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Financial control and audit of the project as a condition for co-financing investments from the Structural Funds

INTRODUCTION

Ever since Poland joined the EU investments in our country have been on the increase, both at the regional and local level. The development of many investment projects is contingent on their co-financing by the EU budget (e.g. the **European Social Fund (ESF)**, the **European Regional Development Fund (ERDF)**). In order to obtain EU funding for investment projects one must meet a number of formal conditions. One of these conditions is the commitment of each EU Member State to introduce obligatory audits of the EU funding used.

The programmes of utilizing resources from the **structural funds (SF)** are controlled on the basis of regulations adopted by the European Commission, the national legislation (in particular the National Development Plan), and regulations pertaining to particular funds. The institutions responsible for managing and implementing operational programmes with the use of SF are controlled by the Minister of Finance. The controls are carried out by the specially established managing authorities and bodies intermediating in the process of accounting for projects co-financed using EU funding. The controls are carried out in accordance with the annual control plan approved by the Committee for Control and Audit of the Structural Funds and the Cohesion Fund. **The control of projects** is the basic type of control exercised under the control system for the EU aid awarded from EU funds implemented within particular programmes. Therefore, in order to be co-financed using EU funds each project must undergo a financial control. In case of larger investments an additional internal or external audit of the implemented project is required.

The purpose of the present work is to discuss the conditions and principles of carrying out audits of projects co-financed using EU funding in Poland. The work presents an overview of the formal grounds for conducting internal and external audits of projects. Moreover, the work discusses the theoretical and practical aspects of project audits and the most common formal, financial and substantive irregularities encountered during audits of projects.

FORMAL CONDITIONS FOR CARRYING OUT FINANCIAL CONTROLS AND AUDITS OF PROJECTS

As has already been mentioned, **financial control of projects** is the basic type of control carried out within the EU funds control system. Pursuant to the National Development Plan, the control of projects consists in verifying whether the co-financed goods and services were actually delivered, i.e. checking whether the actions planned in the projects were in fact implemented, and verifying the authenticity of the expenditure demonstrated in applications for payment. Both managing authorities and intermediate bodies are entitled to carry out project controls. In principle, however, it is the implementing institution, i.e. the institution which contracts and clears the accounts of the beneficiary, that is responsible for carrying out the control. Project control is carried out in two stages [Commission..., 2006]:

Stage 1 – verification of the beneficiary’s application for payment filed with a relevant institution; it pertains, *i.a.*, to the eligibility of expenditure on the basis of the certified copies of documents evidencing the said expenditure, enclosed with the application for payment;

Stage 2 – on-the-spot control, it should be carried out at the site of the project or in the beneficiary’s head office for all EU co-financed projects. On-the-spot project control consists in verifying the authenticity of expenditure incurred, the progress made and the effects of project implementation.

In case of larger investment projects an additional internal and/or external audit of a project is the basis for obtaining co-financing (Figure 1). The beneficiary implementing the project is responsible for ensuring that the audit is carried out. It is also the beneficiary who is charged with the costs of the audit.

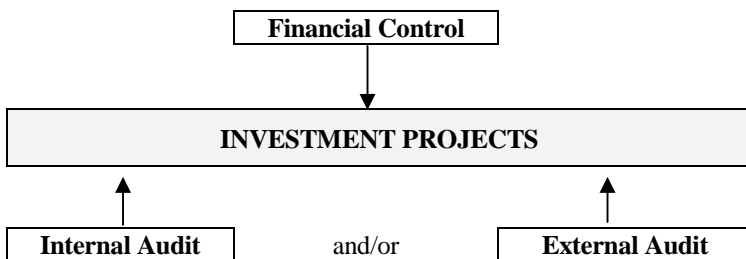


Figure 1. The system control of projects co-financed from the SF

Source: own work.

If the investment project is implemented by a public finance sector entity, the audit is carried out by an internal auditor employed at that entity or at a parent institution. In some instances defined in specific regulations, the audit may be carried out by an external auditor (a chartered accountant). If the investment project is implemented by a private party, the audit is carried out by an external auditor.

An external audit is obligatory co-financed for projects using resources obtained under particular programmes from the SF, such as e.g. the ESF and the ERDF. An external audit of a project must be carried out of the projects [Commission..., 2006]:

- 1) **Sectoral Operational Programme of Human Resources Development (SOPHRD)** under the ESF: projects with the value of PLN 700 000 or more and projects implemented by one beneficiary, whose total value amounts to or is greater than PLN 1 000 000,
- 2) **Integrated Regional Development Operational Programme (IRDOP)** under the ERDF – Projects whose value depends on the Priority (within which they are implemented):
 - within Priority I – over PLN 32 500,
 - within Priority II – PLN 750 000 or more, or a total amount of PLN 1 000 000 or more for projects implemented by one beneficiary,
 - within Priority III (with the exception of the “Micro-entrepreneurship” action) the total amount of PLN 30 000 000 or more for one or several projects.

The main goals of both the internal and external audit of a project meeting the requirements specified are:

- 1) assessment of eligibility of expenditure connected with the implementation of the project,
- 2) assessment of the effectiveness of the project management and control mechanisms,
- 3) assessment of correctness and reliability of financial reporting connected with the project.

As regards the beneficiaries of projects co-financed under **SF programmes**, an external audit must be exercised if the beneficiary that tenders, executes agreements, and is implementing the project has not established an internal audit unit in their organizational structure. Internal and external audits of projects implemented under the SF are first and foremost focused on:

- tender procedures, procedures for executing agreements necessary to implement the project;
- compliance with the rules of documenting and archiving documents;
- compliance with reporting procedures;
- compliance with control and expenditure verification procedures;
- compliance of the implemented projects, actions, and programme with the UE horizontal policies.
- expenditure approval procedures with respect to eligibility and proper documentation of expenditure;
- internal control procedures with respect to transfer of and accounting for grants;
- project implementation reports.

As per the project implementation agreement, the beneficiary may choose the auditor at their discretion. Should the European Union funding be inappropriately

exploited, the sanctions imposed shall include the obligation to repay the relevant portion of the obtained funding (along with the interest accrued) and exclusion from the list of prospective beneficiaries.

FORMAL BASES OF FINANCIAL CONTROL AND AUDIT FOR EXERCISING PROJECT

Financial controls and audits of projects co-financed using resources from the SF are exercised on the basis of regulations issued by the European Commission as well as the national legislation [*Commission...*, 2006; *Rozporządzenie...*, 1999 as amended]. It should be noted that currently there are no universally applicable, detailed legal acts governing the audits of EU co-financed projects. So far only the regulations (both Polish and European) which govern the ways of using EU funds have been released.

The said regulations are very general and do not contain any detailed provisions concerning the audits of the projects co-financed using EU funding and the operational programmes. It should be emphasized that Supplements to Sectoral Operational Programmes, which specify the types and authors of projects eligible for EU funding within particular programmes, constitute a valuable source of information for auditors. Moreover, in particular UE Member States the authorities managing operational programmes have issued general guidelines for financial controls and audits of EU funds. However, through their guidelines the managing authorities refer internal and external auditors to international and national auditing standards and other regulations.

Table 1 presents standards and other regulations for internal and external audit of projects co-financed using SF.

Table 1. Standards and other regulations for audit

Internal Audit	External Audit
<ol style="list-style-type: none"> 1. Regulations issued by the European Commission, as well as establishing particular Sectoral Operational Programmes. 2. Supplements to Sectoral Operational Programmes. 3. General guidelines for financial controls and audits of EU funds. 4. National ordinances of particular ministers establishing the implementation of resources from the structural funds. 	
4. The INTOSAI standards on control.	4. The International Standards on auditing.
<ol style="list-style-type: none"> 5. The national legislation on audit: <ul style="list-style-type: none"> – the Law, as well as ordinances and communications of the Minister of Finance on internal audit, – the internal auditing standards, – the management control standards. 	<ol style="list-style-type: none"> 5. The national legislation on audit: <ul style="list-style-type: none"> – the Law on Auditing, – the National Standards on Auditing.

Source: own work.

The basic regulations and standards governing **internal audits** and the operation of the internal control system are specified in:

- 1) the Public Finance Law [2009],
- 2) the ordinance of the Minister of Finance (MF) on executing and documenting internal audits [2009],
- 3) the management control standards for public finance sector entities [*The Communication...*, 2009],
- 4) the International Standards for the Professional Practice of Internal Auditing, which are binding for internal auditors in public finance sector units [*The Communication...*, 2010],
- 5) the Communication of the Minister of Finance on the Internal Audit Charter in public finance sector entities and the Ethics Code of internal auditors in public finance sector entities [*The Communication...*, 2006],
- 6) the INTOSAI standards, which contain guidelines for exercising internal controls, developed by the International Organisation of Supreme Audit Institutions (INTOSAI) for the public finance sector in UE [*Code...*, 2004].

The basic rules of external auditing, on the other hand, follow from the **International Standards on Auditing** (IAS) [*Międzynarodowe Standardy...*, 2009, 2010], the **Act on Statutory Auditors** [2009], as well as the **National Standards on Auditing** (NAS) issued by the National Council of Statutory Auditors in 2010 [*Uchwała...*, 2010]:

- **NAS No. 1 – General principles of auditing financial statements** contains, *i.a.*, the guidelines for preparing auditor's opinions and audit reports,
- **NAS No. 3 – General Principles of Auditing Financial Statements / Consolidated Financial Statements and Delivering Other Certifying Services** discusses, *i.a.*, the issues related to the execution of agreements for the delivery of certifying services by an external auditor.

The said regulations, however, do not lay down the detailed rules of auditing projects co-financed using EU funding. The guidelines developed by the institutions managing EU funding within particular operational programmes indicate the entities authorized to audit EU projects and specify the catalogue of auditors' competences. Moreover, these guidelines specify the scope of audits of the projects co-financed using EU funding. An audit should involve an examination of documentation and of the relevant internal control procedures (especially pertaining to financial control).

An external auditor prepares an **opinion and a report** on the exercised external audit, while an **internal auditor** prepares only a **report on the audit task**. Types of opinions issued by an external auditor: positive opinion (no reservations), opinion with some reservations, negative opinion or conditional opinion. Both the external auditor's report and the internal auditor's report on the audit consist of two parts: the information part and the report proper. The report

proper (or the essential part of the report) should specify: the purpose of the audit; project completion date and a brief description of the project audited; subject-matter of the audit; actions taken and audit techniques implemented, including the specification of the sample size and the methodology of composing the sample; material facts, including problems in project implementation ascertained in the course of the audit (along with specifying their significance and nature, e.g. if they are systemic), indication and analysis of the causes and results of the discovered omissions and irregularities; comments and conclusions as regards the removal of the omissions and irregularities discovered as well as recommendations made on the basis of the audit.

IRREGULARITIES DISCOVERED IN THE COURSE OF THE AUDIT

The internal and external audits of projects co-financed using SF reveal numerous irregularities, both formal, financial and content-related (technical and organizational), and sometimes recognized as fraud (figure 2).

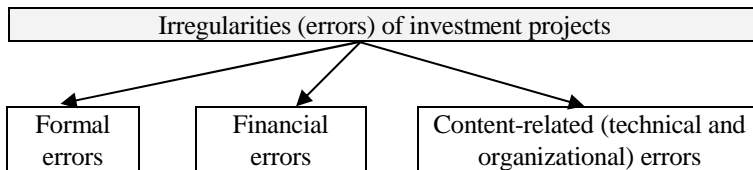


Figure 2. Irregularities (errors) commonly discovered during audits of investment projects

Source: own work.

The definition of “irregularity” is to be found in regulations issued by the European Commission. “Irregularity” is defined as any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure [Article 1, Section 2 of the Council Regulation..., 1995].

Formal errors commonly discovered during audits of projects [Kisiel, 2005; Kisiel, 2007; Szczepankiewicz, 2011]:

- lack of the obligatory annexes to the funding application, such as financial documents, reports on the received public aid, schedule of works and expenditures, building permit, loan commitment (if required), properly filled-in business plan,

- failure to fill in the application form in accordance with the instructions or failure to provide information in some sections of the application form,
- funding application signed by a person who is not duly authorized or the submitted documents have not been initialled by the applicant,
- project inconsistent with the rules of operation (e.g. the investment was launched prior to filing the funding application, inclusion of actions inconsistent with programme documents in the list of eligible expenditure),
- discrepancies between original application forms and their copies or document copies have not been certified as true copies of the original documents,
- the applicant is not eligible to apply for funding,
- promotion measures inconsistent with EU requirements (overestimated costs, too small information area),
- inclusion of costs which had not been mentioned in the application or entering the costs of personnel not involved in the project in the budget,
- unfeasible date of beginning project actions,
- lack of statements of not being eligible to deduct VAT and failure to include this item in the budget,
- providing training programmes to persons who are not employed at companies registered in the territory of the Republic of Poland,
- lack of the required documented experience in implementing and managing projects,
- applicants with a small turnover (revenue) relative to the project scale and with no adequate logistical capacity applying for the funding of projects of great value,
- failure to submit instructors' resumes (for training projects) or incorrect classification of training types (specialized, general),
- failure to provide information about partners.

Financial errors commonly discovered during audits:

- failure to meet eligibility criteria of costs,
- accounting errors in settling the amounts of funding,
- arithmetic errors in budgets, costs indicated as eligible in wrong categories,
- failure to ensure funding for the purpose of co-financing the subsequent stages of the project,
- lump sums recorded without specifying units and their quantity,
- founding amount calculated incorrectly,
- the costs of audit and bank guarantee below the threshold which, if exceeded, creates the audit/bank guarantee obligation, reported as eligible expenditure.

Content-related (technical and organizational) errors commonly discovered during audits [Kisiel, 2005; Kisiel, 2007, Szczepankiewicz, 2011]:

- failure to meet the requirements specified in the project funding agreement,
- improper, untimely management of the project,

- lack of supervision of the actual contractors and subcontractors, resulting in unpunctuality and failure to achieve proper quality,
- ineffective internal control system, inadequate assignment of responsibilities resulting in decision-making chaos,
- fraud consisting in the fact that a given object is a subject of several projects or that the entire project is fictitious.

CONCLUSIONS

The audit of project is aimed at demonstrating that the investment projects, the expenditure and the financial statements are correct and reliable. The most frequently detected formal, financial and content-related irregularities indicate that beneficiaries do not always ensure that the projects co-financed using EU funding are implemented in a legal way consistent with the standards in force. The beneficiary is obliged to ensure the proper quality of the audit by selecting the auditor, providing him/her with access to the information required and creating adequate technical and organizational conditions for the audit. Internal and external auditors, on the other hand, must comply with the laws as well as the international and national auditing standards governing audits in the course of every audit. The basic goal is to examine a sufficiently extensive area the project implemented. The scope of the audit should allow the auditor to formulate a reliable opinion on material facts and (if necessary) to make recommendations suggesting the possible ways of improving project management. Audits carried out by auditors are one of the main conditions for ensuring the quality of project implementation and the execution of funding application.

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Kontrola finansowa i audyt projektu jako warunek współfinansowania inwestycji z funduszy strukturalnych

Streszczenie

Dostęp do środków z funduszy unijnych skutecznie wspomaga realizację wielu projektów w Polsce. Każdy projekt współfinansowany środkami unijnymi podlega kontroli finansowej. Podstawą uzyskania współfinansowania większych inwestycji jest przeprowadzanie dodatkowo audytu wewnętrznego lub audytu zewnętrznego projektu. W opracowaniu omówiono warunki prowadzenia audytu projektów współfinansowanych ze środków funduszy strukturalnych. Wskazano teoretyczne i praktyczne aspekty badania projektów oraz najczęściej spotykane nieprawidłowości w toku audytu realizowanych projektów.

Summary

Access to European Union funding effectively aids the implementation of many projects in Poland. Each project co-financed using EU funding must undergo a financial control. In case of larger investment projects an additional internal or external audit of a project is the basis for obtaining co-financing. The present work discusses the conditions for audits of projects from the Structural Funds. This paper identifies the most theoretical and practical aspects of project financial controls and audits and the common irregularities encountered during audits of projects.