REVIEW OF THE FINANCIAL REGULATION
EARTO RESPONSE TO THE PUBLIC CONSULTATION

Introduction to EARTO

EARTO is the European Association of **Research and Technology Organisations**, RTOs for short. The Association represents approximately 350 such organisations from across the EU and associated countries, employing in total some 150,000 scientists, engineers and technicians.

RTOs – to give a simplified definition – are mission-oriented R&D organisations. The major RTOs are government-sponsored, sometimes government-owned, organisations with a general mission of helping to tackle issues of social relevance (what are often referred to today as "grand challenges") and to support economic competitiveness.

The Scope of our Response

We welcome the opportunity to contribute to the second triennial review of the Financial Regulation and its Implementing Rules. Our response to the present consultation relates especially to the **Framework Programme for Research and Technological Development** – hereafter referred to as the FP – in which RTOs are major players:

- The 5 largest RTOs in the EARTO membership totalled over 1,400 project participations in FP6 for more than €520 million in EU funding
- In total, non-university research organisations accounted for about 1/3 of FP6 funding.

General Observations on the Financial Regulation in Relation to Research and Development

The specific implementing rules for the FP – notably the Rules of Participation and the Model Contract – are of course founded on the Financial Regulation.

We consider that the Financial Regulation as it is presently interpreted and applied is ill-suited to the needs of research and development. In the past – e.g. in FP5 and the early years of FP6 – the Commission services tended to interpret the Financial Regulation and the related FP rules with **intelligent discretion**. This discretion allowed the Commission to take reasonable account of real differences in management and accounting principles and practices as between

different types of organisations and different countries. Today, by contrast, we are experiencing a sustained campaign of ex-post FP6 audits in which a uniform set of rigidly defined and interpreted rules – whereby, incidentally, the Commission is unilaterally and retrospectively changing the definition of FP6 eligible costs which it applied earlier within FP6 – are being applied[1].

The origins of this sustained campaign of ex-post FP6 audits are several and include an auditing approach by the European Court of Auditors which is ill-adapted to the realities of research. Serious damage is being done to the credibility of the FP as a major European research programme, to the reputation of the Commission as a competent administration, to transnational relationships and partnerships among research organisations, business enterprises and universities built up over many years through previous FPs – as well as, undeservedly, to the financial interests of many FP beneficiaries. **That is not, we recognise, the subject of the present consultation: it is, however, essential that the Commission understands fully the consequences of the present Financial Regulation, of the related implementation rules of specific EU programmes, and of the interpretations placed on those rules and the manner of their implementation**. Much is at stake.
It has been suggested that there is a need for a separate and specific Financial Regulation for the FP. We do not consider ourselves qualified to give an opinion on the matter, but we do urge that the suggestion be considered most carefully.

The Commission should also carefully and objectively examine how many EU member states implement their research programmes comparable to the FP. Such an examination would find none of the tensions and criticisms which surround the management of the FP today. There are surely lessons to be learned here –"good practice" – about the intelligent administration of public funding for research.

In studying the wording of the Financial Regulation we find little which appears, in the first instance, objectionable or inappropriate. We have a strong sense that much of the difficulty stems from excessive interpretations of the text. That, in its turn, may be not unrelated to the Commission Staff Regulation, which assigns personal responsibility to individual Commission officials for errors of their own omission or commission. If our observation is correct, the underlying situation must be reformed urgently in such a manner as to invoke the corporate (collective) responsibility of the Commission as the primary responsibility.

As a final general remark, it is essential that the Financial Regulation as it applies to R&D recognises in its wordings, interpretation and implementation certain essential realities of R&D practice[2]. Chief amongst these is that specific R&D work – and especially R&D to support competitiveness and other EU policy objectives, which are the very rationale of the FP – does not arise in a vacuum as the present rules, in a restrictive interpretation, imply (*"necessary for the implementation of the project"*). They arise out of **upstream activities** to

[1] The Secretary General of EARTO was invited to present the views of RTOs on the implementation of FP7 by the ITRE Committee of the European Parliament on November 10th, on which occasion he had the opportunity to explain these matters at length. His presentation is attached.

[2] See also the Council Conclusions on guidance on future priorities for European research and research-based innovation (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/intm/111723.pdf) and the report from the Expert Group on the Role of Community Research Policy in Knowledge-based Economy.

identify emerging needs and to develop promising generic technologies for future applications. They also require **downstream** activities to protect, promote and diffuse research results in order to ensure their widest beneficial application. The costs associated with these upstream and downstream activities are an essential part of what are frequently referred to as "**indirect**" or "**overhead**" costs. They must always be considered eligible costs in reasonable proportion. **In other words, the starting point for the Financial Regulation and related rules must be the full economic cost of R&D: the less the full economic cost of R&D is recognised and compensated, the less the relevance and incentive effect of the FP and the lower participation by the target beneficiary groups will be, and hence the more the programme will fail to meet its objectives.**

Responses to the Questionnaire

PART 1: GRANTS

Information about Grant opportunities
Question 1: Are you sufficiently informed about upcoming call for proposals in a timely manner? What improvements would you suggest?

No observation.

Co-financing and contributions in kind
Question 2: Should the rules be more flexible on co-financing requirements taking into account the type of actions and project managers? How could in-kind contributions best be dealt with, while adhering to the non-profit principle?

In principle, there is no reason not to fund a particular project at 100%, if no other funding is available. In practice, this is rarely likely to be the case, but the possibility should not be excluded.

Performance-based grants
Question 3: Should the use of lump sums, flat rates become the norm rather than the exception? Should the rules allow for costs to be covered on the basis of expected outputs? If yes, can you provide concrete examples?

It should be clearly understood that flat rates, lump sums etc. do not constitute a simplification for most beneficiaries (who operate full-cost accounting procedures). But they may be a simplification for the Commission and their use for smaller-value items, such as travel and accommodation costs, would probably be acceptable to most beneficiaries.

Output-based reimbursement is a much wider issue. Indeed, many research programmes take an output-based approach: a programme of work is agreed; a (large) lump sum is awarded; progress and final reports are delivered, and a final appraisal considers solely whether the originally proposed and agreed objectives have been pursued in a reasonable manner, i.e. no input accounting.

It is in the nature of much R&D work that it is high risk and speculative: whether specific results will be attained is uncertain, and the precise expenses which will be made are unpredictable. Nevertheless, the examples of many reputable and successful R&D programmes around the world show that programmes can be operated effectively and efficiently in such a manner.

Non profit rule
Question 4: Should the rules strictly adhere to the non-profit principle or should there be room for some flexibility in this matter? Do you have examples of good practices from other public authorities?

The no-profit rule appears irrelevant, given the co-financing principle. Even in the absence of co-financing, a subsidy of 100% will not give rise to profit (assuming there are no direct receipts from the project).

If the intention of the Commission is to reserve for itself the right to judge whether a participant could or should provide more co-financing from its own or other sources, this would be to open a can of worms of infinite size. Why not also consider future income streams from licensing technology resulting from an EU-funded R&D project? Why not consider future income streams from the new or improved products or processes introduced by industry as a consequence of an FP project? To attempt to do so would, of course, be wholly unrealistic.

The non-profit principle, if it is to remain, must be applied in such a way as to respect the financial margin of surplus which participants may apply to their **direct costs** in order to cover their **indirect costs**: this is to state again – see above – that the point of departure must always be the **full economic cost of R&D**.

Ceilings for small grants
Question 5: What, in your view, would be the appropriate amount for low and very low value grants?

No observation

Financial stability for grant applicants
Question 6: How could the rules on operating grants be more flexible? In which way? What are your views on the duration of the framework partnership agreements?

No observation

'Cascading grants involving third parties'
Question 7: Can you give concrete examples and types of actions where the strict limitation on cascading grants became an obstacle for achieving the goal of your action?

No direct observation. Subcontracts are usual and necessary in R&D projects and, by and large, this is sufficiently recognised by the FP.

PART 2: THE COMMISSION'S HANDLING OF FINANCIAL FILES

Pre-financing payments to beneficiaries
Question 8: From your experience, what alternative solutions could be proposed for pre-financing payments while safeguarding tax payers' money?

The recent excessive interpretation whereby participants are being asked to maintain separate bank accounts for each EU-funded project creates huge administrative burdens for large beneficiaries with many, even hundreds, of FP project participations.

The best approach may well be for the Commission simply to forgo its right to the interest (i.e. consider any gains for the beneficiary to be part of the subsidy).

Pre-financing guarantees
Question 9: What mechanism, other than pre-financing guarantee, could be explored while ensuring adequate protection of community funds?

They should be abolished and the FP Guarantee Fund should cover this, as indeed was intended when it was originally proposed.

Tendering thresholds for low value contracts
Question 10: Based on your experience, do you think current thresholds are still adequate or should they be increased, and why?

No observation.

Paperwork for applicants
Question 11: How could the application procedure for both grants and contracts be further improved?

No observation.

Additional Comments

The Financial Regulation assigns a margin of discretion to "the authorising officer" which results in unequal and arbitrary treatment and for which the reasons are frequently not communicated, are refused, or otherwise remain inscrutable. References to "the authorising officer" should be replaced by "the Commission", and the Commission should ensure a coherent practice in the interpretation and implementation of specific rules.

Article 180, §2 - Implementing Rules	**Amended Article 180, §2 - Implementing Rules**
The certificate shall certify, in accordance with a methodology approved by ***the***	*The certificate shall certify, in accordance*

***authorising officer responsible**, that the costs declared by the beneficiary in the financial statements are real, accurately recorded and eligible in accordance with the grant agreement.*	*with a methodology approved by **the European Commission**, that the costs declared by the beneficiary in the financial statements are real, accurately recorded and eligible in accordance with the grant agreement.*

The definition of **eligible costs** should be reasonable and should respect the full cost principle: direct and indirect costs, upstream and downstream of research. Article 172a, Implementation Rules, alinea a of paragraph 1 should be abolished.

Article 172a, Implementation Rules, alinea c of paragraph 1 should be modified by replacing "implementation" by, for example, "purpose", whereby "purpose" should be understood to include necessary upstream and downstream activities related to the research.

Article 172a, §1, alinea c – Implementing Rules	**Amended Article 172a, §1, alinea c – Implementing Rules**
*They [eligible costs] are necessary for **the implementation** of the action or of the work programme which is the subject of the grant.*	*They [eligible costs] are necessary for **the purpose** of the action or of the work programme which is the subject of the grant.*

Article 172a, Implementation Rules, alinea d of paragraph 1, in which reference is made to "the applicable accounting standards of the country" and "according to the usual cost accounting practices of the beneficiary", is currently ignored almost systematically by the Commission, its auditors, and the European Court of Auditors. The principle should be enforced as provided for, i.e. how a beneficiary identifies, values and attributes (direct and indirect) costs should correspond to the accepted national practice (e.g. national research funding councils) and its own usual practice in its dealings with bodies similar to the Commission (which can in case of need be verified by auditors).

Article 172a, § 1, alinea d – Implementing Rules

They [eligible costs] are identifiable and verifiable, in particular being recorded in the accounting records of the beneficiary and determined according to the applicable accounting standards of the country where the beneficiary is established and according to the usual cost accounting practices of the beneficiary.

Article 172a, Implementation Rules, paragraph 2 should be modified by replacing "may" by "shall". The current formulation is, for example, applied systematically by the Commission within the FP to justify not reimbursing VAT which is not recoverable by a beneficiary, even though the sense of the Financial Regulation is quite clearly that such reimbursement should be possible (according to Article 172a, §2, alinea c).

Article 172a, §2 – Implementing Rules	Amended Article 172a, §2 – Implementing Rules
*Without prejudice to paragraph 1 and to the basic act, the following costs **may** be*	*Without prejudice to paragraph 1 and to the*

considered as eligible by the authorising officer responsible:	*basic act, the following costs **shall** be considered as eligible:*
[...]	*[...]*
(c) value added tax paid, and which cannot be refunded to the beneficiary according to the applicable national legislation;	*(c) value added tax paid, and which cannot be refunded to the beneficiary according to the applicable national legislation;*

Article 181, Implementation Rules, paragraph 3, foresees a limit of 7% for indirect costs, which is generally applied by the Commission to Coordination Actions within the FP and which is hugely dissuasive to many potential contractors because the figure is out of line with economic reality. Again, we would argue for full-cost accounting and reimbursement on that basis.

With regard to reports by external auditors ("audit certificates") – cf. Article 180, Implementation Rules – the Commission should be held to explicitly accept or reject with reasons such reports within a reasonable period, such as 90 days. Such accepted reports should be binding and not subject to ex-post audit or evaluation unless there is new, *prima facie* evidence of fraud.

Article 173, paragraph 4 of the Implementing Rules should be revised accordingly.

Article 173, §4 – Implementing Rules	Amended Article 173, §4 – Implementing Rules
Where the application concerns grants for an action for which the amount exceeds €500 000 or operating grants which exceed €100 000, an audit report produced by an approved external auditor shall be submitted. That report shall certify the accounts for the last financial year available.	*Where the application concerns grants for an action for which the amount exceeds €500 000 or operating grants which exceed €100 000, an audit report produced by an approved external auditor shall be submitted. That report shall certify the accounts for the last financial year available **and the European Commission shall explicitly accept or reject the auditors' report within 90 days**. **Once accepted by the European Commission, such reports shall become binding and shall not be subject to ex-post audits or evaluation unless there is new prima facie evidence of fraud.***

To the same end, the following sentence should be added to article 180: *The European Commission shall explicitly accept or reject the auditors' report within 90 days. Once accepted by the European Commission, such reports shall become binding and shall not be subject to ex-post audits or evaluation unless there is new prima facie evidence of fraud.*

Where a report by an external auditor, or an ex-post audit, reveals errors made in good faith by a beneficiary, administrative penalties should not be imposed in addition to any corrective payments[3].

[3] Cf. Article 114, §4 – Financial Regulation

In addition to this, the cost of ex-post audits and costs associated with these audits (such as the cost of re-calculating financial statements) should be covered by the Commission and recognised as eligible. Article 172a of the Implementing Rules, §2, alinea b should be amended to cover ex-post audits.

Article 172a, §2, alinea b – Implementing Rules	Amended Article 172a, §2 – Implementing Rules
(b) costs related to external audits required by the responsible authorising officer either upon the request for financing or upon the request for payment;	*(b) costs related to external audits required by the Commission either upon the request for financing or upon the request for payment,* ***and costs related to ex-post audits****;*

Where a report by an external auditor, or an ex-post audit, reveals errors to the advantage of a beneficiary, the Commission should be obliged to make corresponding payment (whereas today it is known to plead "absence of available budget").