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ANNEX 2

ANNEX

to the

**COMMUNICATION OF THE COMMISSION TO THE EUROPEAN PARLIAMENT
AND THE COUNCIL**

**Application of net financial corrections on Member States
for Agriculture and Cohesion Policy**

The envisaged procedure for applying net financial corrections for Cohesion Policy Funds

Net financial corrections have to be applied in case a serious deficiency in the functioning of management and control systems is identified (144 and 145 CPR). This annex sets out the envisaged procedure for applying net financial corrections on the basis of the preparatory work for the delegated act on the criteria for determining serious deficiencies, the criteria for establishing the level of financial correction to be applied and the criteria for applying flat rates or extrapolated financial corrections. The following examples illustrate the procedure foreseen in the delegated act of the Commission:

Step 1: Assessing the deficiencies

On the basis of audits effective functioning of management and control systems is assessed through the compliance of the following key requirements (main key requirements in the diagram in bold) foreseen in the CPR.

Key requirement of management and control system	
1	Adequate separation of functions and adequate systems for reporting and monitoring where the responsible body entrusts execution of tasks to another body.
2	Adequate procedures to ensure a reliable system for recording data for monitoring, evaluation (including data on common and specific indicators), financial management, verification and audit purposes including the link with electronic data exchange system with beneficiaries.
3	Appropriate procedures for selection of operations.
4	Adequate management verifications.
5	Adequate audit trail.
6	Effective implementation of proportionate anti-fraud measures.
7	Appropriate procedures for drawing up the management declaration and annual summary of the final audit reports and of controls carried out.
8	Appropriate procedures for drawing up and submitting payment applications.
9	Appropriate procedures for drawing up and certifying the completeness, accuracy and veracity of the annual accounts.
10	Appropriate procedures for maintaining computerised records of expenditure declared and the corresponding public contribution.
11	Appropriate procedures for keeping account of amounts recoverable and withdrawn.
12	Adequate systems audits and audits of operations.
13	Adequate procedures for providing a reliable audit opinion on the annual accounts and for preparing the annual control report.

Step 2: Identifying serious deficiencies

For the purposes of Article 144(1)(a) CPR, the main types of serious deficiencies involve breaches of one or more of the above-mentioned key requirements.

The assessment of compliance and effectiveness of each key requirement and of the whole management and control system is made in one of the following categories:

Assessment of serious deficiency (Article 144 CPR)	Levels of compliance and effectiveness	Description
Limited or no deficiency	Category 1	Works well; only minor improvement(s) needed. There are no deficiencies or only minor deficiencies found. These deficiencies do not have any significant impact on the functioning of the key requirements / authorities / system.
	Category 2	Works, but some improvement(s) are needed. Some deficiencies were found. These deficiencies have a moderate impact on the functioning of the key requirements / authorities / system.
Serious deficiency	Category 3	Works partially; substantial improvements are needed. Serious deficiencies were found that have led or may lead to irregularities. The impact on the effective functioning of the key requirement / authorities / system is significant.
	Category 4	Essentially does not work. Numerous serious deficiencies were found which have led or may lead to irregularities. The impact on the effective functioning of the key requirements / authorities / system is significant - it functions poorly or does not function at all. The deficiencies are systemic and wide-ranging. As a consequence, no assurance can be obtained from the assessment of the key requirements / authorities / system.

Step 3: Establishing the level of a flat-rate correction

a) Corrections shall be established on the basis of individual irregularities. When this is not possible nor cost/efficient, the level of the required correction may be established based on the results of the audit of a representative sample of operations (extrapolated correction) or at flat rate.

b) The level of the flat rate correction shall be proportionate to the seriousness of the irregularity or deficiency identified and, where possible, will take into account the following criteria: relative importance of the serious deficiency (in particular the number of key requirements assessed in category 3 or 4); degree of risk of loss to which the Union budget was exposed due to the system deficiency; extent of the serious deficiency (either in relation to the overall programme or part of it, or to types of operations / specific aspects of expenditure declared); vulnerability of the expenditure to fraud due to the system deficiency.

c) Based on the assessment of the criteria described above, the percentage of the flat rate correction will be determined: 5%, 10%, 25% or 100%.

d) The table below sets out criteria for the application of different levels of flat rate corrections. Flat-rate corrections can be increased for repeated breaches involving the same deficiency where the Member State has failed to take adequate corrective measures for the part of the system that is affected, following a previous correction.

Correction rate	Criteria
100%	The rate of correction shall be 100%, where the serious deficiency in the management and control system is sufficiently fundamental, frequent or widespread, that it represents a complete failure of the system that puts at risk the legality and regularity of all expenditure affected.
25%	The rate of the correction shall be 25%, where the serious deficiency in the management and control system is sufficiently frequent and widespread that it represents an extremely serious failure of the system that puts at risk the legality and regularity of a very high proportion of expenditure affected.
10%	The rate of the correction shall be 10%, where the serious deficiency relates to part of the system not fully functioning or functioning so infrequently or so inconsistently that it puts at risk the legality and the regularity of a high proportion of the expenditure affected.
5%	The rate of the correction shall be 5% when the serious deficiency relates to part of the system not functioning consistently and which puts at risk the legality and regularity of a significant proportion of the expenditure affected.

In exceptional cases, where the use of flat rates would be disproportionate, the rate of correction may be reduced (for example between 100% and 25%).

Illustrative example for cohesion policy

The Commission identified inconsistencies in the management declaration and audit opinion and annual control report received by 15 February an operational programme. On this basis the Commission carries out an audit and re-performs audits of some of the operations included in the representative sample audited by the audit authority. The Commission’s audit results in an error rate that would have been much above materiality level (2%), while the audit authority reported an error rate below 2%. This demonstrates that a) the audit authority’s work and opinion for this accounting year is not reliable and b) the management and control system for the programme as a whole presents serious deficiencies, not reported neither in the audit opinion nor in the management declaration. In addition the Commission audit has ascertained that key requirement 3 (selection of operations) and 5 (adequate audit trail) were not fully complied with, in all cases.

The Commission will launch a procedure for a net financial correction and will assess the detected serious deficiencies, taking into account that various key requirements essentially did not work (key requirements 11 and 12 on audits on operations, and procedures to report a reliable audit opinion), while other key requirements have worked partially and substantial improvements are needed (key requirements 3, 4, and 5: management verifications, selection of operations, audit trail). The Commission therefore concludes that 25% of the programme expenditure must be corrected. The Member State is informed about this assessment and conclusion, and invited to provide a reply within two months. As indicated above, without additional new and acceptable audit evidence from the Member State during the hearing, the Commission must adopt a decision for a net financial correction within six months of the hearing date (or of the date of acceptance by the Member State).