

Audit of Public Procurements under Projects Financed From Structural Funds

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The aims of the present paper are (i) to introduce ways of checking the procedures of awarding public procurement contracts and (ii) to suggest a few practical examples for applying financial corrections in case of errors or fraud in the field of public procurement.

Under the applicable Community law, this article provides technical information to the attention of public authorities, experts, beneficiaries or potential beneficiaries and other bodies involved in monitoring, control or implementation of cohesion policy regarding the interpretation and enforcement of Community provisions for public procurement. Article seeks to provide explanations and interpretations of the European Commission services on these rules to facilitate implementation of operational programs and encourage good practice as well as to enhance knowledge of public procurement.

Keywords: *Audit, Irregularities, Public Procurements, Professional Scepticism, Structural Funds*

1 Introduction

The non-reimbursable structural funds represent financial instruments through which the European Union acts in order to reduce the economic and social discrepancies between regions aiming to achieve the economic and social cohesion in the European space. An essential condition in order to benefit from this Community support is the transparent management and implementation of the absorption process of the non-reimbursable structural funds, which implies: elaboration of projects in accordance with the Community Guidelines adopted by the European Parliament, Council (EC) and Commission (EC), public procurement made in accordance with the European Directives promulgated in this regard, contracting, construction, supervision, monitoring and impact of the projects financed from non-reimbursable structural funds.

Each EU member state designates a public authority or a public or private national institution, regional or local, from the operational point of view independently of the management and certification authority, for each operational program and responsible for checking the efficient operation of the management and control system.

The legal basis for the audit structural funds is represented by Council Regulation (EC) no. 1083/2006 laying down general provisions on the European Regional Development Fund, European Social Fund and Cohesion Fund care stabilește că organismul desemnat cu auditul fondurilor europene trebuie să se asigure că se efectuează controale ale operațiunilor pe baza unui eșantion adecvat pentru a se verifica cheltuielile declarate, lucrările de audit și control respectă standardele de audit recunoscute la nivel internațional.

Alvin ARENS and James K.LOEBBECKE recognize three essential types of audit: financial audit, compliance audit and operational audit, as it is described in their work „Auditing, an Integrated Approach” [1].

Thus, the overall objective of the audit of operations is to obtain reasonable assurance that management and control system works and that the statements of expenditure presented to the Commission are correct and that the underlying transactions are legal and regular, and specific objectives are to verify the conditions under Article 16 of Commission Regulation (EC) no. 1828/2006. As for audit scope, it is to obtain sufficient, relevant and reliable audit evidence to

support the annual opinion on the operation of the system, by applying audit detailed techniques and background procedures on operations. As a result of irregularities identified in the award of public procurement contracts, on June 11, 2011 the European Commission suspended payments for projects funded through some of operational programs and asked the institutions involved in management and implementation of European funds to meet the corrective measures taken in order to get stable and efficient operation of management and control system of certain programs.

Requested and implemented corrective actions aimed inter alia:

- alignment and detailing the role and functions of all institutions involved in public procurement verification process;
- formal integration of institutions responsible for control ex-ante and ex post procurement within management and control systems and ensuring their proper accountability for strengthening efficiency of public procurement checks (National Authority for Regulating and Monitoring Public Procurement - ANRMAP, Unit coordination and Verification of Public Procurement (UCVPP));
- ensure the functioning of correction mechanism at the level of management and certification authorities.

More than ever, current global financial and economic crisis requires deep reflection and appropriate behaviors, on all levels, including the absorption and use of community grant funds.

In October 2010 European Commission issued and published the Green Paper "Audit Policy: Lessons from the crisis" that identifies the need for the role and scope of audit work to be considered in the overall context of economic crisis financial [2].

In these times of crisis that crosses the entire world and is also experiencing significant in our country, for professional auditors is essential to identify the most effective audit methods to help create a climate of confidence in the viability and effectiveness

of grant funded projects, without which cannot be made the necessary plan for overcoming the crisis. It is obvious that the challenges faced by beneficiaries of EU funds have a direct repercussion on efforts that auditors must provide to assess their impact on the implementation of the projects. In this context, understanding the risks beneficiaries of grants are exposed to because of present economic circumstances is becoming a significant requirement of the audit missions, subservient directly to providing quality professional services [3].

Currently the main challenge for auditors is the audit of public procurement - one of the areas most prone to irregularities and fraud in the implementation of structural funds. Beneficiaries of structural funds try to assign public procurement contracts using very different methods by non-compliance of equal treatment, mutual recognition, principles non-discrimination, transparency, proportionality.

The challenge of this approach is caused by the fact that the external public audit of the external funded grants should fully comply with International Audit Standards and Community Regulations. Therefore, personal contributions to the research subject theme must be reported to the conceptual, institutional and procedural existing framework.

The documentation sources used by the author to elaborate this article were: existing legislation, specialized literature, guides, manuals and other documents created by various authorities and recognized at the European and National level, and practical examples taken from types of situations of eluding legal regulations for public procurements. These examples are based on real situations, derived from the conclusions of many audit missions carried on by the authority designated to audit European funding. In order to elaborate this material, the author gathered, processed and interpreted information regarding this subject, combining the conclusions drawn from analyzing the above mentioned documents with those from his own

experience in the area of EU funding auditing.

2 The institutional system responsible for verifying public procurements process

Public procurements generally speaking, but especially the ones funded by EC, represent a process with a high risk of fraud and corruption, especially now during this negative context of financial instability, imbalances and vulnerabilities of the economic system generated by this period of crisis. Throughout such a time, the risk of appearance of such unlawful phenomena is highly increasing. Non-compliance with national and EC public procurement directives refers to different methods and procedures that allow „disguising” the award of contracts by setting some apparently legal qualification requirements for potential bidders. It is of extreme importance to widely prevent and combat such a phenomenon, but also to know and eliminate procedures that may lead to financial corrections that will have a direct impact on the degree of absorption of EC funding and also on the consolidated general budget.

In this respect we have to mention that, in Romania, the institutional system with responsibilities for verifying public procurements was consolidated in 2011 by specifying the role and functions of all institutions involved in the process of public procurements verification, formal integration of the institutions responsible with ex-ante and ex-post verification of public procurements into management and control systems and ensuring a proper accountability of these by strengthening the effectiveness of public procurements control and ensuring the functioning of the correction capacity mechanism at the level of management authorities and certifying authority, constituted of:

- National Authority for Regulating and Monitoring of Public Procurement (NARMPP), that has the scope of ex-ante verification of all tender documents and tender notices issued by the contracting authority to be posted in the

Electronic System for Public Procurement (ESPP);

- Unit for Coordinating and Verifying Public Procurement (UCVPP), verifies ex ante the procedural aspects of awarding public procurement contracts;
- Management Authority does verification after the beneficiaries signed public procurement contracts, so that to ensure that national and EC public procurement directives were followed when payments were made. They have to make financial corrections if they find deviations from compliance with existing legislation, according to the existing legal provisions that are shortly presented in Table no.1
- Certifying and Paying Authority has the scope of verifying if they received proper information from the Management Authority regarding the procedures and controls of the public procurements contracts for which expenses were claimed.

We also have to mention that the guidelines of the COCOF Guide were adopted in the normative framework of public procurement control procedures. This refers to the financial corrections to be made to expenditure co-financed by the structural funds for non-compliance with the rules of public procurement contracts [4].

3 General considerations regarding risk-based approach

Audit authorities may need to be alert with regard to irregularities and fraud, in particular with regard to the awarding procedures for public procurement contract (when discussing, designing and performing the audit the auditor may consider the procurement area as highly exposed to the risks of fraud).

An auditor performs an audit to obtain reasonable assurance that management and control systems function effectively, so that certified expenditure is legal and regular.

For the purposes of Regulation (EC) no. 2988/95 of December 18, 1995 regarding protection of the European Communities financial interests, the term "irregularity" is a

broad concept and covers both intentional irregularities, as well as the unintended irregularities committed by economic operators. For the purposes of structural funds, a suitable definition is stipulated in Regulation (EC) no. 1681/94: "irregularity means any violation of a provision of Community law resulting from an act or an omission by an economic operator which has or could have the effect of prejudicing the general budget of the European Union by charging an expenditure to the general budget".

The same definition is given in Regulation (EC) no. 1083/2006 laying down some general provisions on the European Regional Development Fund, European Social Fund and Cohesion Fund for the period 2007-2013 (Regulamentul (CE) nr. 1083/2006) [5].

In accordance with Regulation (EC) no. 1681/94, when notifying irregularities to the Commission, Member States are required to identify if the irregularity involves "suspected fraud" [6]. It is not necessary for the auditors to have the competences for detecting and investigating fraud. However, even when an auditor obtains reasonable assurance, he/she must maintain professional scepticism throughout the audit. If during risk assessment, planning of the audit or system and substantive tests, the auditor concludes that circumstances indicate a possible fraud, he/she needs to know how to deal with the suspicion of fraud and how to report it.

ISA 240- The auditor's responsibility to consider fraud in an audit of financial statements defines professional scepticism as „an attitude that includes a questioning mind and a critical assessment of audit evidence” [7].

According to standard IIA 1210.A214, the internal auditor (and the external auditor as well) should have sufficient knowledge to identify the indicators of fraud but is not to have the expertise of a person whose primary responsibility is detecting and investigating fraud [8].

It is recommended that the measures taken by auditors in the area of public procurement

irregularities and fraud prevention be proportional with the fraud systems and indicators, on the basis of good practices principle.

The Guide of the Association of Certified Fraud Examiners identifies sixteen common and recurrent fraud schemes [9].

There are three elements that are the basis for the perpetration of fraud, which can be summarized as the "fraud triangle": *opportunity, rationalization and financial pressure*.

The concept of the fraud triangle was originated by fraud researcher Dr. Donald R. Cressey.

Opportunity: Even if a person has a motive, there should also be an opportunity. Deficient internal control systems may give rise to an opportunity (the presumed likelihood of the fraud not being detected is an essential consideration for the author of the fraud).

Rationalization: A person can develop a justification for himself/herself by reasonably rationalizing their acts.

Financial pressure: The "need or greed" factor. Pure greed can often be a strong motive. Other pressure can arise from personal financial problems or personal vices.

„Breaking the fraud triangle” is key to fraud prevention. Of the three elements, opportunity is most directly affected by strong internal control systems and therefore it is the element which can most easily be managed [9].

The Association of Certified Fraud Examiners (ACFE) uses a specific taxonomy which lists the type of fraud an organization might encounter [10].

ACFE divides fraud into three fraud types as a starting-point for an organization to identify which areas are vulnerable to fraud (Ghidul Asociației Experților Autorizați în Investigarea Fraudelor - Association of Certified Fraud Examiners):

- intentional manipulation of financial statements (e.g. inappropriately reported revenues);

any type of misappropriation of tangible or intangible assets (e.g. fraudulent expense reimbursements);

- corruption (e.g. bribery, bid rigging, undisclosed conflict of interest, embezzlement).

The Audit Authority from the Romanian Court of Accounts is the institution responsible to audit structural and cohesion funds granted to Romania by the European Union and it conducts its audit operations in keeping with the international audit standards (including, but not limited to INTOSAI, IAASB-ISA) and also with the community and national law [11].

The general scope of the audit differs according to the type of audit and consists in obtaining sufficient appropriate audit evidence so that auditors will be able to draw reasonable conclusions on which to base the audit's opinion [12].

In the context of non-reimbursable community funds, the operational audit consists in obtaining sufficient and relevant audit evidence based on which the auditors can obtain reasonable assurance that the statements of expenses regarding the operations financed by non-reimbursable structural funds fairly present, under all material aspects, the incurred expenditures and the transactions which are based on are legal and fair.

According to the definition given by article 2 from Council Regulation no 1083/2006 „operation” represents „a project or group of projects selected by the managing authority of the operational programme concerned or under its responsibility according to criteria laid down by the monitoring committee and implemented by one or more beneficiaries allowing achievement of the goals of the priority axis to which it relates”.

In order to obtain necessary audit evidence, the auditors perform audit tests that are of a cumulative nature and are mainly obtained through audit procedures.

- **Transactions tests** - are used to evaluate the transactions made in the organization that are registered in the separate project's accounting. The documents that

the records are based on are thus examined.

- **Account balances tests** - aim at collecting evidence regarding account balances in general, at a certain moment, rather than individual transactions that led to the respective account balances.
- **Analytical procedures**- on the basis of checking lists for selection, evaluation, contracting, public procurement, monitoring procedures and of transactions' recording in data bases.

In order to obtain such information, the auditor needs to have the necessary knowledge and abilities to be able to gather sufficient and sound evidence for each assessment from the financial statements, so that they will be in accordance with the defined financial audit standards. The auditor has to take into consideration that audit evidence is more persuasive rather than conclusive and use professional judgment and professional skepticism when he/she evaluates the quantity and quality of audit evidence and thus, their degree of being sufficient and appropriate, in order to base the auditor's opinion.

In the context of Commission certified expenses, in our opinion, professional scepticism mainly supposes that the auditor critically evaluates the validity of procedures for public procurement, contracting, goods delivery and works execution and also of the ones doubting the veridicity of the documents or declarations of the beneficiaries of non-reimbursable funds.

The auditor should mainly be concerned to obtain and evaluate evidence, by using various procedures (inspection, observation, inquiry, confirmation, recalculation, re-performance, reviewing/verification, etc.), in order to reduce audit risk to an acceptable low level.

- **inspection (verification) of records/documents** - consists in examining accounting records regarding performed transactions and operations, and also their supporting documents. On site inspection to verify the existence of works, to examine the physical status of

the project's objectives for which the auditor verifies the declared expenses.

- observation - consists of looking at a process or procedure being performed by others.

For example: observation of the process of transactions data recording in SMIS by the entity's personnel.

- examination - of the documents produced during the process of evaluation, contract awarding, public procurement, monitoring and data base recording, following their circuit and conformity with national and community legal framework.
- inquiry - supposes addressing questionnaires to the personnel involved in the implementation of the project in order to obtain relevant information regarding the audited domain.
- confirmation - consists in the answer to an inquiry in order to corroborate the information contained in the transaction file.

E.g.: In order to analyze the situations of incompatibility and conflict of interest at the level of the audited entities it is necessary to check the data base of the National Trade Register Office through the online system RECOM for providers of goods, works and services for the audited projects, and also for the individuals who took part in the procurement procedures carried on at the level of the audited projects.

- Re-performance - represents the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either by hand, or using computer - assisted audit techniques (CAAT).

E.g.: re-performance of selection and contract awarding procedures.

- reviewing - the process that analyzes and verifies the data from the separate financial statements of the project, in order to determine if the records of transactions are reflected in a correct manner.

The nature, timing and extent of the necessary audit procedures are a matter of professional judgment, the selected/chosen procedures being necessary to accomplish the audit's objectives and to significantly reduce the risk of not detecting significant misstatements in the financial statements.

4 Case study - Financial correction applied in case of irregularities detection relating to the procurement and implementation of contracts for services, supplies and works execution - case study

Let us assume that an economic operator applied for receiving non-reimbursable financial support with a view to implement a project aiming at building a housing district for disadvantaged people.

As the funding application sent to the authorized institutions was declared eligible, a grant contract is drawn in which the amount of the financial support and the conditions that are to be met for refunding the expenditures are clearly stated. Concerning the facts that we wish to present here, we must mention that the financing contract states the EC and national regulations that must be taken into account in the process of awarding procurement contracts to reach all the goals set in the financial request, respectively in the grant contract. In order to start the procurement procedures of the works contract, the beneficiary of the grant contract as contracting authority, elaborated the tender documentation including among others: the deadline for submitting offers, the selection criteria and qualification requirements for potential bidders, requirements regarding the works that are the object of the procurement or for the technical equipments the bidders should have.

After analyzing the tender documentation, one may identify the following hypothetical cases of non-compliance with the rules of EC directives regarding the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts:

1. The Beneficiary did not respect the transparency principles by reducing the minimum legal period of time between the date of sending for publication the tender notice and the time limit for receipt of tenders, even though this situation was allowed only on the condition that the prior information notice contained all the information necessary for the contract notice. Consequently, for the above mentioned irregularity, we should apply a financial correction of 10% of the value of the contract, according to Government Emergency Ordinance no. 66/2011.
2. The Contracting Authority did not declare all the selection and contract award criteria in the tender notice published in the Electronic System for Public Procurement and in the Official Journal of the European Union. The Contracting Authority established in the tender documents selection and qualification criteria of potential tenderers that were not mentioned in the published contract notice. As a consequence, the potential economic operators could not evaluate their capacity to take part in the awarding procedure. For this irregularity we should apply a financial correction of 25 % of the value of the contract, according to Government Emergency Ordinance no. 66/2011.
3. When initiating the procedure, that was organized with the aim of ensuring the access to an impartial and open to competition market for the benefit of every potential tenderer, a set of requirements were established regarding the works to be contracted, requirements that included also certain quantities and specifications of the works. The Contracting Authority together with the contractor signed an Additional act to the works contract that stipulated the reduction of the initially agreed price and by default the scope of the contract. As a consequence, it was only those economic operators that considered having the capacity to meet the minimum requirements specified in the tender documents that were present at the awarding procedure. If the requirements of the Contracting Authority, and thus the initial requirements, would have been different (specifically: less works, works with different technical specifications), it is very probable that other economic operators would have been interested and capable of presenting advantageous tenders for the Contracting Authority. For this irregularity we should apply a financial correction of 25 % of the value of the contract, according to Government Emergency Ordinance no. 66/2011.
4. It was specified in the contract awarding documents that the tenderers should have technical endowments (e.g. a concrete plant) that are placed at a certain distance from the location of works. In this way certain operators have been deterred from bidding, thus being necessary to apply a financial correction of 25 % of the value of the contract, according to Government Emergency Ordinance no. 66/2011.
5. Contract awarding to winner trader without being fulfilled the mandatory requirements of the technical and/or training capacity settled in the tender documentation. In this case the contracting authority violated the principle of equal treatment by failing to meet the qualification criteria specified in the tender documentation, consequently according to paragraph 6 of COCOF 07/0037/02-RO Guide and point 1.6 of Annex 1 to GEO no.66/2011, financial correction applicable to this case is 25% of the value for contract in question.
6. Contracting authority used the procedure of negotiation without prior publication of a notice, increasing the initial value of the works contract concluded with the contractor, without additional work being due unforeseen circumstances. For this type of irregularity from the

procurement rules can be applied a correction of 25% of the Addendum value, under paragraph 3 of the COCOF 07/0037/02-RO Guide and paragraph 1.3 of Annex 1 to GEO no.66 / 2011.

7. Unduly increase of execution period of works contract by signing an addendum, since the execution duration was an assessment factor in the contract award. Contracting Authority did not ensure transparency in the scoring of the criteria, that although "the execution period of works" was scored as assessment factor in awarding the contract, and after a while the winner tenderer prolonged contract by an addendum (e.g. from 5 months to 12 months). Recalculating the score obtained by the bidders, if the winning bidder would have been scored for a period of 12 months instead of 5 months, the successful bidder would have been 2nd place bidder. In accordance with paragraph 6 of the COCOF 07/0037/02-RO Guide and point 1.6 of Annex 1 to GEO no.66/2011, financial correction applicable to this case is 25% of the value for contract in question.
8. The contract award process has been affected by conflict of interest; the legal representative of the contracting authority was part of the management of successful tenderer, being vice president. The same procedure was affected by several irregularities in public procurement, namely: a) illegal qualifications and selection criteria required by means of tender documentation, b) change of qualification and/or selection criteria due to multiple requests for clarification and complaints filed, without change of the notice in the Official Journal of the European Union, c) incorrect assessment of how successful bidder has met the qualification and selection criteria established by the tender documentation. A financial correction of 100% of the contract awarded is to be applied, in accordance with paragraph 1.7 of Annex

1 to GEO no.66/2011 and Article 52(1)-(2) of the Regulation no.1605/2002 concerning financial regulation applicable to the general budget of the European Communities.

9. Use of the criteria on experience of experts as evaluation factor for contract award. When awarding contract were used assessment factors non-conforming to national and Community legislation on public procurement. Award criteria was "the offer most advantageous economically" and among the factors of evaluation of technical tender specified in the bid documentation was mentioned the criteria of evaluation "implementation capacity of the project team by expert CV evaluation" for awarding public procurement, which was not allowed by national and Community legislation. Paragraph 7 of the COCOF 07/0037/02-RO Guide and point 1.7 of Annex 1 to GEO no.66/2011 provides a financial correction of 25% in such situations, and when there is an intention to deliberately exclude some bidders can be applied a financial correction of 100%.

The above mentioned irregularities are only part of the methods used –quite often willingly- by the beneficiaries of projects funded by non-reimbursable funds. Their main scope is to unlawfully reduce the participation of certain economic operators and to award public procurement contracts to some contractors who have the same personal interests as the ones of the beneficiaries. In our opinion, it is not sufficient that auditors apply classical audit procedures (inspection, observation, inquiry, confirmation, recalculation, reperformance, reviewing/ verification, etc.) in order to identify the situations of non-compliance with the EC and national regulations that may have a significant impact on the declaration of expenses transmitted to the EC or to the audited projects.

The auditors should critically evaluate the validity of public procurement procedures and the carrying on of works contracts,

supply contracts or service contracts and also of the ones doubting the veridicity of the documents or declarations of the beneficiaries of non-reimbursable funds.

5 Conclusions

From the case study presented in the article results that the main causes for the application of financial corrections are: lack of transparency and publicity within public procurement procedures, causeless shortening of deadlines for submission of tenders, use of restrictive selection and qualifications criteria that does not ensure equal treatment, transparency, free movement and competition throughout the overall process, the existence of conflicts of interest and concluding of addendum to public procurement contract by non-compliance with legal provisions.

For irregularities of public procurement contracts, financial impact was determined by applying financial corrections to the amount of contracts according to COCOF Guidelines on management checks adopted by the Romanian authorities in 2011.

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The auditors should critically evaluate the validity of public procurement procedures and the carrying on of works contracts, supply contracts or service contracts and also of the ones doubting the veridicity of the

documents or declarations of the beneficiaries of non-reimbursable funds.

Operational audit's role is to detect irregularities from legality, regularity and conformity with national and/or European provisions as well as with provisions of contracts or other legal commitments made under these provisions, which damaged or could damage EU/international public donor budgets and/or their national public funds by an amount unduly paid. Reaching this goal and in the same time also an obligation assumed by the Member State is crucial for the EU payments approval and for avoiding the application of financial corrections to the operational programs.

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