Approaching the Risk of Fraud in the Audit of European Projects

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Abstract

Audit reports provide a support for management authorities to ensure that the non-reimbursable European funds provided to beneficiaries in EU Member States are used in their intended manner and that irregularities and frauds do not affect the EU's financial interests.

Approaching the risk of fraud by financial auditors during their engagements is treated by the International Standard on Auditing 240 which explains the auditors' responsibilities regarding fraud in an audit of financial statements. Auditors must identify and assess the risk of material misstatements due to fraud and respond accordingly through the audit procedures they perform and the audit opinion they issue.

ISA 240 specifically refers to the audit of historical financial statements and is mainly applied in the audit of statutory annual financial statements of companies. In this paper, we have researched how the actions prescribed by ISA 240 can be applied in the missions regarding the audit of EU-funded projects.

Key words: financial audit, fraud risk, EU-funded projects
J.E.L. classification: M40, M41, M42

1. Introduction

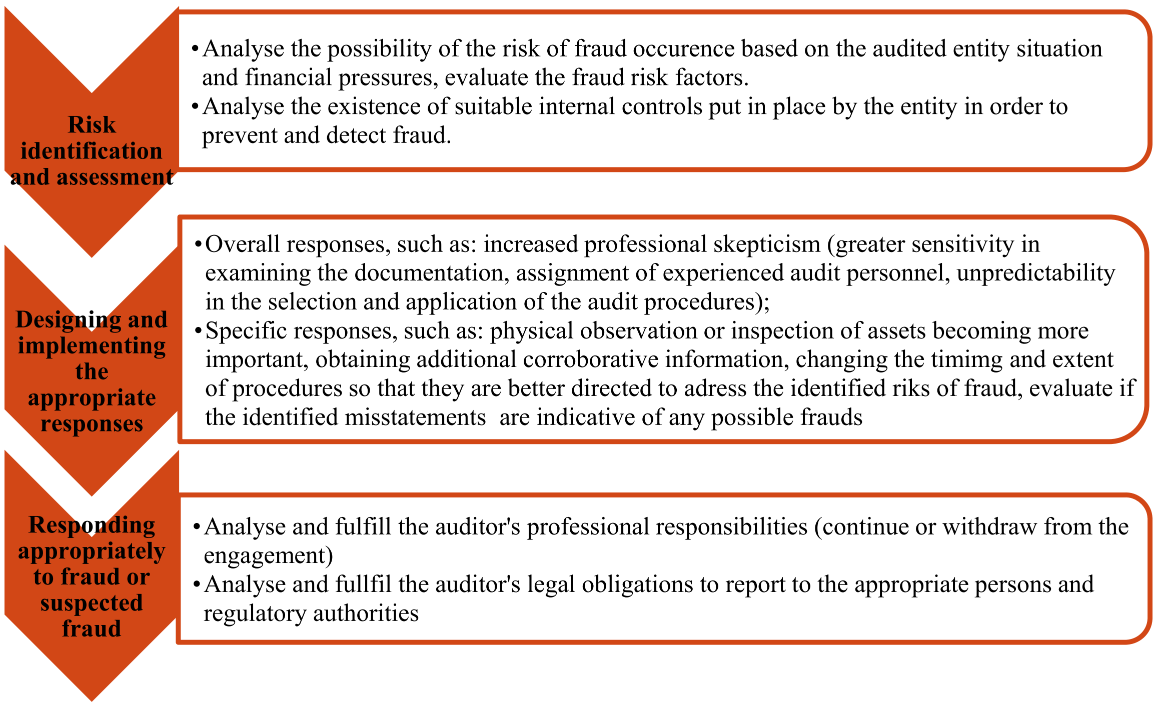
Based on the international standards on auditing (ISA), financial auditors have the responsibility to plan and to perform their audit engagements so as they will obtain audit evidence regarding the presence or the absence of material misstatements in the financial statements caused by frauds or errors. According to the scientific literature on how frauds are dealt with by financial auditors (Briciu *et al.,* 2010, pp.25), the standards on auditing do not make any distinction between the auditors' responsibility regarding the detection of errors and the detection of frauds. The auditors have the responsibility to respect the audit standards and not to discover all the misstatements in the financial statements. They are supposed to obtain a reasonable assurance that the materiality limits as they were set have not been exceeded.

The term "fraud" refers to intentional actions undertaken for own profit by persons among entities' management, those charged with governance, personnel or third parties. The measures the auditors are required to take in order to check the possibility of frauds having taken place are prescribed by *ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements.* Having in view that ISA 240 is specifically oriented to approaching the risk of fraud in the audit of the annual financial statements of companies, we have made a study concerning how the indications of ISA 240 can be applied in the circumstances of auditing EU-funded projects.

2. Theoretical background

The approach followed by financial auditors in dealing with the risk of fraud in their audit engagements are laid down in *ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements.* After reviewing the explanations available in this international standard on auditing, we have made a summarization of the main steps and actions as presented below.

Figure no. 1. Description of financial auditors' approach in relation to the risk of fraud



Source: own representation based on the analysis of ISA 240 (IAASB, 2018, pp. 162-205)

The characteristics of fraud as described by ISA 240 comprise an incentive or pressure to commit fraud, a perceived opportunity to do such actions and some rationalisation of the deeds (IAASB, 2018, pp. 174-175).

Frauds may lead to two specific types of misstatements (Briciu *et al.,* 2010, pp. 24-25):

- Misstatements arising from fraudulent financial reporting, usually for presenting a better profit to investors;
- Misstatements arising from misappropriation of assets, in case of different categories of assets' theft and trying to disguise the stolen assets by fraudulent financial reporting.

3. Research methodology

In order to illustrate how the indications of ISA 240 can be applied in the financial audit of European projects, we have used as an example the implementation of an EU-funded project that is financed through PNDR 2014-2020, the measure *SM 6.2 – Support for the set up of non-agricultural activities in the rural areas.*

We have analyzed the way in which the in-depth guidance of ISA 240 can be applied by financial auditors in an engagement to audit such a project, from the perspective of identifying and responding to the risk of fraud and to the identified suspicions of fraud in the utilization of the European funds received by the project beneficiary.

We have researched the areas of the project implementation process in which the risks of fraud can manifest and the audit procedures that should be employed by financial auditors in order to detect the instances in which frauds may have occurred and the way suspicions of frauds must be dealt with.

4. Findings

In the current programming period of European funds received by Romania as a Member State of the European Union, the Agency for Rural Investment Financing (AFIR) within the Ministry of Agriculture and Rural Development is the management authority responsible for the implementation of the National Rural Development Program (PNDR) 2014-2020.

Within the measure *SM 6.2 – Support for the set up of non-agricultural activities in the rural areas* of PNDR, in the session 2021, projects have been selected based on the financing requests submitted by eligible applicants together with business plans for their proposed non-agricultural activities to be newly set up in the rural areas across the counties of Romania, for the economic and social development of these areas.

The Applicant's Guide issued by AFIR for the measure *SM 6.2,* session 2021 lays down the technical and financial details regarding the projects to be selected and financed. According to this document, selected projects are financed in a percentage of 100% with maximum lump-sums of 50.000 EUR for services and 70.000 EUR for production activities (Applicant's Guide, 2021, pp. 20). The lump-sums are payable by AFIR to the project beneficiaries in two instalments, as follows (Applicant's Guide, 2021, pp. 31-32):

- the first instalment at the very beginning of the project, representing 70% of the non-reimbursable funds is paid immediately after the signing of the financing contract;
- the second instalment at the end of the project, amounting to 30% of the non-reimbursable funds, is paid after and only if all the projects' objectives as set in the business plans have been met, but not later than three years after the signing of the financing contract and without exceeding the deadline of 31 December 2025.

We have researched the financing contracts signed between AFIR and projects beneficiaries within the measure *SM 6.2 – Support for the set up of non-agricultural activities in the rural areas,* session 2021 and we have identified that the beneficiaries have the following obligations related to the project implementation and reporting:

Table no. 1 – The obligations of beneficiaries of projects financed through PNDR 2014-2020, SM 6.2

General obligations regarding the Project implementation	Obligations regarding specific aspects of the Project implementation	Obligations regarding the Technical and Financial Reporting
To execute the project according to its description included in the approved Finance Request	Deadline for beginning the project activities: The beneficiary must begin the implementation activities in a maximum term of 6 months after signing the Financing Contract.	To submit an Execution Report upon requesting the second instalment of the financing, showing the realisation of the project objectives and declaring that the other obligations have been respected: -all the project operations have been recorded separately in the beneficiary's accounting records -all the actions taken are in conformity with the approved Finance Request and Business Plan -the project's publicity has been realized as requested by the Financing Contract.
To ensure the correct implementation of the project's objectives as established in the Business Plan, with the maximum level of professionalism,	Financial target: to obtain revenues from own products selling or services rendered amounting to at least 30% of the first instalment of financial support received, in a maximum term of 33	To submit a Statement of Revenues obtained from own products selling or services rendered within the project. The statement of revenues describes each selling document, the customer and the receipt document (number, date, amount). The revenues obtained must amount to at least

efficiency and vigilance, following the best practices in the respective field and according to the Financing Contract.	months. Otherwise, the second instalment of finance will not be received.	30% of the first instalment received.
All the project activities included in the approved Business Plan become mandatory conditions for maintaining the financial support throughout the Financing Contract duration.	Obligations related to ensuring the publicity of the project financed through European funds. Obligations during the monitoring period of 3 years after the last payment made by AFIR: not to modify the projects' objectives, not to dispose of the investment and not to terminate the agricultural activity as member of an agricultural household.	To submit a Statement of Expenses incurred according to the Business Plan. The statement of expenses describes the type of expenses, each purchasing document (invoice, contract), the supplier, the payment document (number, date, amount) and the bank statement. The expenses incurred must correspond to the approved Business Plan and must respect the eligibility rules and the public acquisitions legislation.

Source: Own processing based on a model of financing contract (AFIR financing contract, 2021)

Upon analysing the beneficiary's obligations, we deduct that EU-funded projects are facing very rigorous time constraints, technical and financial constraints and these may pose difficult challenges to beneficiaries in order to fulfil them. The sanctions are very high in case of not fulfilling the contract's obligations: the financing contract will be terminated and the funds paid by the management authority will be recovered from beneficiaries, together with corresponding interest and penalties.

In the financial audit of such a project, the auditor has to verify the documents that are to be submitted by the beneficiary to the management authority (Execution Report, Statement of Revenues, Statement of Expenses) and the underlying documents with the objective to provide audit assurance/factual findings about the project transactions being real, correctly recorded and reported and in accordance with the financing contract and the applicable legislation.

The application of the steps established by ISA 240 for approaching the risk of fraud can be made in the following way by financial auditors in an engagement to audit projects in this category:

1. **Risk identification and assessment**

The fraud risk factors can be identified based on the conditions that are generally present when fraud exists:

- an incentive or pressure to commit fraud: we consider that there is a pressure for beneficiaries to execute the project within very strict conditions and also to fulfil the financial target (revenues to be obtained from providing goods/services by the beneficiary, in the time horizon as established);
- a perceived opportunity to commit fraud: such an opportunity exists because of the lack of controls from the part of the management authority during the duration of the financing contract (usually, there is just one visit of the management authority representatives on the site of the project, which takes place at the end of the contract)
- an ability to rationalize the fraudulent action: such attitudes may appear, based on the fact that the targets are set too high by the financer, that the European funds are "freely" available and they are intended for the welfare of European citizens, therefore the beneficiary is entitled to get and use them for his/her personal wealth.

Based on the above analysis, in our view the implementation of EU-funded projects of this category is exposed to a high level of fraud risk.

Assessment of the risk of fraud:

- Fraudulent financial reporting may appear in the process of reporting the accomplishment of the projects financial targets to the management authority (overstatement of revenues, in order to achieve the revenues target established as mandatory, for example revenues invoices can be issued to individuals/companies without the services being rendered, acquisitions procedures may not be respected in case of the declared expenses);

- Misappropriation of assets may appear in the process of the execution of the project activities as reported through the Execution Report (theft of projects assets for the beneficiary's personal use, second-hand goods can be purchased instead of new ones in order to make a profit from the price difference between the two, product substitution).

2. Designing and implementing the appropriate responses

We have analysed the specific procedures orientated for detecting possible frauds by reference to *ISA 240-The auditor's responsibilities relating to fraud in an audit of financial statements* and, out of lists with examples of possible audit procedures, we have selected the procedures that are the most relevant and should be employed by financial auditors in the context of European projects.

They can be applied in several distinct areas of audit work, as follows:

- Overall response: maintain a high level of professional skepticism throughout the audit because of the possible high level of fraud risk, evaluate if the identified errors are indicative of any possible frauds, check the original documents of the project and the correlation between the contracting, invoicing and reception documents. Financial auditors should also refer to the Government Resolution no. 875/2011, which presents in Annex 1 a wide range of fraud risk factors and fraud mechanisms that may appear in the usage of European funds in the categories of contracting and public acquisition practices, including corruption and conflicts of interest, frauds related to the reimbursement of the cost of workforce and the cost of consultancy services and be alert to the possibility of their occurrence in the audited project.
- Visit the location of the project as early as possible and evaluate if is appropriate for the investment, according to the approved Business Plan and Finance Request.
- Physical observation or inspection of assets and equipment acquired through the project must be performed by auditors as soon as the acquisition takes place and again during the project phases in order to make sure that the assets and equipment are located and functioning at the project implementation place and that assets substitution has not taken place.
- Inspection of inventory - the timing and extent of procedures can be changed so that they are performed on an unannounced basis, for example in case of inventory counts.
- Corroborating evidence from multiple sources: this can be achieved by obtaining external confirmations related to the revenues and acquisitions of the project. Revenues declared in the Statement of Revenues should be tested by sending confirmations requests to customers in order to confirm the amounts and values of the goods or services received from the beneficiary. Expenses declared in the Statement of Expenses should be tested by sending confirmations requests to suppliers in order to confirm the amounts and the description of the goods provided.
- Checking the accounting records for unusual recordings of documents or fictive journal entries.
- Perform analytical procedures using monthly accounting information in order to discover if revenues and certain expenses, for example workforce cost, have been recorded evenly in each month or if adjustments have been made at unexpected times in order to accomplish the revenues and expenses targets as set in Business Plan.
- Checking the tax records related to the project's implementation, for example check the fiscal registration of assets and employees at the project's location jurisdiction, based on tax declarations and official fiscal documents issued by the fiscal administration (AMPOR Instruction no. 190/23.11.2021, Annex B, pp. 2).

3. Responding appropriately to fraud or suspected fraud

In connection to the auditor's professional responsibilities, unlike the statutory audit of the annual financial statements, we consider that auditors do not have the option to withdraw from the engagement in case they identify frauds or suspicions of frauds.

This is justified by the fact that the audit contracts are usually financed out of the European funds and they are requiring the auditors to provide an audit report intended for the management authority that is providing the financing. In the audit reports, the auditors must present their findings related to the project and the information will be further used by the management authorities in order to take the necessary measures.

Regarding the legal obligations to report to the appropriate regulatory authorities, in case financial auditors identify any frauds or suspicions of fraud having taken place, we consider that they must immediately communicate the information to the management authority and to the Fight Against Fraud Department - DLAF by submitting a suspicion of fraud alert, so that the appropriate measures of fraud investigation will be taken by these as competent institutions in this field.

In case money laundering is suspected to take place within the EU-funded project activities, financial auditors have the obligation, as reporting entities, to inform the National Office for Prevention and Control of Money Laundering.

5. Conclusions

The implementation of EU-funded projects may be exposed to high levels of fraud risk because there is a high possibility that the fraud conditions may be present and the risk factors be identified. Fraud in the EU-funded projects context can manifest both through fraudulent financial reporting and misappropriation of assets, in a direct connection to the projects implementation activities and the technical and financial reporting due to be submitted to the management authorities.

ISA 240 offers plenty of guidance on approaching the risk of fraud that can be applicable in the financial audits of European projects. Based on our research, audit procedures employed by financial auditors for tackling fraud risk in European projects should be strongly directed to the following actions:

1. performing more site visits to observe the projects' location, usage of assets and functioning of the equipment acquired for performing the projects' planned activities;
2. obtaining external confirmations from third parties regarding the revenues obtained from products sold or services rendered and the acquisitions financed by the non-reimbursable funds;
3. checking the accounting records for unusual entries and unexpected monthly trends;
4. inspecting the original documents and the tax administration records related to the project.

Financial audit services are usually contracted at the end of the projects implementation, when the audit reports are required to be submitted to the management authority. In order for the auditors to perform more verifications on site throughout the duration of the project, it is essential that the acquisition of the financial audit services be made at the beginning of the financing contract and not at later stages of the project implementation. In this way, auditors may be able to monitor the projects activities as they are progressively performed and may bring a better contribution through their audit work.

We consider that the conclusions we have reached based on researching the case of an European project funded through PNDR 2014-2020, measure *SM 6.2 – Support for the set up of non-agricultural activities in the rural areas* can be generalised to the projects financed through other measures and operational programs, as the context and conditions are very similar to all EU-funded projects and the fraud risk factors are very likely to be present during the implementation activities and the utilisation of the European funds.

6. References

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