EARTO Paper on the Horizon 2020 Funding Model
Input for the Mid-Term Review

22 September 2016

The European Commission was guided by the goal of simplification when drafting the funding model for Horizon 2020 projects. By limiting the eligibility to direct costs while covering indirect costs with a 25% flat rate on direct costs, the Commission aimed to achieve a simpler, fairer and more reliable funding of research and innovation projects in Horizon 2020. EARTO members very much welcome and support these goals and remain ready to provide our expertise to assess if these goals will actually be achieved over the lifetime of Horizon 2020.

The financial experts of EARTO members across Europe share their experiences and good practices on a regular basis and have an inside view on the workings and implications of Horizon 2020 funding rules in the RTO community and beyond. The EARTO Working Group Financial Experts looks at the following questions:

- **Simplification**: Does the funding model of Horizon 2020 decrease the administrative burden for beneficiaries?
- **Fairness**: Does the funding model of Horizon 2020 foster the equal treatment of beneficiaries in Horizon 2020 projects?
- **Reliability**: Will beneficiaries' efforts for compliance with Horizon 2020 rules be honoured in future audits?

This paper matches RTOs' hands-on experiences applying Horizon 2020 funding rules with the well-intended goals of these rules. Based on the conclusions, EARTO offers recommendations for a simpler, fairer and more reliable funding model aiming to improve the effectiveness of EU spending.

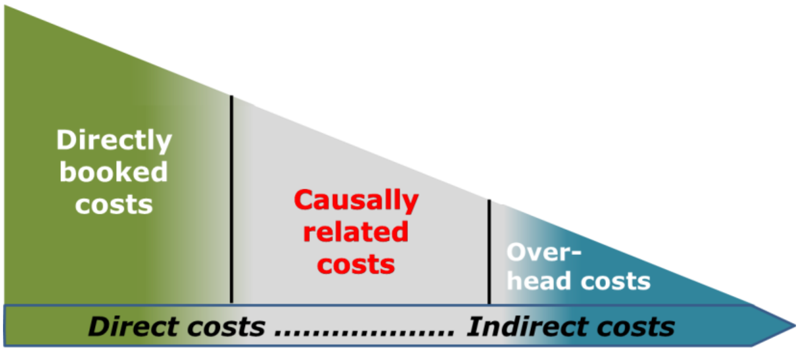
Horizon 2020 Funding Model: Based on a Clear Distinction between Direct and Indirect costs

Eligibility of costs is a clear-cut issue in Horizon 2020: direct costs are generally eligible and funded at 100% and topped with a 25% flat rate for covering indirect costs. Actual indirect costs are not eligible. This concept is based on the assumption that there is a clear separation ("firewall") between the category of direct costs and the category of indirect costs:

- Direct costs are directly attributable to the project and therefore seen as essential for the execution of the project. This category is limited to booking entries for direct project hours via time sheets and project-specific third-party invoices and may include under certain provisions also explicitly measured costs (e.g. large research infrastructure).
- Indirect costs are not directly attributable to the project and therefore seen as not essential for the execution of the project. This category includes all other costs items such as more general mark-up rates. Also, in Horizon 2020 the EC considers detailed internal invoices as indirect costs, which was not the case in FP7.

Business Reality: Direct and Indirect Costs Represent a Continuum

Generally accepted[1] concepts of cost accounting do not support this idea of a "firewall" between direct and indirect costs. Many more cost items, not only those linked to project hours and single invoices, vary with the rate of output and are causally related with the implementation of – in the context of Horizon 2020 – a research project.



This concept reflects the accounting reality of European RTO as well as many other beneficiaries: costs causally related to the project can and must be accounted for by applying additional qualified and tested cost accounting methodologies. These include internal invoicing for shared resources used for the implementation of the project (e.g. shared services or use of infrastructure) or the allocation of bulk purchases to individual projects (chemicals, energy, materials etc.). The booking entries are generated using methodologies such as the calculation of internal service fees, the use of average pricing or cost allocations based on patterns of usage. These methodologies are well-established business practice, compliant with national accounting and funding rules and offer a reliable audit trail for auditors.

Beneficiaries Need to Apply Varying Concepts of Direct Costing Depending on their Business and Funding Framework

The argument that the type of bookings are business decisions that could be changed to meet Horizon 2020 standards falls short. Beneficiaries operate under a complex framework of national accounting standards, auditing requirements and tax regulations, they have different business models, organisational structures and complexities of their research activities. As a result, larger organisations need to rely more on cost accounting instruments to allocate causally related costs essential for the implementation of a project. In some case, national rules and regulations may favour certain cost accounting practices.

Implications of Divergence of Horizon 2020 Funding Rules from Business Reality

- The eligibility of a cost item essential for the execution of the project does not depend on the materiality of the item but on booking technicalities (e.g. Is there a single order invoiced separately – or is it retrieved from stock resulting from bulk purchases?).
- As beneficiaries try to adapt to Horizon 2020 rules, the administrative burden increases in order to meet booking and measuring requirements for eligible costs (e.g. by increasing the level of detail required in bookings).
- The same cost items may systematically be eligible at one beneficiary, but not at another due to varying frameworks (e.g. organisations with more complex research activities are at structural disadvantage as they have to rely on cost accounting methodologies not eligible in H2020).
- The use of efficient and high-quality in-house resources is put at a disadvantage in H2020 (e.g. technical services are not eligible when billed via standard internal invoice, but accepted as a third-party invoice).

[1] A broader definition of direct cost is commonly used e.g. in the context of accounting standards, tax regulations or business schools.

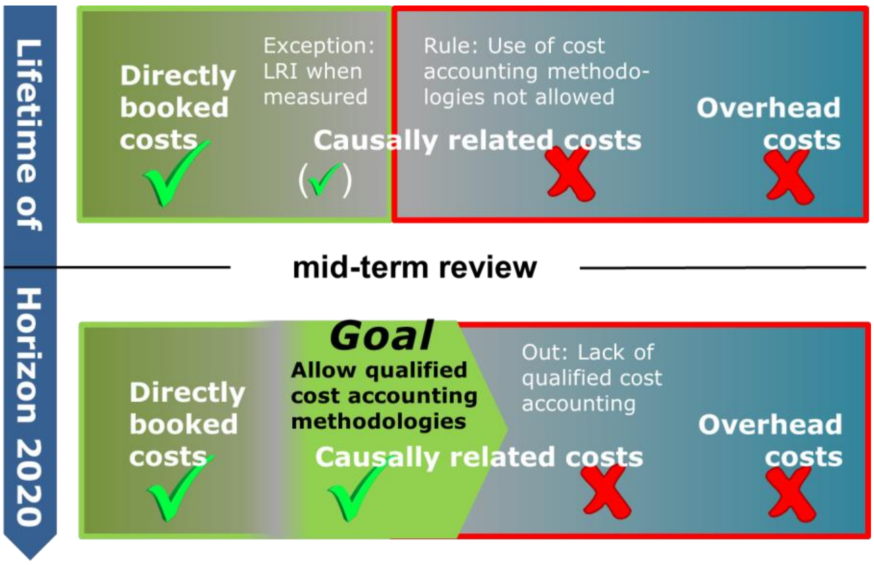
Risk Assessment of the Horizon 2020 Funding Model

EARTO members see the following risks associated with the current funding model over the lifetime of Horizon 2020:

- **Extensive guidelines in H2020's Model Grant Agreement (MGA) enhance the risks**
  Every clarification and example in MGA adds to "rule universe". Booking and measurement requirements limit eligibility of costs depending on size or type of beneficiary. Examples in the MGA become the only correct solution for a cost item, no alternatives are allowed.
- **No unified understanding of direct costs**
  Beneficiaries generally expect costs reimbursed as direct costs in FP7 to be also eligible in Horizon 2020, but the Commission's new direct cost concept does not embrace all FP7 direct costs. Even large, deeply involved RTOs required time to understand the differences.
- **Audits will fully expose eligibility risks at later stages in Horizon 2020**
  Beneficiaries apply H2020 rules in good faith as projects are implemented. Direct costs items may not be fully scrutinised until Commission/ECA audit activities turn to Horizon 2020. This risk is even higher for smaller and/or less involved beneficiaries.
- **Goal of simplification at jeopardy**
  Limiting funding to direct costs should enhance assurance for beneficiaries, but the concept of direct costs envisioned by the Commission adds to the administrative burden and risk exposure of many beneficiaries.

Recommendation 1: Using Midterm-Review of Horizon 2020 to Reduce Risk by Accepting Business Reality

The Commission should take the chance of the midterm review of Horizon 2020 to refine the concept of eligible direct costs. When materially identical cost items are essential for the implementation of the action, qualified cost accounting methodologies should be accepted.



It is a prerequisite for organisations using methodologies for accounting for causally related costs that those methodologies are their usual accounting practice, reflect national rules and regulations and provide a proper audit trail.

The refinement of the eligibility of direct costs should be clarified in a revised Model Grant Agreement and in guidance for audit activities by the Commission and its partners. The goals associated with the funding model in Horizon 2020 will significantly benefit from improved eligibility criteria for direct cost: by accepting the business reality at beneficiaries executing research projects, risk exposure in future audits will be reduced.

Large research infrastructure costs: well-intended refinement to Horizon 2020 funding model, but facing similar problems in beneficiaries' practice

By introducing the direct costing of large research infrastructures (LRI), the Commission is committed to keep Horizon 2020 attractive for key beneficiaries operating sophisticated research infrastructures. As the capitalised and operating costs of research infrastructures are not covered by the 25% flat rate for general overhead costs according to the simplified Horizon 2020 funding model, Research and Technology Organisations welcome a simplified methodology for declaring the costs of large research infrastructures as direct costs. However, the limited concept of direct costs used increases the administrative burden of LRI costing by e.g. requiring the instalment of meters and an advanced level of detail. In addition, the different structural and funding framework of beneficiaries leads to varying results concerning access to LRI costing and acceptance of certain cost categories (e.g. difference in structure of balance sheet). ***EARTO encourages the Commission to include LRI rules in the proposed refinement of the direct cost concept, thus lowering the administrative burden for beneficiaries.***

Recommendation 2: Looking beyond Horizon 2020

When setting the framework for FP9, the Commission should reconsider the limited concept of eligible direct costs and re-establish a general acceptance of qualified cost accounting methodologies including full-cost accounting, preferably complying with the national accepted calculation methodologies. By doing so, the Commission can solve the problem when there is no material difference for the implementation of a project between direct costs at one beneficiary and indirect costs at another. The acceptance of the beneficiaries' usual accounting practices is a true simplification for those with professional cost accounting systems.

EARTO very much welcomes the Commission's willingness to simplify and improve EU budget implementation and controls. In this respect, care must be taken that rules do not undermine the positive impact of research & innovation programmes. To better shape programmes and policy, EARTO members are pleased to provide their extensive experience as EU funding beneficiaries and remain open for dialogue with the EC, European Parliament, Member States and European Court of Auditors on the above-mentioned recommendations.

Note to the reader:

EARTO - European Association of Research and Technology Organisations
EARTO is the European trade association of the research and technology organisations (RTOs), a non-profit organisation founded in 1999. EARTO groups over 350 RTOs with a combined staff of 150,000, an annual turnover of €23 billion, special equipment and facilities to a value of many €billions and more than 100,000 customers from the public and private sectors annually.

EARTO Working Group Financial Experts*: composed of 20 Financial Controllers and Specialists working within our membership. Established in 2013, this Working Group is following the financial and legal aspects of Horizon 2020 implementation, including the new Large Research Infrastructure scheme.*

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