

## **IDENTIFICATION AND ASSESSMENT OF AUDIT RISK AND FRAUD RISK ON THE FIELD OF PUBLIC PROCUREMENT**

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### **Abstract**

*The need to strengthen control/audit on the field of public procurement was imposed after the enactment in 2016 of the new legislative package on the field.*

*Starting from the legislation in the field of public procurement, from the practice in the field and the current economic context, this paper presents the procedures for assessing fraud, as well as concrete examples of fraud specific to the field of public procurement. Some examples of indications of fraud identified and presented in the paper refer to: the possibility of taking bribes for the award of certain contracts, links between the persons involved in the award procedures and members of their families, disclosure of certain information concerning the offer, coercion/exclusion, dubious evaluation of bidders, procurement procedures in complicity.*

**Key words:** *audit risk, public procurement, fraud*

**JEL classification:** *K42, H57, M42*

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### **1. Introduction**

Public procurements are essential for stimulating the economic growth of states, creating new jobs, efficient use of public money and satisfying the public interest.

The particularly important role of public procurement is also emphasized by the European Commission, which states in a half-yearly report that every year, the EU public authorities spend around 14% of GDP on public

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procurement. This percentage represents over 1.9 thousands of billions euros ([https://ec.europa.eu/info/sites/info/files/file\\_import/european-semester\\_thematic-factsheet\\_public-procurement\\_ro.pdf](https://ec.europa.eu/info/sites/info/files/file_import/european-semester_thematic-factsheet_public-procurement_ro.pdf)).

Public procurement policy must ensure the most efficient use of public funds, and the procurement markets must be kept open throughout the EU (Europe 2020 Strategy).

The need to strengthen control in the field of public procurement is therefore necessary, first of all, due to the importance of this field, but also as a result of the adoption in 2016 of the new legislation in the field of public procurement, which specifies that "the finding of the contraventions and the application of the contravention sanctions are made by persons empowered for this purpose by the Court of Accounts of Romania, respectively ANAP, depending on the institution that establishes the violation." (Law no. 98/2016 concerning public procurement; Law no. 99/2016 concerning sectorial public procurement). This need to strengthen control also emerges from the content of the National Strategy in the field of public procurement.

Legal regulations (laws, decisions, regulations, norms, codes, etc.) represent the fundamental element for the method of achievement of the audit action, as their content determines the audit criteria.

In the case of the external audit in the field of public procurement, the main regulations that can be used in obtaining the understanding of the audited entity and in identifying the audit criteria, have their origin in decisions of the legislature, as follows:

- Law no. 500/2002 concerning public finances, with subsequent amendments and completions;
- Law no. 273/2006 concerning local public finances, with subsequent amendments and completions;
- Law no. 98/2016 concerning public procurement;
- Law no. 99/2016 concerning sectorial public procurement;
- Law no. 101/2016 concerning remedies and appeals for the award of public procurement contracts, sectorial contracts and licensing and service concession contracts, as well as for the organization and functioning of the National Council for Solving Appeals;
- Government Decision no. 394/2016 for the approval of the Methodological Norms for the application of the provisions regarding the award of the public procurement contract / framework

agreement from Law no. 99/2016 concerning sectorial public procurement;

- Government Decision no. 395/2016 for the approval of the Methodological Norms for the application of the provisions regarding the award of the public procurement contract / framework agreement from Law no. 98/2016 concerning public procurement;
- Law no. 217/24.10.2008. For the amendment and completion of Law no. 94/1992 concerning the organization and functioning of the Romanian Court of Accounts, published in the Official Gazette no. 724/24.10.2008.

## **2. Considerations regarding identification and assessment of audit risk**

One of the numerous definitions given to the audit risk is "the possibility of making, materially, recommendations and conclusions which are false or non-conforming with reality over the audited entity" (Ghiță. M, 2004) or, another simple and suggestive define it as "the risk that an auditor assumes when issuing an audit opinion which is inappropriate in terms of the financial statements audited" (Dobroțeanu, L., Dobroțeanu, C., 2002).

In practice, there are three components of audit risk:

- the risk of some significant errors being present in the audited situations (inherent or essential risk);
- the risk of non-discovery of some errors due to malfunctioning of the internal control of the entity (control risk);
- the risk of non-discovery or non-detection of some errors (non-detection risk).

Depending on the auditor's ability to intervene on them, these components are grouped as follows:

- *The risk that the audited situations contain errors (inherent and control risk).* From this point of view, these risks are not under the control of the internal auditor. He assesses the risks associated with the audited entity, but cannot control them in any way.

- *The risk that the auditor will not detect these errors (detection risk).* This risk category is under the control of the auditor who exercises this control by selecting and applying control tests to statements he wishes to evaluate.

The audit risk, including its components, can be established both in quantitative terms (in percentages) and in qualitative terms (low, moderate or high risk).

**The inherent or essential risk** arises when the reality from the field does not correspond to the information contained in the documents and is equivalent to the possibility that a category of economic operations may contain errors, which could be significant individually or when combined with incorrect information from other categories of economic operations, due to the absence of ineffective internal controls.

To estimate the inherent risk, auditors must perform an assessment of the context in which the audited entity operates, as well as the characteristics of the audited operations.

In assessing the inherent risk, the influence of a number of factors must be taken into account: the nature of the entity's activity; unusual or complex transactions; the susceptibility of some assets to be lost or misappropriated; the integrity of the entity's management; the specifics of the calculation principles; other risk factors.

When developing the audit plan, auditors should assess the inherent risk associated with the audited financial statements. In preparing the work program, the auditor should take this assessment into account in order to appreciate the size and nature of errors for the categories of significant transactions or at least to be able to determine whether these errors present an inherently high risk. Therefore, the inherent risk assessment, in particular, is recommended to be carried out in the preliminary phase of the audit.

Regarding public procurement verification, possible inherent risk factors are:

- significant and recent amendment of the legislation concerning public procurement in our country;
- the legal provisions leave room for interpretations;
- public procurements made by the entity have high values;
- the findings of the previous audit / control action revealed cases of fraud or corruption;
- the results from the control reports of other control / audit bodies;
- appeals and complaints from other tenderers regarding a tender;
- possible conflicts of interest.

As the **control risk** is constantly present due to the inherent limitations of the accounting and internal control system, the auditor evaluates, even from

the planning stage, the efficiency and effectiveness of these systems in preventing and detecting significant errors. To this end, the auditor performs control tests to obtain audit evidence.

Control tests may include:

- control of the supporting documents underlying the economic-financial operations, in order to obtain audit evidence regarding compliance with the internal control procedures;
- observation of internal controls where, as a result of their exercise, no deviations or dysfunctions were found;
- restoration of internal controls.

The control risk assessment is performed in depth at the level of each balance of the accounts or category of financial operation and two situations can be registered (Paraschivescu, D. Niță, N., 2008):

➤ the auditor finds that the accounting and internal control systems do not work efficiently and effectively, in which case the control risk is situated at a high level;

➤ the auditor identifies the accounting and internal control systems as being efficient, able to prevent, detect and correct significant erroneous information; In this case, the control risk is at a lower level.

*The inherent and control risks are interrelated and it is therefore advisable to assess the two components simultaneously.* Also, the management of the entities counteracts the impact of the inherent risks and internal control by consolidating and improving the accounting and internal control systems. In such situations, if the auditor attempts to assess the inherent and control risk separately, there is a possibility of an inadequate assessment of the audit risk.

The following are examples of risk factors in the field of public procurement associated with control risk:

- superficial or non-existent internal control procedures;
- not implementing the entity's internal control procedures or their improper implementation;
- frequent or recent changes in the internal control procedures;
- inefficient or little control over the public procurement domain of an entity.

**The non-detection risk** indicates the likelihood that the audit procedures applied by the external public auditors will not detect situations of non-compliance with existing legal provisions in relation to a specific objective and which may be significant individually or when combined with situations of

non-compliance with the legal provisions in the case of other specific objectives (The Court of Accounts of Romania, Guide on how to verify public procurement and sectorial public procurement, 2016).

The opposite of the non-detection risk is the assurance that the auditor obtains from the substantive procedures he uses.

The non-detection risk is generated by a series of factors, among which I mention:

- the auditor does not use the most appropriate audit procedures;
- the auditor does not apply a certain procedure correctly;
- the auditor misinterprets the audit evidence obtained;
- the auditor does not apply appropriate sampling procedures. There is inevitably a risk associated with sampling whenever the auditor verifies less than 100% of all transactions.

The non-detection risk is determined after establishing the other two components of the audit risk: the inherent risk and the control risk.

The non-detection risk is inversely proportional to the inherent and control risks. Thus, in order to maintain a low level of audit risk, the auditor should establish a low level of non-detection risk if the inherent and control risks are high, and conversely, if the inherent and control risks are weak, the auditor will accept a higher level of the non-detection risk, thus reducing the audit risk.

The detection risk presents the following risk factors in the field of public procurement:

- knowingly concealing audit evidence;
- secret agreements between bidders, between the staff responsible for public procurement within the entity or even with the management of the entity;
- audit procedures are inefficiently designed and their application does not lead to conclusive results.

However, regardless of the level of inherent and control risks, the auditor should apply those substantive procedures that support a rigorous risk assessment.

### **3. Procedures for assessing the risk of fraud in the field of public procurement**

The term fraud appears in the broader concept of “irregularities”.

Therefore, the wide field of action we are dealing with is the fact that there is no clear delimitation between irregularity and fraud, it can be stated that

the distinguishing element between the two is the extent to which the action underlying the non-compliance of the specific objective verified with the applicable legal regulations is intentional or unintentional.

The external public auditor is interested in the fraud that causes significant misstatements in the form of misappropriation of assets.

The investigation of fraud consists in carrying out some detailed investigations in order to determine whether the indicators of fraud are confirmed and whether they really lead to a fraud, by coagulating the precise and descriptive elements of the fraud.

The external public auditor will conduct interviews with the management or with the persons responsible for the public procurement within the entity in order to identify whether they are aware of or suspect fraud in the field of public procurement. At the same time, the external public auditor will ensure the obtaining of the point of view of the internal public auditors of the entity concerning the risks of fraud in the field of public procurement.

**The audit procedures used by auditors in case of the risks assessed by the significant misrepresentation as a result of fraud** may include:

a) changing the nature of the audit procedures in order to obtain more conclusive audit evidence, for example by using computer-assisted audit techniques. At the same time, the auditor may consider it useful to obtain additional corroborative information provided by him through external confirmations or interviewing the non-financial staff of the entity regarding any changes that appeared in the public procurement contract.

b) changing the schedule of the audit procedures by applying, for example, detailed tests at the end of the reporting period, when the assessed risks of material misstatement as a result of fraud are more obvious;

c) the scope of the audit procedures by increasing the sample size or performing the analytical procedures in a more detailed manner.

**Audit procedures in response to the risks of avoiding controls by the management** for the purpose of identifying misappropriation of assets or for the purpose of fraudulent financial reporting. The risk of avoidance or evasion from controls by the management exists in all entities to some extent. Due to the position of the management through its handling capacity, the risk of committing fraud is quite high. Clues that might suggest these aspects include: transactions that take place outside the normal course of business and that seem to take a very complex form (for example, the transaction involves several

entities); inadequate documentation; transactions involving previously unidentified entities.

All information obtained by the external public auditor regarding the audit risk and fraud risk assessment shall be recorded in a working document entitled *Audit risk and fraud risk assessment*.

The auditor must have sufficient knowledge in order to identify evidence of fraud, but this does not mean that he or she must have the competence of a person whose main responsibility is to identify, detect and investigate frauds (Dascalu, E., Nicolae, F, 2006).

There are certain risk situations in public procurement that the auditor should express an increased interest:

- Closing the financial year and the need to spend all the amounts provided in the budget;
- Emergency situations and similar events;
- Lack of transparency and information concerning procurements;
- Preference of some bidders over others;
- Participation in the auction of some companies owned by politicians or companies based in tax haven countries.
- The main actors of corrupt practices in public procurement can be: the top management, tenderers and subcontractors, the public procurement staff of the contracting entity; public officials.

In the following tabel, there are presented some *examples of common fraud systems that may occur during the public procurement process*:

**Table 1: Fraud systems in the public procurement process**

Nr.	Fraud systems in the public procurement process	Explanations/ Details
1.	<b>Taking bribes and illegal commissions</b>	is the most common indication of fraud in exchange for the award of a public procurement contract. This can easily result either from the unjustified favorable treatment of a tenderer in the award of a contract or the repeated awarding of contracts to the same tenderer, either as a result of an inexplicable increase in the financial capacity of the persons from the management of the

		contacting entity or from their incomplete submission of wealth declaration.
2.	<b>The existence of a conflict of interest</b>	highlighted by not submitting or not updating the conflict of interest form by the persons within the contracting authority or the existence of some possible links between the staff of the contracting authority and members of their families as potential suppliers.
3.	<b>Complicity award procedures</b>	where specific indicators of fraud are found under the following cases: all tenderers keep the price high and the winning bid is too high compared to the cost estimates; rotation, by agreement, of the winning bidders according to region, branch of activity, type of works; the loss of tender procedures belongs to fictitious companies; rejected bidders become subcontractors; qualified bidders are forced to withdraw their bids.
4.	<b>Disclosure of the data concerning the auction</b>	to a favorite tenderer, either by infringing the procurement procedure by an inexplicably long bidding period, a repeated auction without objective justification, or by the existence of some unusual tenders, for example, the winning bid has a very small reduction in price below the price of the next bid.
5.	<b>Handling the tenders by the staff of the contracting authority</b>	by canceling the winning tender for an error, in order to repeat the auction and award the contract to another favored tenderer; possible corrections on the offer after submission; complaints from bidders; offers are not kept in a secure location with limited access.
6.	<b>Fictitious companies</b>	used as an instrument of fraud either by <i>employees</i> in order to embezzle funds by authorizing payments to such fictitious companies, or used by <i>contractors</i> to submit tenders under secret cooperation systems, in order to artificially increase costs or issue false invoices. Fraud indicators: the service provider cannot be found in the nomenclatures of companies, at the Trade Register, on the internet; company without office space, staff, website; company registered in tax

		havens; company with unclear ownership structure.
7.	<b>Repeated and suspicious awarding of contracts to a single tenderer</b>	is often the result of corruption. This may take place through fragmenting, by the contracting authority, the acquisitions into two or more procurement contract in order to avoid a competitive procedure, in accordance with the legal provisions; restrictive requirements imposed by the contracting staff; extending the previously awarded contracts by successive additional acts instead of their re-auctioning them.
8.	<b>Price manipulation</b>	takes place when contractors do not provide complete and up-to date data concerning costs and prices in the financial offer. Specific indicators of fraud appear when the contractor postpones or refuses to present supporting documents or charges high prices compared to those in similar contracts.
9.	<b>Unbalanced procedures</b>	characterized by the following aspects: discrepancies between the offer prices; certain elements that are estimated at unjustifiably low costs compared to market prices, are subsequently removed from the list of requirements according to the contract.

The following aspects of fraud are encountered in the actual implementation of the contract:

1. **Failure to comply with the specifications of the contract** also constitutes fraud in the field, by falsely and knowingly declaring by the contractors that they have fulfilled them. The indicators of fraud in this case are: high rates of defects and immediate repairs; low quality, unsupplied products, works or services not provided; absence of certificates or inspection documents; complaints from users.

2. **False invoices, with excessive or duplicate prices** issued by the contractor on his own account or in cooperation with employees responsible for the contracting process following their corruption. In this case, the following aspects appear as fraud indicators: the goods or services cannot be located or are not in the inventory; there are no completed minutes of receipt of the goods or services from invoices; the invoicing prices and item descriptions do not correspond to

the contractual provisions, multiple invoices with identical amount, number, date; discrepancies between supporting documents and invoice; total payments made to the supplier exceed the value of the contract.

Aspects regarding these common fraud systems in the public procurement are found legislated in the Government Decision no. 875/2011 for the approval of the Methodological Norms for the application of the provisions of the Government Emergency Ordinance no. 66/2011 regarding the prevention, ascertainment and sanctioning of the irregularities occurred in obtaining and using the European funds and /or national public funds related to them, published in the Official Gazette no. 659 din 15.09.2011.

As I have shown through these practices, a special emphasis must be placed also on the *risk of corruption*. Corruption has detrimental consequences for the public entities, because it diverts society's resources from their destination, affecting the assurance of financial order and discipline, the efficiency of the use of public money. Therefore, in order to control the phenomenon of corruption, a phenomenon that has attracted even the attention of the European bodies and which has serious consequences, by diverting the public financial resources from their purpose and destination, it is required the active involvement of the external public audit.

#### **4. Conclusions**

The role and importance of public procurement in a state is mainly materialized in the economic growth of states, improving the life style of the community, efficient use of public funds so as to maintain an optimal price-quality ratio, the fight against corruption, fiscal discipline.

The need to strengthen control in the field of public procurement is therefore necessary, first of all, due to the importance of this field, but also as a result of the adoption in 2016 of the new legislation in the field of public procurement.

Given the large volume of contracts concluded between the state and the private sector, but also the cash flows generated by them, the field of public procurement is exposed to a high risk of corruption.

The impact of public procurement fraud can be primarily financial, then economic, on health, on market competition, on research and of course on value erosion in general. Public procurement fraud is manifested primarily due to legislative vulnerabilities: incomplete, unstable, ambiguous, recently amended legislation; lack of unitary regulations for all actors; problems in the

implementation of the decisions of the National Council for the Settlement of Disputes. In addition, the paper also presents the practical vulnerabilities in the public procurement system that lead to fraud in this area: the existence of a conflict of interest, complicity award procedures, handling the tenders by the staff of the contracting authority, repeated and suspicious awarding of contracts to a single tenderer, price manipulation, fictitious companies, unbalanced procedures, disclosure of the data concerning the auction.

There are certain risk situations in public procurement that the auditor should express an increased interest:

- closing the financial year and the need to spend all the amounts provided in the budget;
- emergency situations and similar events;
- lack of transparency and information concerning procurements;
- preference of some bidders over others;
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The main actors of corrupt practices in public procurement can be: the top management, tenderers and subcontractors, the public procurement staff of the contracting entity; public officials.

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