have been incurred by the beneficiaries (i.e. the work in progress) of the pre-financing amounts outstanding at year-end, but not yet reported to the Communities. These amounts are taken as expenses in the economic outturn account. Due to the complex and time-consuming nature of this exercise, it

should be pointed out that the estimates of accrued charges are performed only during the year-end closure process. During the year and therefore in the present report, only gross figures of pre-financing amounts are available and presented.

4.2. Constitution of balance as of 30.6.2008: year of payment and type of clearing

The float or advance is either used for the purpose for which it was provided during the period defined in the agreement or it is repaid – if the beneficiary does not incur eligible expenditures he has the obligation to return the pre-financing advance to the European Communities. Thus pre-financing paid is not a definitive expense until the relevant contractual conditions are met and so is recorded as an asset on the balance sheet when the initial payment is made.

The table below shows the way the pre-financing was used in that context, i.e. either for the purpose for which it was provided during the period defined in the agreement (Invoice) or it is repaid (Recovery Order).

When the control put in place by the different services of the Commission to follow-up pre-financing revealed anomalies, appropriate actions were taken and, if required, adjustments were then initiated in the accounting system. The most common error relates to the pre-financing opening balance as of 1/1/2005 when accrual accounting numbers were first uploaded onto the system following a manual census by all services.

Table 2

EUR millions					
Type of clearing Year of Payment	PAID Amount	Cleared since 1.1.2005 by			Open Amount 30/06/2008
		INVOICE	Recovery Order	Adjustments	
PAID BEFORE 2005	34 504	-12 511	-433	-1 599	19 961
PAID IN 2005	11 535	-5 773	-94	-114	5 554
PAID IN 2006	11 377	-4 322	-93	-127	6 835
PAID IN 2007	20 221	-1 090	-14	-154	18 963
PAID IN 2008	17 678			-121	17 557
TOTAL	95 315	-23 696	-634	-2 1115	68 870

At 30/06/2008, the outstanding pre-financing gross balance amounted to EUR 68.9 billion.

This balance is a result of the amount open at 1 January 2005 and subsequent transactions carried out by all the Commission services involved:

- A total of EUR 60.8 billion pre-financing was paid out from the EU budget over the years 2005 to 2007. In the first semester of 2008 it includes about EUR 11 billion in long-term advances paid for the 2007-13 Structural Funds programming period. It also includes about EUR 1.5 billion paid for the EAFRD and EUR 1.5 billion for the 7th Framework Programme for Research.
- The Commission has received enough justifications to clear pre-financing for about EUR 24 billion, including EUR 3.7 billion in the first semester of 2008 for pre-financing paid in previous years.

- The Commission had to recover EUR 634 million when contractual conditions were not met by beneficiaries, including EUR 66 million in the first semester of 2008 for pre-financing paid in previous years.
- Corrections for about EUR 2.2 billion were initiated by the Commission services, mainly to the opening balance when accrual-based accounts were first prepared.

The table below shows the same data but as a percentage of the total amount paid in each year.

Table 3

					% of PAID amount
Type of clearing Year of Payment	PAID Amount	Cleared since 1.1.2005 by			Open Amount 30/06/2008
		INVOICE	Recovery Order	Adjustments	
PAID BEFORE 2005	100%	-36%	-1%	-5%	58%
PAID IN 2005	100%	-50%	-1%	-1%	48%
PAID IN 2006	100%	-38%	-1%	-1%	60%
PAID IN 2007	100%	-5%	0%	-1%	94%
PAID IN 2008	100%	0%	0%	1%	99%

As of 30/06/2008 58% of the pre-financing paid before 2005, 48% of the pre-financing paid in 2005, 60% of the pre-financing paid in 2006 and 94% of the pre-financing paid in 2007 remains open. The percentage of the remaining pre-financing paid before 2005 is still high as it mainly includes long-term pre-financings under shared management for Structural Funds programmes 2000-2006.

4.3. Progression of use or clearing of pre-financing

The amount of the pre-financing asset is reduced (wholly or partially) by the acceptance of eligible costs and amounts returned. When a pre-financing amount is fully or partially accepted by the Communities, following analysis of the eligibility of a cost claim received, then the accepted amount of eligible expenditure is removed from the balance sheet and taken as an expense in the economic outturn account. This may clear the pre-financing amount in whole or in part.

The table below shows the evolution between reporting periods of the outstanding balance of pre-financing paid in a specific year as a percentage of the total amount paid in this year.

Table 4

Reporting date Year of Payment	Open Amount 31/12/2004	Open Amount 31/12/2005	Open Amount 31/12/2006	Open Amount 31/12/2007	Open Amount 30/06/2008
PAID BEFORE 2005	100%	82%	71%	62%	58%
PAID IN 2005		95%	73%	55%	48%
PAID IN 2006			94%	70%	60%
PAID IN 2007				98%	94%
PAID IN 2008					99%

4.4. Detailed movements of pre-financing between 31/12/2007 and 30/6/2008

The table below shows the detailed movements of pre-financing between 31/12/2007 and 30/6/2008, showing the way the pre-financing was used i.e. either for the purpose for which it was provided during the period defined in the agreement (Invoice) or it is repaid (Recovery Order) or adjusted. Amounts are presented in EUR millions.

Table 5

EUR millions						
Type Of Clearing Year of Payment	Open Amount 31/12/2007	PAID Amount in 2008	Cleared in 2008 by			Open Amount 30/06/2008
			INVOICE	Recovery Order	Adjustments	
PAID BEFORE 2005	21 486	-	-1 273	-20	-232	19 961
PAID IN 2005	6 354	-	-735	-11	-54	5 554
PAID IN 2006	7 990	-	-1 062	-26	-67	6 835
PAID IN 2007	19 811	-	-660	-9	-179	18 963
PAID IN 2008	-	17 678	0	0	-121	17 556
	55 641	17 678	-3 731	-66	-653	68 870

At 31/12/2007, the outstanding pre-financing gross balance amounted to EUR 55.6 billion.

During the first semester of 2008 an additional EUR 17.7 billion pre-financing was paid out from the EU budget. It includes about EUR 12 billion long term advances paid for the 2007-13 Structural Funds programming period. It also includes about EUR 1.5 billion paid for the EAFRD and EUR 1.5 billion for the 7th Framework Programme for Research.

The Commission has received enough justifications to clear pre-financing for EUR 3.7 billions, had to recover EUR 66 million and processed to adjustments for about EUR 725 million.

The outstanding pre-financing gross balance at 30/06/2008 is therefore EUR 68.9 billion.