

## **Draft recommendation of the European Ombudsman concerning his inquiry into complaint 3373/2008/(BB)(BU)JF against the European Commission**

Recommendation

**Case 3373/2008/(BB)(BU)JF - Opened on 22/12/2008 - Recommendation on 20/09/2010 -  
Decision on 30/01/2012**

(Made in accordance with Article 3(6) of the Statute of the European Ombudsman [1] )

### **THE BACKGROUND TO THE COMPLAINT**

1. The Earth Data Network for Education and Scientific Exchange (EDNES) is a non-profit association offering an international framework for scientific cooperation between its members. EDNES acted as project coordinator on three contracts for research and technological development projects with the European Commission (Directorate-General Information Society and Media -'DG INFSO').

2. The contracts were defined as 'shared-cost research and development' contracts, within the meaning of Annex IV (Rules for financial participation by the Community) to Decision 182/1999/EC of the European Parliament and of the Council of 22 December 1998 concerning the fifth framework programme of the European Community for research, technological development and demonstration activities (1998 to 2002) [2] . Their aim was to implement three similar projects, in former republics of the Soviet Union, under the Fifth Framework Programme (FP5).

3. The projects were the following:

- " *New Methods of Working for Information Society Technologies Promotion to Commonwealth of Independent States WISTCIS* " (IST-1999-14106);
- " *Telework Solutions for Promotion of EU Cooperation in Business and Research with the Commonwealth of Independent States TELESOL* " (IST-1999-29038); and
- " *Teleworking as a Tool for Information Society Technologies Programme Promotion to Baltic States TELEBALT* " (IST-2001-33041).

4. Article 23(1)(a) of Annex II (General conditions) to the FP5 contract [3] stipulates:



*" Only the costs of the actual hours worked by the persons directly carrying out the scientific and technical work under the project may be charged to the contract ... [S] uch persons must:*

- be directly employed by the contractor in accordance with his national legislation,*
- be under the sole technical supervision of the latter, and*
- be remunerated in accordance with the normal practices of the contractor, provided that these are regarded as acceptable by the Commission ... ". (emphasis added)*

5. EDNES itself has no employees and no means of hiring any. It therefore developed ways to pay salaries to employees of Russian research institutions through a local Russian company based in Moscow ('the Russian company'). EDNES implemented the projects (for the latest project) in the former republics of the Soviet Union until November 2003. The projects were successful.

6. By letter dated 21 January 2005, the Commission informed EDNES that, in accordance with Article 26 of Annex II to the FP5 contract [4] , it had decided to carry out a financial audit on the cost statements, which EDNES submitted in relation to the contracts. It added that an external audit firm would be used for such a purpose.

7. On 11 July 2006, the audit firm sent the provisional audit report to EDNES and invited it to make comments within one month. The main findings of the audit are outlined below.

(a) EDNES should have deducted the VAT from the costs of goods bought during the contracts' implementation.

(b) EDNES should not have included certain ineligible costs of goods bought during the contracts' implementation and claimed for them under the category 'Consumables'.

(c) EDNES was not allowed to pay salaries to employees who were not directly employed by it. According to the auditors, in order to comply with the contracts, EDNES should have made the payments through a subcontract, which had been formally approved by the Commission beforehand. The corresponding 'Personnel' costs under the three contracts were, therefore, declared ineligible. As a consequence, the costs which EDNES reported under the category 'Overheads' became ineligible as well. This was because, under the FP5 contract, 'Overheads' were only allowed as a percentage of the 'Personnel' costs [5] .

8. On 8 August 2006, EDNES sent its comments to the audit firm and to the Commission. EDNES mainly expressed its surprise that the audit firm considered ineligible the costs declared as 'Overheads'. This was in spite of the fact that the Commission's project officer had approved the cost statements, which EDNES submitted to the Commission. EDNES highlighted the practical difficulties it encountered during the execution of the contracts. These included (i) the difficult environment (relating to the employment regulations, banking system and commercial



exchange rules) in former republics of the Soviet Union in the late 1990's/early 2000's, where the projects were carried out; and (ii) the very nature of the projects, which required extensive use of the Russian language, since it was the only common language in the countries involved. EDNES added that the final reports, as well as the regular annual reviews concerning the projects, concluded that they were completed successfully. Neither the reviewers nor the project officer ever warned EDNES with regard to the eligibility of costs. Consequently, EDNES made the following main comments on the provisional audit report.

(a) The report declares ineligible all the 'Personnel' costs, on the grounds that EDNES unduly subcontracted the hiring and management of personnel to a Russian company. However, EDNES always maintained control of the hiring and management of personnel working on the projects, and never delegated this role. EDNES used out-staffing procedures through the Russian company, which only executed EDNES' payment instructions. This arrangement was the object of an agreement between EDNES and the Russian company, which EDNES made available to the auditors. It enabled EDNES to avoid the difficulties in coping directly with the complex employment and tax rules in Russia. EDNES also provided the auditors with the corresponding time sheets and salary receipts.

(b) EDNES considered the report's conclusion on 'Personnel' costs unacceptable. It also "*mechanically*" objected to the conclusion on 'Overheads'.

(c) Based on the ineligibility of the 'Personnel' costs, the report also declared ineligible the 'Travel and subsistence' costs [6]. This was the first time EDNES heard that 'Travel and subsistence' funds were exclusively intended for the personnel paid by EDNES. However, EDNES reimbursed 'Travel & subsistence' costs to many other participants in the different events organised under the projects, always after requesting and obtaining the permission of the project officer where relevant. The project officer participated in most of the said events, and was always informed of EDNES' reimbursement of the expenses incurred by the participants. Moreover, EDNES is a non-profit organisation which does not have the necessary resources to employ personnel on a permanent basis. All of its 'permanent' staff contribute to the running of the association on a voluntary basis.

(d) The report also declared ineligible the office supplies directly related to the projects, which EDNES claimed under 'Consumables'. EDNES considered this conclusion debatable.

(e) EDNES accepted the conclusions of the report concerning the non-eligibility of local taxes paid for 'Other specific costs'.

9. By letter dated 15 January 2007, the Commission informed EDNES that, after carefully reviewing the above comments, it decided to modify the draft audit report. These modifications implied that costs rejected under the categories 'Personnel' and 'Travel and subsistence' could be considered under the categories 'Subcontracting' and 'Other specific costs'. The Commission informed EDNES that the audit was closed, and that its final results would be distributed to the relevant Commission services, which would make the necessary adjustments to the costs overclaimed. These adjustments could affect future payments under the contracts, or result in a



recovery order being issued.

10. On 26 February 2007, EDNES sent an appeal to the Commission, in which it mainly argued that the Commission's project officer was fully aware of the organisational setup using the Moscow company. EDNES therefore had no reason whatsoever to suspect that there could be any problems in this regard. Moreover, if the project officer had had any objections to this practice, which was applied in the case of the first project, WISTCIS, he could have raised them regarding the following two projects, TELEBALT and TELESOL. The project officer did not do so, even though the two said projects were negotiated well after WISTCIS. EDNES also pointed out that it is " *a very simple non-profit organization* ", which does not have any own funds or employees, and cannot afford to pay the Commission's recovery claim. EDNES asked for a meeting with the Commission.

11. In its letter dated 6 June 2007, the Commission apologised for the delay in answering EDNES' above appeal, explaining that it had been caused by the need to consult the various services concerned. The Commission regretted having to confirm that the results of the audit report had to be implemented, but, nevertheless, agreed to meet EDNES in Brussels.

12. On 16 July 2007, EDNES sent another appeal, addressed to the Commissioner for Information Society and Media, in which it requested her to waive the recovery claim concerning the 'Overheads'. According to EDNES, it would be an unfair penalty if EDNES had to bear the 'Overheads' costs for the three projects which had been successfully implemented, and which were supposed to be 100% funded by the Commission.

13. In its answer of 28 August 2007, the Commission reiterated that the core of the problem was the organisational setup involving the Moscow-based company, with which EDNES concluded a service contract. The Commission considered that it correctly applied the relevant financial provisions of the contracts, in a measured way, and in full appreciation of the results produced by EDNES.

14. On 18 January 2008, EDNES sent another appeal to the Commissioner for Information Society and Media. EDNES stated that it did not object to the Commission's and the auditors' statements referring to legal and administrative rules, but reiterated that it had been unfairly treated and penalised. EDNES acknowledged that it had not complied with some contractual provisions regarding the hiring of personnel, which it " *neglected inadvertently* ". However, it insisted that had not done so with the intention of tricking the Commission. On the contrary, it had kept the Commission constantly informed, through its project officer, who never raised any objections. Moreover, in light of the audit conclusions, EDNES took steps to change its practice regarding another project, 'IST4Balt', under the Sixth Framework Programme. This confirms that it never intended to trick the Commission. Therefore, EDNES repeated its request that the Commission should waive its claim for the recovery of the 'Overheads' costs.

15. By letter dated 19 February 2008, the Commission explained that a desk audit or a simple analysis of a signed costs claim did not allow it to verify either its accuracy, or the evidence on which the claim for costs was based. It stated that when it makes payments, it does so trusting



that the claims are correct, and the project officer concerned did not have the information at the relevant time which would have led him to question EDNES' cost claims.

16. By letters dated 7 and 8 May 2008, the Commission informed EDNES that it calculated the impact of the audit conclusions on the total eligible costs, and intended to recover EUR 47 177.96 for WISTCIS, EUR 15 279.19 for TELESOL and EUR 30 292.78 for TELEBALT. The Commission invited EDNES' comments within one month, in the absence of which it would send corresponding debit notes to EDNES.

17. In its letter dated 10 May 2008, EDNES maintained its view that the Commission had treated it unfairly. It informed the Commission of its intention to submit a complaint to the European Ombudsman.

18. On 4 July 2008, the Commission sent EDNES the three following debit notes: No 3230807027 (concerning WISTCIS), No 3230807024 (concerning TELESOL) and No 3230807025 (concerning TELEBALT). The debit notes demanded payment to the Commission by 17 August 2008, of the amounts mentioned in paragraph 16 above.

19. By letter dated 13 August 2008, EDNES informed the Commission again that it was preparing a complaint to the European Ombudsman. Therefore, it requested the Commission to postpone the above deadline for repayment.

20. On 22 August 2008, the Commission (DG INFSO) acknowledged receipt of EDNES' above request. It informed EDNES that it had submitted the request to the relevant services for their advice and decision concerning the deadline for repayment.

21. On 3 September 2008, the Commission's accountant sent three reminders to EDNES concerning the debit notes.

22. By letter dated 24 September 2008, EDNES reminded the Commission that it had still not received an answer to its request of 13 August 2008 for the postponement of the deadline for repayment.

23. In a letter dated 3 October 2008, the Commission's accountant explained to EDNES that debit notes cannot be modified where the recovery claim is maintained. However, the accountant informed EDNES that it could make the repayment at a later date. This offer was subject to (i) EDNES accepting that the debt would accrue interest as of the due date of the debit notes; and (ii) EDNES providing a bank guarantee for the amounts owed.

## **THE SUBJECT MATTER OF THE INQUIRY**

24. On 16 August 2008, EDNES submitted its complaint to the Ombudsman, and renewed it on 3 and 25 October 2008 [7] .



25. On 22 December 2008, the Ombudsman opened an inquiry into the following allegations and claim [8] .

Allegations :

- The Commission acted unfairly by not accepting as eligible the complainant's costs relating to salaries it paid to Moscow employees, even though (i) it knew that the complainant could not efficiently carry out the projects without doing so, and (ii) the complainant kept the Commission regularly informed of its practices through contractual cost reports and frequent face-to-face discussions.
- The Commission unilaterally changed the contracts by transferring funds between different budget lines well after the contracts' end-dates.
- The Commission failed to reply in substance to its letter dated 13 August 2008.

Claim :

The Commission should waive the parts of reimbursement orders No 3230807027, No 323080724 and No 3230807025, corresponding to the overheads declared ineligible (the complainant accepted to repay the sums corresponding to VAT that was not deducted and to "*ineligible consumables*").

## THE INQUIRY

26. The Commission submitted its opinion on 15 May 2009. EDNES sent its observations on 30 June 2009.

27. After careful consideration of the opinion, the Ombudsman was not satisfied that the Commission had responded adequately to the complaint. He therefore made a provisional finding of maladministration and, in accordance with Article 3(5) of his Statute, proposed a friendly solution to the Commission.

28. On 15 January 2010, the Ombudsman received the Commission's reply, which he forwarded to EDNES with an invitation to make observations. On 24 February 2010, EDNES sent its observations.

## THE OMBUDSMAN'S ANALYSIS AND CONCLUSIONS

### A. Alleged unfairness in not accepting overhead costs and the related claim

*Arguments presented to the Ombudsman*

29. EDNES alleged that the Commission acted unfairly by not accepting as eligible the costs



relating to salaries it paid to the employees in Moscow. This was in spite of the fact that (i) the Commission knew that EDNES could not efficiently carry out the projects without doing so, and (ii) EDNES kept the Commission regularly informed of its practices through contractual cost reports and frequent face-to-face discussions. Nevertheless, EDNES acknowledged in its complaint that it could not produce any material proof that the Commission's project officer was indeed aware of the above practices. EDNES claimed that the Commission should waive the parts of the reimbursement orders corresponding to the overheads declared ineligible. EDNES accepted to repay the sums corresponding to the VAT [9] that was not deducted, and to "*ineligible consumables*".

30. The Commission considered that it applied the relevant financial provisions of the FP5 contract correctly and in a measured way, in full appreciation of the results produced by EDNES on the projects. It explained that the issue here concerned the eligibility of the costs which EDNES claimed under the category 'Personnel', and it referred again to the relevant provisions of the FP5 contract [10]. According to the Commission, EDNES had claimed the respective costs under the category 'Personnel', which, under the reimbursement terms of the FP5 contract, resulted in a flat-rate surcharge for overheads (41%, 65% and 80%, respectively) on the eligible costs [11].

31. With respect to EDNES' argument that the Commission's project officer was aware of EDNES' organisational setup, the Commission stated that, prior to the financial audit, it had no knowledge of that setup, and was unaware of the nature and the extent of EDNES' contractual arrangements with the Russian company. As already stated in its letter to EDNES dated 19 February 2008, the Commission reiterated that the accuracy of the claimed amounts could only be verified through a financial audit, and not via a desk audit by the project officer or by a simple analysis of the signed cost claim. The Commission made the payments on trust that the claims were correct, and the project officer thus did not have the information at that time to question the claimed amounts.

32. After the financial audit, the Commission learned that EDNES subcontracted the majority, or even all of the assigned work packages to the Russian company for all three audited projects, and that all of the work was performed by staff based in Russia. The Commission rejected these costs as 'Personnel' costs for the following reasons:

(a) The staff involved was not directly employed by EDNES, and did not work under its technical supervision, as required by Article 23(1) of Annex II to the FP5 contract. Moreover, EDNES did not provide evidence of the working time charged to the project by means of time records during the audit, and the auditors had no access to detailed payroll records.

(b) EDNES submitted to the auditors the service contract, which it had concluded with the Russian company, according to which the latter would perform the work assigned under the terms of the contracts with the Commission. The service contract foresaw the inclusion of a profit margin equal to 11% of the amounts invoiced to EDNES. Such contractual arrangements reflected the nature of a subcontract rather than an employment relationship. On this basis, the Commission reclassified the costs concerned from 'Personnel' to 'Subcontracting'.





33. As a consequence of the above reclassification, the Commission rejected all 'Overheads' surcharges on the Russian company's costs. The Commission considered this reasonable for the following reasons:

(a) The work was not performed in EDNES' premises. Therefore, EDNES did not incur any 'Overheads' costs. EDNES did not dispose of any premises or infrastructure which could have been used to perform the assigned research work and which may have economically justified any compensation for overheads. Moreover, the service charges which the Russian company charged EDNES most probably already included overhead charges (these were different from the profit margin). The application of a flat-rate charge on these service costs, declared by EDNES, meant that the Commission was actually requested to reimburse overheads on top of overhead components which were already included in the service charges from the Russian company. This was neither justifiable under the terms of the contracts, nor economically reasonable.

(b) By reclassifying the costs from the category 'Personnel' to the category 'Subcontracting', the Commission retroactively accepted the subcontracting to a subcontractor located in a third country, although this approval was never formalised through the contract or its amendment. It also retroactively accepted that the subcontracting of coordination tasks gave rise to eligible direct costs [12] .

34. In light of its position on EDNES' allegation, the Commission stated that it could not accept as eligible the overheads costs claimed in relation to the above subcontract. Therefore, the Commission was unable to waive the recovery, and sought to ensure its implementation.

35. In its observations, EDNES emphasised that the issue in the present case was not the eligibility of personnel costs using a purely accounting logic. It acknowledged again that the personnel costs which it incurred during the execution of the contracts should, ideally, have been spent differently. EDNES' misapplication of the contractual provisions resulted partly from its " *limited legal culture* ". EDNES argued that the Commission should not use recovery of the 'Overheads' costs as a means of penalising it for having overlooked a contractual provision [13] , for the following reasons:

(a) The Commission, through its project officer, was aware of the organisational setup which EDNES used to implement the projects, since the project officer (i) knew that EDNES could not officially employ personnel; (ii) he knew that EDNES had a " *branch* " in Moscow; and (iii) he saw the time sheets of personnel paid through the Russian company, as well as salary receipts signed by the personnel.

(b) The Commission recognised that the overall achievements of the projects were in line with its expectations, and that the salaries were paid for the sole purpose of ensuring the successful execution of the contracts. By making the recovery claim, the Commission was deliberately ignoring these achievements.





(c) EDNES is an association with very limited resources. It is run by volunteers who do not receive any remuneration. Apart from the reimbursement of the travel and subsistence costs incurred for the projects, they did not receive any contributions under the contracts. EDNES indicated that it did not have the resources to satisfy the Commission's recovery claim, and that the recovery could lead to its " *death* ". It pointed out, however, that only associations similar to EDNES are capable of implementing certain types of Community actions.

(d) It was particularly unfair of the Commission to argue that, if the payment of the salaries to the Russian company were deducted, EDNES did not incur any 'Overheads' costs. EDNES did incur expenses in performing the contracts, and needed the 'Overheads' costs to carry out the projects. EDNES does have a branch in Moscow [14] , which has premises " *explicitly dedicated to EDNES-Moscow* ". The employees did benefit from these premises, which were also used by the 'Moscow Information Dissemination Center'. In November 2003, the Commission's representative in Moscow visited these premises during the Moscow Conference held during WISTCIS.

(e) By recovering the 'Overheads' costs, the Commission was requiring EDNES to co-fund the projects in which 100% of the eligible costs were supposed to be funded by the Commission.

36. EDNES went on to state that it subcontracted only the payment of the salaries to the Russian company, and not all of the assigned work packages, as stated by the Commission in its opinion. EDNES itself had complete responsibility for the technical supervision of the staff working on the projects, and it provided the auditors with the appropriate time sheets when they visited its premises.

37. EDNES also stated that it provided the auditors with evidence proving that it never actually paid any profit margin to the Russian company. Furthermore, it never paid any service charges to the Russian company, which was also not foreseen in their service contract. Thus, the Commission's statement about reimbursement of " *overheads on top of overhead components already included in the service charges from the Moscow company* " was not acceptable. Similarly, contrary to what the Commission stated in its opinion, EDNES did not subcontract any coordination tasks to the Russian company.

38. EDNES thus maintained its claim that the Commission should waive its recovery claim concerning the 'Overheads' costs.

#### *The Ombudsman's preliminary assessment leading to a friendly solution proposal*

39. At the outset, the Ombudsman acknowledged (as did EDNES) that, from a strictly legal point of view, the Commission was entitled to reject the costs which EDNES declared under the category 'Personnel', and, as a consequence, not to accept the costs declared under the category 'Overheads'. Indeed, according to Article 23(l)(a) of Annex II to the FP5 contract, persons carrying out the project work must be directly employed by the contractor. According to Article 24(1)(b) of Annex II to the FP5 contract, overheads are calculated on a flat-rate basis as a percentage amount of the eligible personnel costs.



40. However, the Ombudsman pointed out that the law in force also provided the Commission with a basis for not enforcing the recovery in this particular case. Article 87 of Commission Regulation (EC, Euratom) No 2342/2002 laying down detailed rules for the implementation of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities ('the Implementing Regulation') includes the following provisions:

*" 1. The authorising officer responsible may waive recovery of all or part of an established amount receivable only in the following cases:*

*[...]*

*(c) where recovery is inconsistent with the principle of proportionality.*

*2. In the case referred to in point (c) of paragraph 1, the authorising officer responsible ... shall apply the following criteria which are compulsory and applicable in all circumstances:*

*(a) the facts, having regard to the gravity of the irregularity giving rise to the establishment of the amount receivable (fraud, repeat offence, intent, diligence, good faith, manifest error);*

*(b) the impact that waiving recovery would have on the operation of the Communities and their financial interests (amount involved, risk of setting a precedent, undermining of the authority of the law).*

*Depending on the circumstances of the case, the authorising officer responsible may also have to take the following additional criteria into account:*

*[...]*

*(b) the economic and social damage that would be caused were the debt to be recovered in full. "*

41. The Ombudsman considered that EDNES submitted the following convincing arguments, on the basis of which the recovery in the present case could be regarded as disproportionate (Article 87(1)(c) of the Implementing Regulation):

(a) The use of the organisational setup involving the Russian company not only enabled EDNES successfully to carry out the projects. It also allowed it to cope with the practical difficulties linked with working in the difficult environment, with respect to employment and tax regulations, banking system and commercial exchange rules, which prevailed in many former republics of the Soviet Union in the late 1990s and early 2000s. The Commission recognised the overall achievements of the projects. Moreover, the very nature of the projects required an extensive use of Russian, which was the only common language in the countries involved.

(b) EDNES did incur 'overheads' expenses when performing the contracts, since the staff



working on the projects used the premises of EDNES' branch, which also accommodated a conference held during WISTCIS in November 2003. In addition, a Commission representative visited those premises.

(c) EDNES never paid any service charges to the Russian company.

(d) By recovering the 'Overheads' costs from EDNES, the Commission did in fact require it to co-fund the projects.

42. EDNES also argued that it regularly informed the Commission (through its project officer) of its practices through the contractual cost reports and frequent face-to-face discussions. However, it also acknowledged that it could not produce any material proof that the project officer was in fact informed.

43. EDNES further acknowledged that it inadvertently overlooked the contractual requirement, according to which the personnel working on the projects ought to be directly employed by the contractor.

44. The Ombudsman considered that EDNES' above statements demonstrated that there was no fraud, repeated offence, or intention to disregard the contractual provisions on its part, and that it acted in good faith (Article 87(2), first paragraph, (a), of the Implementing Regulation).

45. EDNES' goodwill was further supported by the fact that, once it learned about the audit conclusions, it took steps to change its practice in another project 'IST4Balt' under the Sixth Framework Programme.

46. The Ombudsman trusted that the Commission would consider carefully the economic and social damage that the recovery in the present case could cause to EDNES (Article 87(2), second paragraph, (b), of the Implementing Regulation). As EDNES pointed out, it is an association with very limited resources, without the financial means to satisfy the Commission's recovery claim. The recovery could, therefore, lead to its " *death* ".

47. The Ombudsman also pointed out that, according to EDNES' observations, only associations similar to EDNES were capable of implementing certain Community actions. These organisations are run by volunteers. In the Ombudsman's view, the recovery envisaged in the present case could discourage such organisations from entering into similar contracts with the Commission. This could prevent the Commission from implementing external Community actions in some specific regions due to lack of partner organisations. The Commission could thus take this into account when assessing the positive impact which waiving the recovery in question could have on the Communities' operation and financial interests (Article 87(2), first paragraph, (b), of the Implementing Regulation).

48. In view of the above considerations, the Ombudsman made the preliminary finding that enforcing the Commission's recovery claim in this particular case could be regarded as unfair and disproportionate. He, therefore, made a corresponding proposal for a friendly solution



below, in accordance with Article 3(5) of his Statute, that

*"[t] he Commission could consider waiving the recovery from EDNES of the amounts corresponding to the 'Overheads' for the three projects. "*

*The arguments presented to the Ombudsman after his friendly solution proposal*

49. First, the Commission emphasised that the European Community is bound both by the provisions of the FP5 contract to recover sums unduly received by participants in research projects, and by the Financial Regulation and its Implementing Rules to ensure that recovery orders are enforced. Recovery is therefore the rule, and waiver the exception.

50. It further emphasised that if it had insisted on strict compliance with the contract, the complainant would have been required to reimburse more than EUR 300 000. However, after a careful review of the file, and taking into account the successful results of the projects, the good faith of the complainant, and the not-for-profit nature of EDNES, the Commission's Authorising Officer decided to limit the claim for recovery to EUR 92 719. This amount corresponded mainly to the ineligible 'Overheads' costs which had not, in fact, been incurred, and for which no proof of actual cost could be produced. It represented a reduction of approximately 65% of what might have been considered recoverable.

51. The Commission encourages non-governmental organisations to participate in Community programmes and considers that the legal framework provides more than adequate possibilities for such organisations and their particular financial circumstances. For example, the cost of direct hiring of additional personnel to carry out research work can be reimbursed. However, the Community financial contribution reimburses only costs actually incurred in carrying out the research work. Overhead costs may be claimed to the extent that, as with all other costs, they are necessary for the project [15] , and they relate to indirect costs associated with the personnel working directly on the project. Where there are no eligible personnel costs, by definition there are no overhead costs.

52. The grants provided under the research Framework Programme are based on the shared-cost principle. These grants differentiate between a grant recipient and a subcontractor, or service provider. This shared-cost principle means that beneficiaries co-fund the completion of a project by contributing their own resources, at their own cost. This principle also applies when the costs for reimbursement reach 100% of the eligible costs. Ineligible costs incurred are not reimbursed, and they remain the responsibility of the participant. Co-funding typically can take the form of providing staff or logistical resources in the areas of management, IT and/or infrastructure.

53. The audit performed on site convinced the Commission that all of EDNES' real costs incurred in Moscow were covered. It considered EDNES' Moscow premises to be part of the Institute of the Globe in Moscow. The auditors were not provided with any proof that rent was paid for these premises. In addition, all EDNES' claims for personnel, travel and subsistence costs (including the costs incurred for accommodating a conference held during WISTCIS in



November 2003) were finally reclassified. The Commission decided to include them in the categories of "subcontracting" and "Other specific costs". This rendered them acceptable as costs eligible for reimbursement by Community funding. Moreover, the costs claimed for personnel hired directly through the subcontractor at an hourly rate of between EURO 13 and EURO 21 were reimbursed by the Commission. This rate certainly exceeded the hourly rate usually paid in Russia at that time, and could be interpreted as reflecting the price for subcontracted work which included an overhead element. Consequently, the subcontracted work was paid at the price charged by the subcontractor, which included not only the subcontractor's costs, but also its overheads and a profit margin. Therefore, it can be assumed that all the costs incurred were reimbursed through the Commission's financial grant. Any further reimbursement of costs would generate a profit for EDNES, which was not allowed under the legal framework in place, or it would eliminate the co-funding requirement.

54. The Commission again stated that EDNES did not indicate at any time during the negotiations of the contract, neither in the technical annex, nor in the cost statements sent to the Commission services, that the employees working on the projects were not directly employed by EDNES. The service contract between EDNES and the Russian company was revealed to the Commission only following the auditors' visit in March 2005 to EDNES' premises in Strasbourg.

55. In view of the above, the Commission considered that the Community financial contribution paid to EDNES, ostensibly to cover "overheads" for EDNES personnel, needed to be recovered in order to comply with the contractual provisions, and the basic principle of cost-sharing, particularly in view of the fact that all identifiable costs were reimbursed. In so doing, any question of EDNES having made a profit would be avoided. The Commission considered this to be in line with the principle of proportionality, particularly in view of the efforts it had made to accommodate the costs incurred within the eligibility requirements of the contract. Consequently, the Commission could not accept the Ombudsman's proposal for a friendly solution which, in its view, would not be consistent with (i) the principle of sound financial management; (ii) the basic requirements of the Financial Regulation; or (iii) the grant provisions for Community funding under the research Framework Programmes.

56. In its observations, EDNES emphasised that although it did not have any employees, and its officers were all volunteers, this did not mean that it did not incur any costs relating to their contributions to the Commission projects. Conducting three projects inevitably gives rise to "overhead" spending, and despite the fact that the Commission considered that EDNES paid the personnel to help perform the projects by means of a subcontract, the management of this personnel involved tasks for which EDNES incurred costs, even if its officers were not paid a salary.

57. EDNES pointed out that it was not obliged to submit documents to justify its overhead costs to the Commission when reporting on finances. Although the Commission never requested EDNES to submit any such documents at any stage of the audit procedure, EDNES nevertheless provided the auditors with documentary evidence when they visited its Strasbourg premises.



58. EDNES further emphasised that, when negotiating the contracts with the Commission, it was told that estimating "overhead" costs as a flat-rate amount of the personnel costs was simply an easy way to estimate the "overhead" weight of the projects. In this respect, it drew attention to the Commission's reply to the Ombudsman's proposal for a friendly solution, and took the view that, from a "*layman* ['s]" point of view, "overhead" costs would not relate strictly to "personnel", but also to "depreciation of buildings and equipment".

59. EDNES further submitted that the Commission did not present and advertise the fact that the projects would be conducted as "cost-shared programmes". Quite the opposite was the case, since emphasis was put on "100 % coverage" by the Commission. In any event, EDNES stated that it never claimed reimbursement of the costs relating to the activities of its officers dedicated to the completion of the projects. Similarly, it never claimed reimbursement for the book-keeping costs associated with the projects' accounts.

60. At the time the three contracts were executed, EDNES' Moscow branch was located in the premises of the Russian Academy of Sciences, and at least one room was reserved for EDNES' exclusive use. The Commission never requested any evidence of rent paid for those premises. In any event, this type of expenditure would normally fall under "overhead costs", for which no formal proof had to be submitted to the Commission.

61. EDNES also emphasised that it was the auditors who requested to see the contract with the Russian company when they visited Strasbourg. EDNES gave them unrestricted access to this and any other requested document. The Commission did not request to see the said contract while the projects were being carried out, despite the fact that it was made repeatedly aware, throughout the preparatory stages establishing the contracts between the Commission and EDNES, that EDNES could not hire staff. Similarly, throughout the execution of the contracts, the Commission's representative was perfectly aware of the conditions under which EDNES was working. EDNES did not any time intend to "trick" the Commission, as is further demonstrated by the fact that EDNES voluntarily submitted an amendment to the Commission in order to modify the provisions of another contract, after taking advice from the Commission's Project Officer.

62. EDNES discussed the hourly rates with the Commission's Project Officer on several occasions before finally applying them. It also reported them regularly in all the finance reports submitted to the Commission throughout the execution of the projects. The Commission did not comment on them at that time. EDNES asked the Commission to suggest an amount for the hourly rates at the time the projects were being executed, but no guidance was given in this respect.

63. EDNES concluded by expressing its disappointment that the Commission merely looked into regulatory aspects, and seemed unwilling to listen to its arguments. It again emphasised that it was a non-profit organisation and that it had suffered a great deal as a result of this matter. Notably, it was forced to reduce its activities with the result that no new research project has been initiated in the past two years. Consequently, it has received no income and has,





effectively, already been "killed" by the Commission. In light of all the foregoing, EDNES reiterated its claim that the Commission should waive the parts of the reimbursement orders corresponding to the overheads declared as being ineligible.

*The Ombudsman's assessment leading to a draft recommendation*

64. First, the Ombudsman notes that the Commission does not doubt that EDNES acted in good faith. This important fact, allied to the non-profit nature of the complainant's association, and the results of the projects, which are widely recognised as successful, led the Commission to make a significant reduction in its claim for reimbursement. The Ombudsman most certainly welcomes this approach and considers that the Commission judged the situation fairly in so far as it weighed the need to respect the applicable financial rules against the complainant's overall conduct, and what it achieved in carrying out the projects. The Ombudsman notes that the Commission nevertheless continues to hold the view that there were "overhead" costs which EDNES did not incur and/or was unable to justify, and that these costs should be recovered.

65. The Ombudsman also notes the Commission's argument that the recovery of EUR 92 719 would be justified, among other things, in order "to avoid a profit element". In the Ombudsman's view however, were the Commission to cancel the recovery of the above amount, this would by no means represent a profit for EDNES, particularly in view of its repeated claims that the reimbursement process was leading to its "death". The Ombudsman considers it unfair to suggest that EDNES could profit from the cancellation of the Commission's recovery, when, all along, EDNES was, and still is, fighting for its very survival.

66. In its reply to the Ombudsman's proposal for a friendly solution, the Commission referred to certain provisions of the FP5 contract which would, apparently, make it possible for "overhead" costs to provide cover for costs relating to "administration and management, depreciation of buildings and equipment, water, electricity, telecommunications and postal charges, office supplies, and administrative personnel costs not charged to the contract". In this respect, the Ombudsman would like to point out that EDNES repeatedly argued that it had a branch in Moscow, and that its premises were used exclusively by the staff working on the projects. The argument put forward by the complainant in its observations on the Commission's reply regarding the costs it incurred in connection with the management of the Moscow-based staff appears reasonable to the Ombudsman, and he considers that it merits the Commission's due attention.

67. In addition to the EDNES' above convincing arguments, and those summarised in paragraphs 41 onwards, the Ombudsman feels compelled to point out again that EDNES is a non-profit association which offers an international framework for scientific cooperation. Its "core business" is research and technology. Its staff consists of volunteers, and not "legal experts". It carries out its work professionally, even in difficult financial and linguistic conditions, such as those pertaining to post-Soviet Union countries, and its performance has been so satisfactory that the Commission has recognised its success. EDNES' good faith, which is clearly acknowledged by the Commission, is manifested further by the fact that, when requested, it provided the auditors with all documentation relating to the projects. It left no room for the belief





that similar "legal" mistakes could occur in the future. In the Ombudsman's view, despite making some mistakes, EDNES has provided sufficient assurances to prove that it is a trustworthy applicant for Community funding, and that it can carry out Community-funded projects satisfactorily.

68. The Ombudsman further notes the negative effect which the present case has had on EDNES' ability to apply for funding for new research projects, and that this, in effect, means it can no longer continue to function. The Commission's claim for reimbursement has already affected the complainant dramatically. In the Ombudsman's view, pursuing the recovery in such circumstances is anything but proportionate and fair.

69. If the Commission enforces the recovery on the complainant in the present circumstances, other voluntary-based, non-profit associations are likely to be discouraged from entering into Community-funded research and technology contracts with the Commission. This may result in a lack of partner organisations capable of implementing important external Community actions in specific regions.

70. In light of all of the foregoing, the Ombudsman finds that it would be disproportionate and unfair for the Commission to enforce its recovery claim in this particular case, and such recovery would result in an instance of maladministration. He therefore makes a corresponding draft recommendation below, in accordance with Article 3(6) of the Statute of the European Ombudsman.

## B. Alleged unilateral change of contracts

### *Arguments presented to the Ombudsman*

71. EDNES alleged that the Commission unilaterally changed the contracts by transferring funds between different budget lines, long after the contracts' end-dates.

72. The Commission emphasised that if it had not transferred funds from "Personnel" costs to "Subcontracting" costs, it would have had to reject all personnel costs, and subsequently have had to claim reimbursement of those costs in their entirety from EDNES.

### *The Ombudsman's assessment*

73. The Ombudsman notes EDNES' argument that the Commission should have consulted it before it made any change in the budgetary lines. Although, in principle, the Ombudsman would encourage such prior contact, in the case at hand, the modification carried out by the Commission allowed it to significantly reduce the amount claimed for reimbursement from EDNES. Consequently, the Ombudsman is of the view that, ultimately, the modification was not prejudicial to EDNES and, therefore, no maladministration can be found on the part of the Commission as regards this aspect of the complaint.



## C. Alleged failure to reply

### *Arguments presented to the Ombudsman*

74. EDNES alleged that the Commission failed to reply in substance to its letter dated 13 August 2008.

75. The Commission referred to the following communications: (i) its letter dated 22 August 2008, in which DG INFSO informed EDNES that its request for the postponement of the payment had been submitted to the relevant services for a decision and advice; (ii) its Accountant's reminders of 3 September 2008, relating to debit notes drawn up before the Accountant received EDNES' above request; and (iii) its Accountant's letter dated 3 October 2008, explaining to EDNES that, in cases where claims were maintained, debit notes could not be modified, and offering it the possibility to make late payment. In light of the foregoing, the Commission considered that it duly answered the complainant's letter dated 13 August 2008.

### *The Ombudsman's assessment*

76. In its letter dated 13 August 2008, EDNES requested the Commission (DG INFSO) to postpone the deadline of 17 August 2008, which it had set for reimbursement. On 24 September 2008, EDNES had to call the Commission Accountant's attention to the fact that its above request remained unanswered. The Accountant finally replied to its request on 3 October 2010. In light of the foregoing, the Ombudsman considers that, ultimately, the Commission took a position on the substance of EDNES' request of 13 August 2008, and there was no instance of maladministration.

## D. The draft recommendation

On the basis of his inquiries into this complaint, the Ombudsman makes the following draft recommendation to the Commission:

The Commission should waive the recovery from EDNES of the amounts corresponding to the 'Overheads' for the three projects.

The Institution and the complainant will be informed of this draft recommendation. In accordance with Article 3(6) of the Statute of the European Ombudsman, the Institution shall send a detailed opinion by 31 December 2010. The detailed opinion could consist of the acceptance of the draft recommendation and a description of how it has been implemented.

P. Nikiforos DIAMANDOUROS



Done in Strasbourg on 20 September 2010

[1] Decision of the European Parliament of 9 March 1994 on the regulations and general conditions governing the performance of the Ombudsman's duties (94/262/ECSC, EC, Euratom), OJ 1994 L 113, p. 15.

[2] OJ 1999 L 26, pp. 1 - 33. Annex IV stipulates, among other things, the following: "[t] he Community will contribute financially to the research and technological development activities, including demonstration activities, hereinafter referred to as 'indirect RTD actions', carried out under the specific programmes implementing the framework programme ... 1. Indirect RTD actions [:] The indirect RTD actions will comprise: shared-cost actions, which will be the principal mechanism for implementing the specific programmes ... "

[3] A model FP5 contract can be found at <http://cordis.europa.eu/fp5/management/provisions/r-modcost-l.htm> [Link]

[4] " 1. The Commission, or any representative authorised by it, may initiate an audit at any time during the contract and up to five years after each payment of the Community contribution... The audit procedure shall be deemed to be initiated on the date of receipt of the relevant registered letter with acknowledgment of receipt sent by the Commission ... 3. On the basis of the findings made during the financial audit, a provisional report shall be drawn up. It shall be sent by the Commission to the contractor concerned, who may make observations thereon within one month of receiving it. The final report shall be sent to the contractor concerned. The latter may communicate his observations to the Commission within a month of receiving it. The Commission may decide not to take into account the observations conveyed after that deadline. On the basis of the conclusions of the audit, the Commission shall take all appropriate measures which it considers necessary, including the issuing of a recovery order regarding all or part of the payments made by it ... "

[5] According to Article 24(l)(b) of Annex II to the FP5 contract, "[c] ontractors using the full costs system may charge overheads calculated ... on a flat-rate basis. In this case, they shall charge to this contract a flat-rate amount of 80% of the eligible personnel costs ..." (emphasis added)

[6] According to Article 23(4) of Annex II to the FP5 contract, "[a] ctual travel and related subsistence costs for personnel working on the project may be charged to the contract. " (emphasis added)

[7] The complaint, originally registered under reference 2291/2008/BB, was first inadmissible on the basis of Article 2(4) of the Ombudsman's Statute because EDNES submitted it only three days after sending the Commission the request for the postponement of the deadline for repayment dated 13 August 2008. The renewed complaint was registered under reference number 3373/2008/BB.

[8] As amended by EDNES' related correspondence of 13 January 2009.



[9] According to Article 22(3) of Annex II to the FP5 contract, non-eligible costs include indirect taxes and duties, including VAT.

[10] See paragraph 4 above.

[11] According to Article 24(1)(b) of Annex II to the FP5 contract, "[c] ontractors using the full costs system may charge overheads calculated ... on a flat-rate basis. In this case, they shall charge to this contract a flat-rate amount of 80% of the eligible personnel costs referred to in Article 23(l)(b) and (9) of this Annex. A contractor may request a lower percentage when this is required, for instance, by his internal rules. " The Ombudsman understood that EDNES made use of the latter possibility and requested the corresponding lower percentage for two of the contracts.

[12] The Commission referred to Article 5(1) of Annex II to the FP5 contract, which states that, where the subcontract is concluded for the performance of coordination tasks, the related expenses may not be charged as direct costs. This provision also states that the Commission's prior written approval is required: (a) where the cumulative amount of the subcontracts for the contractor exceeds 20% of his estimated eligible costs or EUR 100 000; or (b) where the subcontractor is established in a third country.

[13] Article 23(l)(a) of Annex II to the FP5 contract, according to which persons carrying out the project work must be directly employed by the contractor.

[14] According to EDNES' website <http://www.ednes.org> [Link], "[t] hree EDNES branches are actively involved in implementation of the 1ST projects: Moscow, Kiev and Baku. EDNES Moscow branch is operational since 1993 when EDNES was founded. It is linked with the Centre of Geophysical Data Studies and Telematics Applications (CGDS) of Institute of Physics of the Earth of Russian Academy of Sciences ... "

[15] Article 22.1 of Annex II to the FP5 contract: " Eligible costs are the costs defined in Articles 23 and 24 of this Annex. They shall fulfil the following conditions: - be necessary for the project ... "

Article 22.4 of Annex II to the FP5 contract: " No cost may be charged to more than one of the eligible cost categories referred to in Articles 23 and 24 of this Annex ".

Article 24.1 of Annex II to the FP5 contract: " Contractors using the full costs system may charge overheads calculated:

(a) on the basis of actual costs, in so far as allowed by their accounting system. Such overheads may include in particular the costs of administration and management, depreciation of buildings and equipment, water, electricity, telecommunications and postal charges, office supplies, and administrative personnel costs not charged to the contract pursuant to Article 23(9) of this Annex. They shall be calculated in accordance with the normal accounting



*conventions and principles applicable to the contractors, provided that they are regarded as acceptable by the Commission.*

*(b) on a flat-rate basis. In this case, they shall charge to this contract a flat-rate amount of 80% of the eligible personnel costs referred to in Article 23(l)(b) and (9) of this Annex. A contractor may request a lower percentage when this is required, for instance, by his internal rules ".*