

Information Note on Fraud Indicators for ERDF, ESF and CF

This is a Working Document prepared by the Commission services. On the basis of the applicable Community law, it provides technical information to the attention of public authorities, practitioners, beneficiaries or potential beneficiaries, and other bodies involved in the monitoring, control or implementation of Cohesion Policy on how to interpret and apply the Community rules in this area. The aim of the working document is to provide Commission services' explanations and interpretations of the said rules in order to facilitate the implementation of operational programmes and to encourage good practices. However, this information note is without prejudice to the interpretation of national laws, the Court of Justice and the Court of First Instance or evolving Commission decision making practice.

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1. INTRODUCTION

1.1. Background

In line with Article 274 of the Treaty the Commission shall implement the budget under its own responsibility having regard to the principles of sound financial management. Furthermore, Member States shall cooperate with the Commission to ensure that the appropriations are used in accordance with the principles of sound financial management.

Article 280 of the Treaty stipulates that the Community and the Member States shall counter fraud and any other illegal activities affecting the financial interests of the Community.

Furthermore, under Article 53 b (2) of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities¹, Member States are responsible to prevent and deal with irregularities and fraud in the area of shared management. Under the legal arrangements for shared management, in order to protect the financial interests of the Community, the Member States are principally responsible for setting up management and control systems which are in compliance with the Community law requirements, for verifying that the systems function effectively, through audits by designated bodies, to prevent, detect and correct irregularities and fraud.² In the case of irregularity or suspected fraud the Commission must be informed in accordance with the reporting procedures laid down in Commission Regulations (EC) N° 1681/94 and (EC) N° 1831/94 concerning irregularities for cases related to the programming period 2000-2006 and in accordance with Commission Regulation (EC) N° 1828/2006 (Articles 27-36) for cases related to the programming period 2007-2013.

Regardless of whether the irregularity is non-intentional or intentional (fraud), the affected expenditure must be excluded from co-financing by the Community budget.

This information note provides a list of fraud schemes and related fraud indicators which may be relevant in the area of structural actions with the aim of raising fraud awareness in Member States so that management and control systems can be strengthened to more effectively prevent and detect fraud³.

¹ OJ L 248, 16.09.2001.

² Article 70 of Council Regulation (EC) No 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999, OJ L 210, 31.7.2006 and Section 4 (Articles 27-36) of Commission Regulation (EC) No 1828/2006 setting out rules for the implementation of Regulation (EC) No 1083/2006, OJ L 371, 27.12.2006.

³ Each year the Commission publishes an annual report on the fight against fraud in the Community (e.g. for 2007: *Commission Report to the European Parliament and to the Council, Protection of Communities'*

1.2. Joint Fraud Prevention Strategy

The information note is one of the actions stemming from a broader initiative started in 2008: DG Regional Policy and DG for Employment, Social Affairs and Equal Opportunities, assisted by OLAF, have developed a Joint Fraud Prevention Strategy (JFPS) which comprises a series of anti-fraud actions to raise the level of fraud awareness under shared management and provide guidance and more proactive tools to counter fraud.

As regards guidance in general, starting from 2009, the objective is to make available a "package" to authorities managing the Structural Funds in the Member States, to desk officers in the Commission and Commission and Member States' auditors on various issues relating to fraud.

More specifically, the strategic objectives of the JFPS are to

- reinforce fraud risk assessment;
- **introduce more proactive guidance for Member States for fraud detection;**
- provide more support to Member States' authorities for fraud prevention and detection work;
- raise the level of fraud awareness in DG Regional Policy and DG for Employment, Social Affairs and Equal Opportunities;
- raise the level of fraud awareness in the Member States.

As one of the strategic objectives in the JFPS is to provide more proactive guidance for fraud detection which can in turn contribute to fraud prevention, the Commission has elaborated this information note on fraud indicators so that Member States can add to their awareness on fraud schemes and fraud indicators.

Annexes 1 and 2 to this information note contain an inventory of generally recognised common and recurrent fraud schemes in the fields of contracting and

Financial Interests – Fight Against Fraud – Annual report 2007 – SEC(2008)2300 and SEC(2008)2301 which includes a statistical annex on irregularities, suspected fraud and fraud. In the structural actions area in the 2000-2006 programming period, when reporting on irregularities to the Commission under the reporting regulations in force, Member States have indicated that 12-15 % of the irregularities are "suspected fraud". On the basis of this estimation, in 2007, reported "suspected fraud" affects about 0,31 % of the commitments. These figures, as they are preliminary, should be treated with adequate caution since only a competent judicial authority can qualify suspected fraud as a case of fraud.

public procurement, as well as labour charges and consultancy services, and the associated fraud indicators.⁴

Annex 3 to this information note summarises the procedures for reporting of fraud to the European Anti-Fraud Office (OLAF).

2. DEFINITIONS

2.1. Definition of irregularity

For the purposes of Council Regulation (EC) No 2988/95 of 18 December 1995 on the protection of the European Communities' financial interests the term irregularity is a wide concept and covers both intentional and non-intentional irregularities committed by economic operators.

Article 1(2) of Regulation (EC) No 2988/95⁵ defines "**irregularity**" 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"*⁶

2.2. Definition of fraud in the Treaty

The Convention drawn up on the basis of Article K.3 of the Treaty on European Union, on the protection of the European Communities' financial interests⁷ defines "**fraud**", in respect of expenditure, as any intentional act or omission relating to:

- the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds from the general budget of the European Communities or budgets managed by, or on behalf of, the European Communities;

⁴ A significant part of the information draws on the Association of Certified Fraud Examiner's (ACFE) guide to Contract and Procurement Fraud from 2008. This guide is based on world-wide fraud case investigations and known fraud schemes. See www.acfe.com.

⁵ OJ L 312, 23.12.1995, p.1.

⁶ For the purpose of the Structural Funds an adapted definition is set out in Article 1a of the Regulation (EC) No 1681/94: "irregularity" means 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 by charging an unjustified item of expenditure to the Community budget". The same definition is set out in Article 2 (7) of Council Regulation (EC) No 1083/2006 laying down general provisions for the European Regional Development Fund, the European Social Fund and the Cohesion Fund for the 2007-2013 period.

⁷ OJ C 316 , 27.11.1995, p. 49.

- non-disclosure of information in violation of a specific obligation, with the same effect;

- the misapplication of such funds for purposes other than those for which they were originally granted

It is therefore the component of intentional deceit which distinguishes fraud from the more general term of "irregularity".

In accordance with Article 3(e) of Regulation (EC) No 1681/94 since 2006 the Member States are required to identify, when they notify irregularities to the Commission, whether the irregularities involved "suspected fraud".⁸

2.3. Fraud types

It is recommended that any fraud type classification is tailored to the specific circumstances and environment in which an organisation is working.

The Association of Certified Fraud Examiners (ACFE)⁹ uses a specific taxonomy which lists the type of fraud an organisation might encounter. ACFE divides fraud into three fraud types as a starting-point for an organisation to identify which areas are vulnerable to fraud:

1. Intentional manipulation of financial statements (e.g. inappropriately reported revenues)
2. Any type of misappropriation of tangible or intangible assets (e.g. fraudulent expense reimbursements)
3. Corruption (e.g. bribery, bid rigging, undisclosed conflict of interest, embezzlement)

3. THE REASONS BEHIND FRAUD

There are three elements behind the perpetration of fraud, which can be summarised as the "fraud triangle"¹⁰:

⁸ Article 1a(4) of Regulation (EC) No 1681/94 defines "suspected fraud" as "an irregularity giving rise to the initiation of administrative and/or judicial proceedings at national level in order to establish the presence of intentional behaviour, such as fraud". This definition is reproduced in Article 27 (c) of Regulation (EC) No 1828/2006.

⁹ See "Managing the Business Risk of Fraud – A Practical Guide", the Institute of Internal Auditors, the American Institute of Certified Public Accountants and the Association of Certified Fraud Examiners, 2008. <http://www.ifa-iaf.be/v1/frontEnd/libraryIfa/index.php?action=detail&id=29>.

¹⁰ The concept of the fraud triangle was originated by fraud researcher Dr. Donald R. Cressey. See "The Handbook of Fraud Deterrence", by Harry Cendrowski, James P. Martin and Louis W. Petro, 2007, p. 41.



Opportunity: Even if a person has a motive, an opportunity must be given. Slack internal control systems may give rise to an opportunity (*the presumed likelihood of the fraud not being detected is a crucial consideration for the fraudster*). Examples of weaknesses in the internal control systems are inadequacies related to:

- supervision and review;
- segregation of duties;
- management approval;
- system controls.

Fraud may also occur, if controls are not applied or if persons in positions of authority create opportunities to override existing controls.

Rationalisation: A person can develop a justification for himself/herself by rationalising their acts, e.g. "It is fair to do this – I deserve this money" or "They owe me". "I am just borrowing the money – I will pay it back".

Financial pressure, incentive or motive: The "need or greed" factor. Pure greed can often be a strong motive. Other pressure can arise from personal financial problems or personal vices such as gambling, drug addiction etc.

“Breaking the fraud triangle”¹¹ 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.

4. RESPONSIBILITIES FOR FRAUD PREVENTION AND DETECTION

4.1. Managing and certifying authorities ('management')

Under the system of shared management of the Structural Funds the Member States are principally responsible for setting up management and control systems which are in

¹¹ See “*The Handbook of Fraud Deterrence*”, by Harry Cendrowski, James P. Martin and Louis W. Petro, 2007, p. 41.

compliance with Community requirements, for verifying that the systems function effectively, through audits by designated bodies, to prevent, detect and correct irregularities and fraud.

Whereas primary responsibility for fraud prevention rests with management, successful fraud deterrence may depend on a combination of the efforts of management and auditors.¹²

The aim should be to reduce the element of opportunity in the fraud triangle.

The principal mechanism for reducing opportunity is strong internal control, covering in particular adequate supervision and review and segregation of duties.

Management should also have sufficient knowledge for identifying fraud indicators and should be aware of the obligations to report irregularities and suspected fraud under the regulations in force.

Member States need to pay attention to the correct implementation and dissemination of guidance internally on the reporting obligations with regard to irregularities and suspected fraud as laid down in the applicable regulations.¹³

4.2. Audit authorities (and other audit bodies performing audit work)

According to IIA standard 1210.A2¹⁴, the internal auditor (and the external auditor) 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.

By exercising adequate professional scepticism¹⁵, auditors should be particularly alert to opportunities for fraud, such as control weaknesses in the control and management systems. When relevant, in particular if the management and control environment can be considered high risk, auditors are recommended to make enquiries with managing authorities about their views as to the risk of fraud in order to test the anti-fraud measures in place.

¹² See *"The Handbook of Fraud Deterrence"*, by Harry Cendrowski, James P. Martin and Louis W. Petro, 2007, p. 29.

¹³ Article 70 of Council Regulation (EC) No 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999 (OJ L 210, 31.7.2006) and Section 4 (Articles 27-36) of Commission Regulation (EC) No 1828/2006 setting out rules for the implementation of Regulation (EC) No 1083/2006, (OJ L 371, 27.12.2006).

¹⁴ Institute of Internal Auditors, *International Standards for the Professional Practice of Internal Auditing*.

¹⁵ International standard on auditing 240: *"The auditor's responsibility to consider fraud in an audit of financial statements"*. The same standard also recognises that "the risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud may involve sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations..."

Audit authorities verify, as part of both system audits of management and control systems and audits on operations, that the mechanisms in place for fraud prevention are adequate and effective.

Audit authorities may need to be alert with regard to fraud in particular as regards the procedures for grant awards and contract and public procurement fraud (when discussing, designing and performing the audit the auditor may consider the procurement area as highly exposed to the risks of fraud).¹⁶

5. RECOMMENDATIONS FOR USE OF THIS INFORMATION NOTE

It is recommended that Member States:

1. Take note of this information note for awareness raising purposes and ensure its wide dissemination to all bodies managing structural funds.
2. Use the information provided on fraud schemes in *Annex 1* and *Annex 2*, on a best practice basis, in order to update procedures in connection with checks on and approval of payment claims from final beneficiaries. This could be done by e.g. including in the checklists a reference to this note, and/or any of the fraud schemes listed, in particular in situations in which risk assessment might indicate a high fraud risk.
3. Ensure awareness¹⁷ of fraud reporting procedures, e.g. the websites of the managing bodies and intermediate bodies could include such information (see fraud reporting procedures in *Annex 3*).
4. Ensure that management verifications are carried out in an adequate manner as these verifications are an important tool in deterring and detecting fraud. Reference is made to guidance note "*Guidance document on management verifications to be carried out by Member States on operations co-financed by the Structural Funds and the Cohesion Fund for the 2007 – 2013 programming period*"¹⁸.
5. Use cross-checking of information, including verification of information with a third party if there are fraud suspicions. For instance, the veracity of a doubtful invoice presented by a final beneficiary may be verified with the service provider itself, if needed by examining the book-keeping and records of the service provider on-the-spot.

¹⁶ See Exposure Draft Practice Note to International Standard on Auditing 240 providing additional guidance on public sector issues, point 3.

¹⁷ Most fraud case investigations originate from tips and reports received. Free-phones are instrumental in this respect.

¹⁸ Final version of 05/06/2008, document COCOF 08/0020/04.

CONTRACT AND PUBLIC PROCUREMENT FRAUD

Common and recurrent fraud schemes and the relevant fraud indicators (red flags)

This annex lists sixteen common and recurrent fraud schemes with a description of the scheme and the relevant fraud indicators in the area of contracts and public procurement.

This is a non-exhaustive list of generally recognised schemes.

This annex uses much of the structure and contents which ACFE¹⁹ applies in its instruction for professionals in the field of fraud prevention and detection.

1. Corruption – bribes and kickbacks

Scheme description:

Bribes and kickbacks refer to the giving or receiving of a “thing of value” to influence an official act or a business decision.

Corrupt payments

The “thing of value” need not be money, and often is not (the ambiguity remains and the perpetrator can more easily invent excuses if needed). Any tangible benefit given or received with the intent to corruptly influence the recipient can be a bribe. Specific “things of value” that have been given and received as bribes include e.g.: gifts whose value exceeds thresholds set by organisations/companies, “loans” whether or not repaid, use of credit cards, overpaying for purchases (e.g. paying €500,000 for an apartment worth €200,000), free use of apartment, or discounted rent, free use of a leased car, cash payments, payment by check or bank transfer of false “fees or commissions”, often an agreed percentage of the contract obtained, and paid through a middleman or a *shell company*²⁰ set up by the recipient and hidden ownership interest in the corrupt contractor or seller). The things of value are often given in the order of this listing. This is because the parties may be unsure of the other’s intentions at the outset and the bribe payer may not be able to afford more substantial payments until a contract is awarded.

¹⁹ Association of Certified Fraud Examiners, www.acfe.com. More specifically, the structure and contents draw on the "Contract and Procurement Fraud" training for Fraud Examiners.

²⁰ A shell company is a company that does exist but does not actually do any business or have any assets.

After the contract award, most bribes are paid in the form of kickbacks, meaning that the contractor will pay or “kickback” an agreed percentage of each invoice payment it receives. Whatever manner the bribes are paid, prices are usually inflated or the quality of goods and services reduced, to cover the cost of the payments.

Corrupt payments facilitate many other types of fraud, such as false invoicing, phantom expenditure or failure to meet contract specifications.

Corrupt influence

Corrupt influence in the contract and procurement area is often reflected as: improper selection such as unjustified single source acquisition (there might be multiple awards under the threshold for public procurement), unjustified high prices, excessive quantity of purchases, acceptance of low quality and delayed or no delivery.²¹

Fraud indicators:

The most common indicator of bribes and kickbacks is unexplained favourable treatment of a contractor by a contracting employee over a period of time.

Other red flags:

- close socialisation between a contracting employee and service or product provider;
- unexplained or sudden increase in wealth by the contracting employee;
- contracting employee has an undisclosed outside business;
- contractor has a reputation in the industry for paying kickbacks;
- undocumented or frequent changes to contracts increasing the value of the contract;
- contracting employee declines promotion to a non-procurement position;
- contracting employee fails to file or complete conflict of interest declaration.

2. Undisclosed conflict of interest

Scheme description:

A situation of conflict of interest can occur if an employee of the contracting organisation has an undisclosed financial interest in a contract or contractor. A potential conflict of interest might be immune from legal action if it is fully disclosed and approved by the employer in a timely manner. An employee might e.g. secretly own a supplier or a contractor, set up a shell company through which he or she purchases supplies at an inflated price or have an undisclosed interest in property sales or leases.

²¹ This is often summarised as the "SPQQD" factors: improper Selection, high Price, excessive Quantity, low Quality, delayed or no Delivery.

Fraud indicators:

- unexplained or unusual favouritism of a particular contractor or seller;
- continued acceptance of high priced, low quality work etc;
- contracting employee fails to file or complete conflict of interest declaration;
- contracting employee declines promotion to a non-procurement position;
- contracting employee appears to conduct side business.

3. Collusive bidding

Scheme description:

Contractors in a particular geographic area or region or industry can conspire to defeat competition and raise prices through various collusive bidding schemes.

Complementary bidding

Complementary bids, also known as “shadow” bids, are intended only to give the appearance of genuine bidding and not to secure the buyer’s acceptance.

Cooperating bidders agree to submit higher priced or deliberately non-responsive bids to allow the selection of a favoured contractor at an inflated price. The winner shares a percentage of its profits with the losing bidders, hires them as subcontractors, or allows them to win other high priced contracts. Complementary bids may also be submitted from shell companies or from affiliated firms.

Bid suppression

For bid rigging schemes to succeed the number of bidders must be limited and all must agree to the conspiracy. If a new (a so-called “diver”) or uncooperative bidder enters the competition, the price inflation will become apparent. To prevent this, the conspirators may pay-off outside companies not to bid or use more forceful means to discourage their participation. The conspirators can also coerce suppliers and subcontractors not to deal with non-cooperating companies to protect their monopoly.

Bid rotation

The conspirators submit complementary bids or refrain from bidding in order to allow each bidder to be the low bidder on a rotating basis. The rotation can be based on geographic area – one road contractor gets all work in one region, another company in the next – or by type of job, or by time, etc

Market division

The cooperating companies may divide markets or product lines and agree not to compete in each other's area, or to do so through collusive measures, such as submitting only complementary bids. Sometimes employees may be involved in collusive bidding schemes – sometimes with a financial interest in the “competing” businesses – and receive a share of the inflated prices.

Fraud indicators:

- winning bid is too high compared to cost estimates, published price lists, similar works or services or industry averages and fair market prices;
- persistent high prices by all bidders;
- bid prices drop when new bidder enters the competition;
- rotation of winning bidders by region, job, type of work;
- losing bidders hired as subcontractors;
- unusual bid patterns (e.g. the bids are exact percentage apart, winning bid just under threshold of acceptable prices, exactly at budget price, too high, too close, too far apart, round numbers, incomplete, etc);
- apparent connections between bidders, e.g. common addresses, personnel, phone numbers etc;
- contractor includes subcontractors in its bid which are competing for the main contract;
- qualified contractors fail to bid and become subcontractors or low bidder withdraws and becomes a subcontractor;
- certain companies always bid against each other, others never do;
- losing bidders cannot be located in the Internet, business directories, have no address etc (in other words they are fictive);
- correspondence or other indications that contractors exchange pricing information, divide territories, or otherwise enter informal agreements;
- collusive bidding has been found in the following sectors and is also relevant for structural funds: asphalt paving, building construction, dredging, electrical equipment, roofing, waste disposal.

4. Unbalanced bidding

Scheme description:

In this fraud scheme contracting personnel provide a favoured bidder with useful inside information which is not available to other bidders, for example, that one or several line items in a request for bid will not be used in the contract (some line items may also be vague or ambitious on purpose and the favoured bidder is instructed how to respond). This information allows the favoured firm to submit a lower price than the other bidders, by quoting a very low price on the line item which will not be included in the final contract. Unbalanced bidding is one of the more effective bid rigging schemes as the manipulation is not as obvious as in other popular schemes, such as unjustified single source acquisitions.

Fraud indicators:

- particular line item bids appear to be unreasonably low;
- changes are issued soon after contract awards to delete or modify line item requirements;
- line items for bids are different than the actual contract;
- bidder close to procurement personnel or participated in drafting specifications.

5. Rigged specifications

Scheme description:

Requests for bids or proposals might contain specifications which are tailored to meet the qualifications of a particular bidder, or which only one bidder can meet. This is particularly common in IT and other technical contracts.

Specifications which are too narrow can be used to exclude other qualified bidders, or to justify single source acquisitions and avoid competition altogether.

A pattern of rigged specifications which favour a particular contractor suggests corruption.

Fraud indicators:

- only one or a few bidders respond to request for bids;
- similarity between specifications and winning contractor's product or services;
- complaints from other bidders;
- specifications are significantly narrower or broader than similar previous requests for bids;
- unusual or unreasonable specifications;
- high number of competitive awards to one supplier;

- socialisation or personal contacts between contracting personnel and bidders during the bidding process;
- the buyer defines an item using brand name rather than generic description.

6. Leaking bid data

Scheme description:

Contracting, project design or bid evaluation personnel can leak confidential information to help a favoured bidder formulate a technical or financial proposal, such as estimated budgets, preferred solutions, or the details of competing bids.

Fraud indicators:

- poor controls on bidding procedures, e.g. failure to enforce deadlines;
- winning bid just under the next lowest bid;
- some bids opened early;
- acceptance of late bids;
- late bidder is the winning low bidder;
- all bids are rejected and contract is re-bid;
- winning bidder communicates privately with contracting personnel by e-mail or otherwise during bidding period.

7. Manipulation of bids

Scheme description:

In a poorly controlled bidding process contracting personnel can manipulate bids after receipt to ensure that a favoured contractor is selected (changing bids, “losing” bids, voiding bids for alleged errors in specifications, etc)

Fraud indicators:

- complaints from bidders;
- poor controls and inadequate bidding procedures;
- indications of changes to bids after reception;
- bids voided for errors;
- a qualified bidder disqualified for questionable reasons;

- job not re-bid even though fewer than the minimum number of bids were received.

8. Unjustified single source awards

Scheme description:

This scheme often results from corruption, in particular if the pattern is repeated and questionable.

Such awards can be made by splitting purchases to avoid competitive bidding thresholds, falsifying single source acquisition justification, drafting very narrow specifications, extending previously awarded contracts rather than re-bidding.

Fraud indicators:

- single source awards above or just below competitive bidding thresholds;
- previously competitive procurements become non-competitive;
- split purchases to avoid competitive bidding threshold;
- request for bid mailed only to one service provider.

9. Split purchases

Scheme description:

Contracting personnel may split a purchase into two or more purchase orders or contracts in order to avoid competition or higher-level management review. For example, if the threshold is €250,000, a single procurement of goods and services for €275,000 can be split into two contracts – one for goods for €150,000 and the other for €125,000 – to avoid bidding.

Split purchases (often called “salami slicing”) can indicate corruption or other schemes by a purchasing employer.

Fraud indicators:

- two or more consecutive, related procurements from the same contractor just under competitive bidding or upper level review thresholds;
- unjustified separation of purchases, e.g. separate contracts for labour and materials, each of which is below bidding thresholds;
- sequential purchases just under the thresholds.

10. Co-mingling of contracts

Scheme description:

A contractor with multiple similar work orders might charge the same personnel costs, fees or expenses to several of the orders, resulting in over-invoicing

Fraud indicators:

- similar invoices presented under different jobs or contracts;
- the contractor invoices for more than one job for the same time period.

11. Cost mischarging

Scheme description:

A contractor can commit fraud by intentionally charging costs which are not allowable or reasonable, or which can not be allocated, directly or indirectly, to a contract. Labour costs are more susceptible to mischarging than material costs because employee labour can in theory be charged to any contract.

Labour costs can be manipulated by creating fictitious time sheets, altering time sheets or supporting documentation or simply invoicing for inflated labour costs without supporting documentation.

Fraud indicators:

- excessive or unusual labour charges;
- labour charges inconsistent with contract progress;
- apparent changes to time sheets;
- time sheets cannot be found;
- the same material costs charged to more than one contract;
- charging indirect costs as direct costs.

12. Defective pricing

Scheme description:

Defective pricing occurs in contracts if contractors fail to disclose current, complete and accurate cost or pricing data in their price proposals resulting in an increased contract price.

Fraud indicators:

- contractor refuses, delays or is unable to provide supporting documents for costs;
- contractor provides inadequate or incomplete documentation;
- out-of-date pricing information;
- apparent high prices compared to similar contracts, price lists or industry averages;

13. Failure to meet contract specifications

Scheme description:

Contractors which fail to meet contract specifications and then knowingly misrepresent that they have met them commit fraud.

Examples of such schemes include the use of sub-standard building materials, inferior quality parts, failure to lay the required foundation in road projects etc. The motive, of course, is to increase profits by cutting costs or to avoid penalties for failing to meet deadlines etc. Many such schemes are difficult to detect without close inspections or tests by independent subject matter experts. The fraudsters may seek to bribe the inspectors though.

Fraud indicators:

- discrepancy between test and inspection results and contract claims and specifications;
- absence of test or inspection document or certificates;
- low quality, poor performance and high number of complaints;
- indications from the contractor's expense records that the contractor did not e.g. purchase materials necessary for the works, does not own or did not lease equipment necessary for the work or did not have the necessary labour on the site (NB: this type of cross-checking can be valuable).

14. False, inflated or duplicate invoices

Scheme description:

A contractor might knowingly submit false, inflated or duplicate invoices, either acting alone or in collusion with contracting personnel as the result of corruption.

Fraud indicators:

- invoiced goods or services cannot be located in inventory or accounted for;
- no acknowledgment of receipt for invoiced goods or services;
- questionable or no purchase order for invoiced goods or services;
- contractor's records do not reflect that the work was done or that the necessary costs were incurred;
- invoice prices, amounts, item descriptions or terms exceed or do not match contract items, purchase order, receiving records, inventory or usage records;
- multiple invoices with the same amount, invoice number, date etc;
- sub-contracts in cascade;
- cash payments;
- payments to off-shore companies.

15. Phantom service providers

Scheme description:

a) An employee can authorise payments to a fictitious seller in order to embezzle funds. The scheme is most common where there is a lack of segregation of duties between requisition, receipt and payment.

b) Contractors can set up phantom companies to submit complementary bids in collusive bidding schemes, to inflate costs or simply to generate fictitious invoices.

Experience has shown that fraudsters tend to use names of companies which are similar to the names of real companies.

Fraud indicators:

- service provider can not be found in any directories, the Internet, Google and other search engines etc;
- service providers address can not be found;
- the service provider lists incorrect street address or phone number;
- off-shore company used.

16. Product substitution

Scheme description:

Product substitution refers to the substitution, without the purchaser's knowledge, of inferior quality items for those which are specified in the contract. At worst, product substitution can be life-threatening, e.g. deficiencies in infrastructure or buildings. Substitution is particularly attractive in contracts calling for expensive high grade materials that can be replaced by similar appearing, much less expensive, products. The substitution often involves component parts which are not easily detected. Specially created samples can also be presented for inspection in order to deceive.

Fraud indicators:

- unusual or generic packaging: packaging, colours or design different than the norm;
- discrepancy between expected appearance and actual appearance;
- product identification numbers differ from published or catalogue numbers or numbering system;
- above average number of test or operation failures, early replacements, or high maintenance or repair costs;
- compliance certificates signed by unqualified or non-certified person;
- significant difference between estimated and actual costs for materials;
- contactor is behind schedule but quickly catches up;
- unusual or obliterated serial numbers; serial numbers are not consistent with legitimate manufacturer's numbering system;
- invoice or inventory item numbers or descriptions do not match purchase order terms.

LABOUR CHARGES AND CONSULTANCY SERVICES FRAUD

Common and recurrent fraud schemes and the relevant fraud indicators (red flags)

This annex lists common and recurrent fraud schemes with a description of the scheme and the relevant fraud indicators in the area of consultancy services.

The most important control in the labour accounting system is the individual employee and the employee's acceptance of the responsibility to accurately record time worked.

This is a non-exhaustive list of generally recognised schemes:

1. Incurred labour cost

Scheme description:

Without any external independent or physical verification, labour is very vulnerable to manipulation. A promoter might knowingly claim false labour, direct and indirect. The critical issue is whether the employee's time is properly charged to the project actually worked on. (No third party documentation may exist such as invoices, purchase orders, etc., to support labour costs).

Fraud indicators:

- distinctive charging patterns;
- sudden, significant shifts in charging;
- decrease in charges to projects/contracts in overrun or near ceilings;
- a disproportionate percentage of employees charging indirect;
- large number of employees reclassified from direct to indirect or vice versa;
- same employees constantly reclassified from direct to indirect or vice versa;
- weak internal controls over labour charging, such as employee time cards signed in advance, employee time cards filled in by the supervisor, time cards filled in with pencil or time cards filled in at the end of the pay period;
- actual hours and euros consistently at or near budgeted amounts;
- use of adjusting journal entries to shift costs between contracts, R&D, commercial work;
- significant increases or decreases in charging to sensitive accounts;
- employee's time charged differently than associated travel costs.

2. Uncompensated overtime

Scheme description:

A promoter might knowingly claim false overtime where no informal credit for the extra hours, such as additional time off, is usually given. The critical issue is whether the employee's time is properly charged to the project actually worked on. No third party documentation exists.

Fraud indicators:

- professional staff required to work a significant amount of unpaid overtime on a variety of projects-both direct and indirect;
- salaried employees only charging the regular hours worked during any day for an extended period;
- a pattern of management directed unpaid overtime with employee bonus based on the extra hours worked;
- overrun contracts/projects worked on only during unpaid hours.

3. Consulting/professional service

Scheme description (based on a real case):

The services were properly supported with detailed consulting agreements, invoices and reports. The subjects covered were germane to the contractor's operations and provided appropriate recommendations to improve the efficiency of certain operations. The contractor implemented the majority of the recommendations. The applicable agreements contained the necessary level of detail and the fees were considered reasonable.

However, for some companies contracted, their services were not previously used. The agreements were not specific in what services the companies were to provide; however, they did detail who would perform the services and the hourly rate involved. The individuals' resumes were not available. The fees were higher for these new companies. The company representative could not explain the higher fees or the specifics of what services were to be provided.

Moreover, invoices from these companies for services rendered in addition were vague in describing services and only referred to the agreement. The expense was a lump sum with no breakdown of hours spent, hourly rate, travel expenses or other expenses. No trip reports or other summary reports were available. No additional information on these companies was available; the promoter was unable to provide anything other than verbal assurances of the services provided.

Finally, the invoices showed a post office box as a mailing address and no listing of these companies in the telephone directory.

Fraud indicators:

- no formal signed agreements or contracts; however, large sums paid for "services rendered" based on invoices with few specifics;
- formal agreements or contracts exist but are vague as to services to be rendered, and no other documented support, such as detailed invoices, trip reports or studies, exists to justify the expenses;
- services paid for were used to improperly obtain, distribute or use information or data protected by law or regulation;
- services paid for were intended to improperly influence the content of a solicitation, the evaluation of a proposal or quotation, the selection of sources for contract award or the negotiation of a contract, modification or claim. It does not matter whether the award is by the prime contractor or any tier subcontractor;
- services paid for were obtained or performed in some way that violated a statute or regulation prohibiting improper business practices or conflict of interest;

4. Labour categories

Scheme description (based on a real case):

A contractor's proposal for a renewal of time and material (T&M) contract, which had been awarded on a yearly basis for the last two years, indicated that the incurred hourly rates were significantly lower than the proposed rates, except for the administrative category. The original proposal had a full work force on board when the contract was originally bid. After being awarded the contract, the contractor hired/used employees at lower salaries than proposed. The qualifications of some of the newly hired employees were below the requirements per the request for proposal. The contractor had placed many of the newly hired employees in labour categories, for which they did not qualify.

Fraud indicators

- significant differences between proposed and actual unit costs or quantities with no corresponding changes in work scope or job requirements;
- task-by-task invoicing consistently at the ceiling level established in the contract. An exception would be if the contract/work order specifies how many hours to bill;
- specific individuals proposed as "key employees" not working on the contract;
- proposed labour not based on existing work force. Massive new hires needed. New hire labour rates significantly lower than proposed;
- employees' skills do not match the skill requirements as specified for their labour category or the contract requirements;

- employees typically charged indirect by the company being charged direct to the contract;
- partners', officers', supervisors' and other employees' time being charged in noncompliance with the contract terms or with the company's established accounting policies and procedures.

PROCEDURE FOR REPORTING OF FRAUD TO THE EUROPEAN ANTI-FRAUD OFFICE (OLAF)

Managing authorities or other authority designated to report on irregularities and fraud to OLAF:

Quarterly reporting in accordance with Commission Regulations (EC) N° 1681/94 and (EC) N° 1831/94 for cases related to the programming period 2000-2006 and in accordance with Commission Regulation (EC) N° 1828/2006 (Articles 27-36) for cases related to the programming period 2007-2013.

Specific instructions to audit authorities²²:

An auditor performs an audit to obtain reasonable assurance that management and control systems function effectively so that certified expenditure is legal and regular. Auditors are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud. However, when obtaining reasonable assurance, an auditor maintains an attitude of professional scepticism²³ throughout the audit. If during risk assessment, planning of the audit or system and substantive tests, the auditor concludes that circumstances indicate the possible existence of fraud, he/she needs to know how to deal with the suspected fraud and how to report it.

The fraud suspicion is **not communicated to the audited entity concerned** (in order to ensure that evidence of fraud is preserved).

The auditors should inform the managing authority or other authority designated to report irregularities to OLAF of the suspected fraud (unless the alleged fraud concerns the Managing Authority itself or another designated responsible body) in order to allow it to take any necessary steps and protective measures to safeguard the Community's financial interests, including coordination with national bodies competent in fraud/irregularities.

General instructions to EU citizens:

Anybody can inform OLAF about suspicions of fraud or corruption affecting the financial interests of the European Union. The general rule is: the earlier and the more concrete the information, the better. Any available documents to support the information, should be provided as well.

²² DG Regional Policy and DG for Employment, Social Affairs and Equal Opportunities have established their own internal fraud reporting procedures for its auditors and staff.

²³ 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". (IFAC, "*Handbook of International Auditing, Assurance, and Ethics Pronouncements*")

In this framework a key role can be played by the OLAF Anti-Fraud Communicators Network (OAFCN) (*), which includes the OLAF Spokesman, spokespersons responsible for public relations and information officers in the national investigation services, with which OLAF co-operates in the Member States.

(*) http://ec.europa.eu/anti_fraud/olaf-oafcnc/en.html

OLAF can be approached in all official languages through these different channels:

- By letter to: European Commission, European Anti-Fraud Office (OLAF), Investigations+Operations, B-1049 Brussels, Belgium

- By e-mail to: OLAF-COURRIER@ec.europa.eu

- Via the [freephone](http://ec.europa.eu/anti-fraud) lines (<http://ec.europa.eu/anti-fraud>)

All contact details: http://ec.europa.eu/anti_fraud/contact_us/index_en.html