IDENTIFICATION AND EVALUATION OF AUDIT RISK IN PROJECTS FINANCED FROM EUROPEAN FUNDS

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Rezumat
The audit of projects financed from European Structural Funds is a requirement expressly stipulated under financing contracts and supposes a series of activities, such as:

- the analysis and verification of the nature, legality, accuracy and eligibility of expenses;
- the verification of using the amounts received in advance;
- the audit of third parties’ accounts;
- the comparison of the expenses with specially assigned accounts and the project budget;
- the verification of project incomes (inclusively of the advances received from the financer, interests to the advances and other incomes generated by the project), etc.

Understanding the entity and its environment, inclusively its internal control proves to be an essential element in the diligent approach of the audit that should be followed by the understanding of the project financed from European Structural Funds and especially of its finality.

The application of the procedures imposed by the international audit standards shall not fully eliminate the audit risk and especially the risk of fraud and errors. The auditors have used as a research method both the theoretical approach and the empiric research. In the theoretical approach have been analyzed the notions of audit risk, fraud and errors in accordance with the applicable legislation, and empiric because certain fraud cases frequently encountered in the development of project financed from European Structural Funds in Romania are presented.

Cuvinte cheie: audit risk, fraud, error, eligible expenses, procedures, control environment.

Clasificare JEL: M42, M49

1. Introduction

The European Union is one of the most prosperous areas in the world in economic view and potentially one of the most competitive. Nevertheless, inside it, discrepancies among member countries are quite high in regard to economic development, especially after the “adhesion wave” from May 2004 and January 2007, when 12 new states became members with full rights. The Cohesion Policy of the European Union has the scope to reduce disparities among its members, succeeding thereby e.g. to increase the gross domestic product of countries, such as Greece, Ireland and Portugal, as well as create millions of new working places within the European space.

The objectives of the Cohesion Policy are performed by the Structural Tools that for the period 2007 – 2013 comprise: European Regional Development Fund (ERDF), European Social Fund (ESF) and the Cohesion Fund (CF).

The European Regional Development Fund and the European Social Fund are also known under the name of “structural funds”. Each structural instrument has a specific destination (Catană and other, 2008):

- the European Regional Development Fund supports investments in varied fields, such as: infrastructure, development of production and processing facilities, institutional structures for new businesses, development of tourism, urban regeneration, medical and teaching units, improvement of environment quality, etc.
the European Social Fund supports investments in the development of human resources and training destined to: the integration of unemployed persons in work by vocational training and varied measures regarding the labor market, the support of entrepreneurs and measures of improving the skills and productivity of employees, actions aiming at social inclusion of disfavored groups, improvement of teaching systems, inclusively of the vocational and technical one.

the Cohesion Fund contributes to the accomplishment of large infrastructure projects, such as construction and modernization of Trans-European transport corridors and major investments in the environment infrastructure (water, sewerage etc.).

Romania is benefiting also from amounts assigned from these funds, accessible by projects drafted by the applicants. The beneficiaries of European funds may be public institutions, non-governmental organizations or partners from the private sector, according to the nature of the intervention fields and operations financed from the concerned program. Beneficiaries of European funds are under the obligation to organize the separate analytical accountancy for each project, keeping the documents throughout the period stipulated in the European Regulation specific to the concerned operational sector program. The beneficiary of European funds is also under the obligation to set available to the authorized bodies (Management Authority, Payment/Certification Authority, Audit Authority, European Commission, etc.) any piece of technical or financial information necessary for the verification or the performance of the audit on the manner of implementing projects.

The report is drafted based on the results assessed by the audit tests and the professional reasoning of the auditor, observing the provisions of the audit standards applicable at international and/or national level, as well as the express requirements of the financier. If the audit opinion is unfavorable, respectively the objectives assumed under the financial contract are not fulfilled or are fulfilled without observing the obligations of the beneficiary, he shall be under the obligation to reimburse the amounts collected from the European financial contribution.

2. Audit Planning

On planning the audit, the fulfilled steps are the following (ISA 300 “Planning of an audit of financial statements”):
- Collection of information on the audited entity and its organization, in order to determine the risks and evaluate the relative significance;
- Defining the objectives and sphere of the audit;
- Performance of a preliminary analysis in order to determine the methods that should be adopted and the nature and the volume of subsequent investigations;
- Highlighting of special issues stipulated on the audit planning;
- Determination of necessities of the personnel and the forming of a team that is to perform the audit.

The auditor’s objective is to plan the audit mission, so that it should be carried out in an efficient manner. Hence, the auditor should establish within planning activities a general strategy that should define the application field, the timing and the direction of the audit and that should supply instructions on the drafting of the audit plan.

The planning of the regularity audit stipulates the organization of audit works so that the attention of the auditor should be focused upon the most significant directions of the mission: the determination of potential issues and the operative execution of the audit activities. The nature and volume of planning activities shall vary according to the size and complexity of the entity, the professionalism of auditors, the previous experience at the audited entity, as well as other criteria. The planning of the regularity audit involves the determination of the General Audit Plan (General Audit Strategy) and the drafting of an audit schedule.

The auditor should establish a general audit plan defining the application field, the timing and the direction of the audit and that offers guidance on the drafting of the audit schedule.

On establishing the general audit strategy, the auditor should:
- identify the characteristics of the mission that define its application field;
- identify the reporting objectives of the audit mission to plan the placement of the audit in time and the nature of the stipulated communications;
- consider the factors that according to the professional reasoning of the auditor are significant for the guiding of the audit team’s efforts;
- consider the results of the preliminary audit mission and, where applicable, the extent to which is relevant the knowledge gained in other missions performed by the mission partner for the entity;
- stipulate the nature, timing and volume of the sources necessary to carry out the audit mission;

The auditor should draft an audit schedule that should include a description of:
- the nature, timing and volume of the planned risk evaluation procedures;
- the nature, timing and volume of the additional audit procedures planned at the level of allegations;
- other planned audit procedures that should be applied so that the audit mission should correspond to the standards.
3. Audit Risk

In accordance with the Term Glossary of IAASB, the audit risk is defined, as follows: “The risk that the auditor should formulate an improper audit opinion if the financial statements are significantly distorted. The audit risk is a function of the risk of significant distortions and of the risk that the auditor would not detect such a distortion.”

The identification and evaluation of the audit risk represents a key-stage from the audit process and ISA 315 Identification and evaluations of risks of significant distortions by understanding the entity and the environment in which it carries out its activity, offering to professional auditors the basic elements that may be used in the process of evaluating the audit risk.

Risk Evaluation Procedures

ISA 315 offers an overview upon the procedures that the auditor should follow in order to gain sufficient information to evaluate the audit risk and such risks should be considered when the audit plan is formulated. ISA 315 continues by providing that the auditor should develop the risk evaluation procedures in order to offer a basis in the process of identifying and evaluating the risks that may lead to significant distortions at the level of the financial statements and of allegations. In ISA 315 are further identified three risk evaluation procedures:

- Interrogations of the management and of other persons within the entity
  Professional auditors should discuss with the management of the client also his objectives and expectations, as well as the plan to fulfill such objectives.

- Analytical Procedures
  The analytical procedures carried out as risk evaluation procedures should help the auditor in the process of identifying unusual transactions or items. Such can identify issues related to the entity about which the auditor was not...
understanding that the evaluation procedures necessary for the knowledge are called “risk evaluation procedures” so that certain information procured by the application of such procedures may be used by the auditor as audit proofs that support the evaluations of significant distortion risks. Furthermore, on the application of the risk evaluation procedures, the auditor can procure audit proofs about the transaction classes, account balances or other distortions and it cannot be prevented or identified and corrected in due time by the internal control of the entity.

The identification and evaluation of significant risks and of risks of significant distortions

In the process of evaluating the significance of the risks, the professional auditor is asked to consider the following issues:

- **Observation and Inspection**
  Observation and inspection may also supply information on the entity and the environment in which it carries out its activity. Examples of such type of audit procedures can cover a very broad sphere, including the observation and inspection of the entity’s operations, of the documents and reports drafted by its management, as well as the headquarters of the entity and the facilities of the enterprise.

- **Inherent Risk**
  This is the susceptibility that a claim upon a transaction class, a balance sheet or a presentation of information is a distortion that could be significant either individually, or when such is aggregated with other distortions before considering any related controls.

- **Control Risk**
  This is the risk that a distortion should appear in an allegation about a transaction class, a balance sheet or in an information presentation and that the distortion should be significant, either individually or when it is aggregated with other distortions and it cannot be prevented or identified and corrected in due time by the internal control of the entity.

- **Identification Risk**
  This is the risk that the procedures run by the professional auditor should reduce the audit risk to an acceptably low level, so that no more current distortions should be identified and that could be significant individually or aggregated with other distortions. It is anyway very important that professional auditors should understand very well the audit risk concept, so as to be able to apply all such knowledge to the questions they should formulated in order to identify and describe proper procedures of risk evaluation.

The auditor should come to know the entity and its environment, inclusively its internal control, sufficient to identify and evaluate the risks that significant distortions of the financial statements should be in place, whether either due to fraud or errors and suffice to draft and apply additional audit procedures. ISA 500, “Audit Proofs”, provides that the auditor should use sufficiently detailed allegations to form a basis for the evaluation of significant distortion risks, as well as to draft and apply other audit procedures. This ISA provides that the auditor should perform risk evaluations at the level of financial statements and allegations based on a proper knowing of the entity and its environment, inclusively its internal control.

As described in ISA 500, the audit procedures necessary for the knowledge are called “risk evaluation procedures” so that certain information procured by the application of such procedures may be used by the auditor as audit proofs that support the evaluations of significant distortion risks. Furthermore, on the application of the risk evaluation procedures, the auditor can procure audit proofs about the transaction classes, account balances or presentations of the information and related allegations, as well as about operative efficacy of the controls, even if such audit procedures are not expressly stipulated as detailed audit tests or control tests.
The financial auditor procures proper and sufficient proofs from such procedures in order to be able to draft a report on the factual assessments. For such purpose, the auditor may use the guidance supplied by the International Audit Standard 500 “Audit Proofs” and especially the paragraphs that refer to the “proper and suffice audit proofs”. The auditor exerts a professional judgment in regard to what means adequate or suffice proofs, if he believes that the guidance supplied by ISA 500, the terms and conditions of the financing contract and ST for this engagement are not suffice.

The indicative list of types and nature of proofs which the auditor can often find at the verification of the expenses includes:

- Book registrations (in electronic or manual format) from the accounting system of the Beneficiary, as well as the journal-registry, subchapters thereof and all salary accounts, registries of fixed assets and other relevant accounting information;
- The proof of the purchase procedures, as well as of the tender documentation, the bids for tenders and evaluations reports;
- The proof of engagements, as well as contracts and order forms;
- The proof of supplying services, as well as approved reports, timesheets, transport tickets (inclusively boarding tickets), the proof of attending seminars, conferences and training stages (inclusively the relevant procured documentation and materials, certificates), etc;
- The proof of having received goods, as well as acceptance documents from suppliers;
- The proof of finalizing works, as well as invoices and receipts;
- The proof of the payment, as well as bank excerpts, payment notifications, the proof of payment from subcontractors;
- For expenses with gasoline and fuel oil, a centralizing list of covered distances, the consumption of used vehicles, the price of fuels and maintenance costs;
- Registries regarding the salary payments and staff, as well as related contracts, payrolls, timesheets. For locally recruited staff for contracts with a limited term, details of the paid remunerations, certified by locally liable persons, broken down into gross salaries, related social securities, insurance and net salary. For experts and/or the staff from the EU space (if the activity is implemented in Europe), analyses and breakdowns of monthly expenses of the supplied work: evaluated on basis of unitary prices per quantifiable time unit and broken down into gross salary, contributions and social security and net salary.

The list of proofs can vary according to the nature of the expenses and practices from the concerned country.

The auditor obtains a suffice understanding of the terms and conditions of the financing contract by revising the financing contract and its appendixes and other relevant information, as well as by interrogating the Beneficiary. The auditor ensures himself that he procures a copy of the original financing contract (signed by the Beneficiary and the Management Authority/ Intermediary Body) and its appendixes. The auditor obtains and revises the expense reimbursement application together with all its appendixes.

The auditor grants a special attention to the General and Special Terms of the Financing Contract that comprises the disclosure of the action. If the auditor believes that the verified terms and conditions are not sufficiently clear, he should request clarifications from the Beneficiary. From among the procedures for the verification of the eligibility of expenses requested by the Beneficiary in the Financial Report for the action, we mention:

- **General Procedure**
  a. The auditor verifies whether the expense reimbursement application is compliant with the terms of the financing contract.
  b. The auditor verifies whether the books of the Beneficiary are compliant with the rules for the safekeeping of registrations and the accounting rules from the financing contract.

  The scope is to:
  - evaluate whether an efficient and effective verification of expenses is feasible;
  - report significant exceptions and weaknesses regarding accountancy, the keeping of registrations, the requirements of the documentation, so that the Beneficiary should be able to undertake subsequent measures to correct and improve such throughout the remaining implementation period of the action.
  c. The auditor verifies whether the information from the expense reimbursement application is reconciled with the accountancy system and the registrations of Beneficiary (e.g.: the trial balance, registrations from analytic and synthetic accounts).
  d. The auditor verifies whether accurate exchange rates have been applied for currency conversions, where the case may be, and in accordance with the national applicable legislation.

- **Conformity of expenses with the budget and analytical revision**
  The auditor performs an analytic revision of the expense columns from the expense reimbursement application and:
  - verifies whether the budget from the expense reimbursement application corresponds to the budget of the financing contract (the authenticity and authorization of the initial budget) and whether the incurred expenses have been stipulated in the budget of the financing contract.
The financial auditor verifies the eligibility of direct costs with the terms and conditions of the financing contract. He verifies whether such costs:
- are necessary for the development of the action. For such purpose, the auditor verifies whether the expenses for a transaction or action have been incurred for the proposed scope of the action and whether such were necessary for the activities and objectives of the action. The auditor further verifies whether the direct costs are comprised in the budget of the grant contract and whether such are compliant with the principles of rigorous financial management, especially in regard to cost-efficacy and the best use of money.
- were assumed by Beneficiary or his partners throughout the implementation period of the action.
- are registered in the accounts of Beneficiary and are identifiable, verifiable and proven with the originals of the support evidence.
  
  The auditor verifies whether the expenses for a transaction or action have been adequately registered in the accounting system of the Beneficiary and the expense reimbursement application and whether such are supported by adequate evidences and supporting documents. Such include an adequate evaluation and the use of accurate exchange rates, when the case may be. He verifies whether the expenses for a transaction or action have been accurate on categories in the expense reimbursement application.
  
  The auditor seeks in a professional manner to obtain adequate and sufficient proofs on the verification of the incurred expenses and – if the case may be – also for the existence of the assets. The auditor verifies the reality and opportunity of the expenses for a transaction or action by examining the proofs of the performed works, the delivered goods or supplied services within a time frame (to specify the implementation period for which the reimbursement is requested), at an acceptable and agreed quality and against reasonable prices or costs.
  
  The rules of public procurement applicable to all financing contracts are the national ones. The financial auditor examines what public procurement rules are applicable for each category of expenses, types of expenses. The auditor verifies whether the Beneficiary complies with such rules and whether the concerned expenses are eligible. When the auditor discovers such non-compliance issues versus the public procurement rules, he presents in the report regarding the performed assessments their nature and financial impact in view of non-eligible expenses.
  
  For the computation of the financial impact further to a public procurement process, the auditor shall consider the guide for the determination of the financial corrections that should be performed upon the expense co-financed from structural funds or from the Cohesion Fund for the non-compliance with the public procurement rules attached to these technical specifications.
  
  The auditor shall not verify the supporting documents regarding the administrative (indirect) expenses declared by Beneficiary and such are automatically reimbursed by AM/OI based on the direct expenses declared by Beneficiary and verified by the auditor, by applying a lump rate established under the Financing Contract. However, the auditor shall verify the classification of such expenses in the percentages of the lump amounts established by AM/OI under the Financing Contract.
Verification of Income from Action

When the case may be, the auditor verifies the fact that the incomes generated by Beneficiary in the context of the action were adequately assigned to the action that is the subject matter of the care financing contract and were accurately recorded in the expense reimbursement application. Having regard to the fact that such engagement is not an audit, the auditor is not requested to evaluate the aggregate income.

4. Fraud cases frequently encountered in the development of projects financed from European Structural Funds in Romania

According to the last OLAF report published in July 2012, as of 31 December 2011, the number of cases investigated by OLAF within the period 2006-2011 was of 1030. Romania is in this view on the first place in the European Union (Table no. 1):

<table>
<thead>
<tr>
<th>N.o.</th>
<th>Country</th>
<th>No. of cases</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Romania</td>
<td>225</td>
<td>21.8</td>
</tr>
<tr>
<td>2</td>
<td>Germany</td>
<td>168</td>
<td>16.3</td>
</tr>
<tr>
<td>3</td>
<td>Italia</td>
<td>112</td>
<td>10.9</td>
</tr>
<tr>
<td>4</td>
<td>Poland</td>
<td>90</td>
<td>8.7</td>
</tr>
<tr>
<td>5</td>
<td>Greece</td>
<td>86</td>
<td>8.4</td>
</tr>
<tr>
<td></td>
<td>Total 5</td>
<td>681</td>
<td>66.1</td>
</tr>
<tr>
<td></td>
<td>Total UE27</td>
<td>1030</td>
<td>100.0</td>
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We can find at the opposite end countries, such as Ireland without any case, Cyprus – 1 case, Luxembourg and Slovenia – 2 cases, Estonia – 3 cases, Denmark - 4 cases, Sweden – 5 cases.

In view of the territory and population, the position of Romania poses serious doubts. If in numeric view, Romania is on the first place, in view of the assumed value of the fraud cases, Romania cedes the top place in favor of Italy, Germany and Greece. From among the frauds of Euro 80 million investigated by DLAF from Romania have been recovered approximately 5%, i.e. Euro 3.6 million and in the 139 criminal files were ruled 9 convictions from among which a single one with execution.

The most frequent fraud cases are concerned with offences, such as:
- forgery of expense settlement documents;
- fund misappropriation;
- overestimation of assets;
- simulation of tenders, forged tenders;
- illegal subcontracting of works awarded at the tender.

Many of these offences have been performed by corrupting public servants that were under the obligation to verify the legality, reality and eligibility of expenses from projects financed from European Structural Funds. No liability of auditors has been noted in the development of the missions regarding such projects.

5. Conclusions

The success of an audit mission of a project financed from European funds supposes first of all the familiarization of the auditor with the audited activities of the entity. A clear vision upon the operations and internal control items from the audited project shall be obtained by a preliminary verification. Actually such represents the planning for the risk analysis and for the stages of the audit mission.

The risk analysis is a major stage of the audit mission that has as a scope the identification of the specific risks within activities carried out under the project, but also the estimation of current internal controls that may occur, eliminate or reduce the tracked risks. The risk analysis has as a scope the assurance of the identification, priority setting and selection of the activities to be audited.

The auditing activity of a project is essential for the evaluation of the accuracy of its development manner, as well as of the manner in which were managed European funds. The audit report should comprise the expression of an authorized opinion upon the objectives assumed under the Financing Contract. The knowing of the entity and of its environment, inclusively of its internal control is a permanent dynamic process of collection, updating and analysis of information during the audit. The identification of the specific risks helps the auditor to select the audit tests that shall
be especially oriented towards the most significant issues, working procedures are chosen, the extent of the procedures, tests and surveys are established, as well as the manner of applying such.

The determination of the significant risks occurring during the majority of audit engagements is an issue of professional reasoning of the auditor. When the nature of the risks is considered, the auditor has regard to a series of issues, among which the most significant are: whether the risk is a fraud risk, whether the risk is related to recent significant evolutions of economic and accounting nature, imposing a special attention; the complexity of transactions, whether the risk involves significant transactions with affiliated parties. A significant role is played by the subjectivism degree in the evaluation of the financial information related to the concerned risk, especially such involving an increased uncertainty margin of the evaluation.

Issues related to the understanding of the entity, the knowledge of the entity or its environment can occur, inclusively to its internal control, sufficient to identify and evaluate the risks of the existence of significant distortions of financial statements, regardless whether such are due to fraud, errors and sufficient to solve such and apply additional audit procedures. It is important for the auditor to know very well the objectives and strategies of the entity, because they generate business risks that can result in significant distortions of the financial statements. It is also necessary that the financial auditor should know a history of fraud cases of European Structural Funds in order to prevent the possibility that cases of forged tenders, unreal expenses, fictive documentations and any non-eligible expenses should reoccur.

All such engulfed issues can result in the formulation of an improper audit opinion, i.e. it is a risk that should be considered, called audit risk. The auditor should plan and perform the audit in order to reduce the audit risk to a sufficiently low level in accordance with the objective of the audit (he scope is to obtain sufficient proper proofs in order to be able to adopt reasonable conclusions on which he should underpin his audit opinion).

6. References

[7] Freeman, N., Development of Performance Audit and of the System Audit in Romania within the Phare project: RO 2002/000.586.03.04.13, Bucharest, 2005;