

Understanding Government Auditing

Recent US corporate collapses, such as Enron and WorldCom, focused world attention on the role and performance of auditors.

According to one international authority, the consequence has been “a loss of confidence in financial statements, in the accounting and auditing professions, and capital markets”. Yet he went on to say, “Enron’s financial statements look good by comparison with the financial statements of many, if not most, governments around the world.”¹

Such opinions are concerning, especially as many different stakeholders rely upon auditors to provide them with comfort and assurance about financial statements and probity.

Misunderstandings persist about auditors, audit institutions, powers of auditors, their accountability, and their processes.

What is an External Audit?

In essence, an external audit is an expression of opinion by a person, possessing the necessary qualifications, on the assertions of other persons responsible for keeping financial records and preparing financial statements. The opinion-giver may be acting on behalf of a government audit institution or a firm of public accountants.

In all organizations, whether in the public or private sector, the responsibility for the accurate recording of transactions and the preparation of financial statements, in accordance with appropriate accounting policies, rests with the management of the entity. Such responsibilities include putting in place and maintaining accounting records and internal controls, preventing fraud and error, and safeguarding assets.

The auditor must carry out such examination of the statements and records and control systems as is necessary to form their opinion.

In the private sector audit examinations are normally undertaken in accordance with the professional standards laid down by the professional body to which the auditor belongs and having regard to legislation, regulations and, where appropriate, the terms of the audit engagement, and reporting requirements.

Public Sector Auditing is a Vital Part of Effective Governance

The starting point in looking at public sector audits is the manner in which the people are governed. Where there is a system of representative democracy and responsible government, the institutions of government and the officials and agencies of government exist to serve the interests of the public. In

such a constitutional system, the parliament is the public’s representative forum and it derives its ultimate legitimacy from the public on whose behalf it has been elected and acts. Parliament has the responsibility to promote the goals of openness, accountability and integrity.

The public sector auditor is normally referred to as the Office of the Supreme Audit Institution (SAI) or Auditor-General. It provides a critical link between the public sector on the one hand, and the parliament and the community on the other. It alone subjects the practical conduct and operations of the public sector as a whole to regular, independent investigation and review.

It is important for Parliament to ensure that the audit scope of the SAI covers the whole of government, all public sector agencies including state-owned enterprises, companies, and joint ventures in which the government has a controlling interest.

A significant guide was issued in Lima in 1977 and republished in 1998 by INTOSAI, the professional organization of supreme audit institutions in countries that belong to the United Nations or its specialized agencies.² This document, as well as identifying the specific objectives of auditing and stressing the importance of the need for independence of the SAI (see Table 1), sets out the Guidelines on Auditing Precepts. These precepts mirror those normally seen in the pronouncements of the professional bodies, which are binding on auditors in the private sector. However, they do cover some additional areas, such as relationships with Parliament.

The cornerstone of effective governmental audit services is auditor independence from executive government. Where there is not a system of representative democracy and representative government, the independence of the Auditor-General, where such a position exists is of course, less assured. Even in countries where such a system does exist, it can still be challenged.

An example of this occurred in the Australian State of Victoria in 1997. The then Premier stripped the Auditor-General of his powers and staff. However, public and professional reaction led to his defeat at the next election. The new Government reversed the decision and strengthened the independence of the position.

The effectiveness of an SAI is directly dependent on the efficiency of the audit process and the quality and relevance of the information reported to Parliament. It is essential that the formats of the SAI reports presented to parliament are simple, clear, and concise, and as far as possible free from masses of financial detail and accounting terminology.

In some countries, the reports of the SAI, after scrutiny of Parliament, are referred to its committees which then test the views expressed by the SAI, examine officers of the depart-

Table 1. Lima Declaration on the Independence of the Auditor-General

Lima Declaration Criteria

- (i) The SAI and individual auditors should be independent of the executive.
- (ii) The legislature should provide the SAI with sufficient resources, for which the SAI is accountable.
- (iii) The SAI may advise or make recommendations on correcting administrative deficiencies, but it should not take part in management or instruction of staff and avoid any participation that would reduce its independence and objectivity.
- (iv) The legal mandate should allow the SAI full and free access to all premises, records, and persons relevant to audited entities and their operations.
- (v) Provisions relating to termination of appointment or removal from office should be exercisable only by special process akin to that relating to the holders of judicial office.

ments and authorities, and then report to parliament as a whole the results of these examinations.

The cost to the country's economy of poor financial management in the public sector is huge. Similarly, the benefits of good financial management and financial reporting by governments can be immense. One of the important outcomes from the work of the SAI can be improvement in government financial management. Good financial reporting underpins good financial management and it makes it easier to control government expenditure, to set fiscal performance targets, and to measure and improve the efficiency of producing public goods and services.

An example of what can be achieved, is reporting on an accrual basis. These initiatives were principally the result of the work of SAIs in conjunction with various departmental officials and the accounting professional bodies.

Differences Between Public and Private Sector Auditing

There is a clear distinction between the reporting role of an SAI and the manner of his appointment to that of an auditor in the private sector. Some other differences are worth noting.

The public sector auditor follows auditing standards similar to those in the private sector, requires an understanding of the system of government, and gives constant attention to compliance with regulations and statutes. As the Lima declaration states (Section 4), "The traditional task of SAI is to audit the legality and regularity of financial management and accounting."

Another difference is materiality. An auditor in the private sector is given guidance by the professional auditing standards in determining what constitutes "materiality". The private sector auditor, within the professional standards, can ignore certain financial variations in the published accounts. However, the public sector auditor in similar circumstances has to report on the basis that the disclosure is in the public interest. An example is when payments have been made without authority, irrespective of the amount involved.

Probably, one of the most important distinctions is legality and compliance issues. In recent times, the private sector auditor is being given increased responsibilities in corporate law to report legal transgressions by listed companies and their officers.

Legality and regularity has and always should be a primary focus of the public sector auditor. Failure to report to Parliament, abuse of the processes of government by executive government, including Ministers and senior public servants, can facilitate a culture of corruption within government. On occasions, such failure can be due to the failure of Parliament to give adequate powers and resources to the SAI.

Authority of SAIs

It is important to understand that whilst the SAI has the overall responsibility to examine and report on the financial administration, generally the office has no executive power to enforce improvements in financial management and procedures.

Who then is responsible for enforcing accountability in the public sector? It is the responsibility of Parliament, which may be exercised through its legally constituted committees and the government directly through its central agencies such as the Departments of Treasury and Finance.

Audit Regulation and Processes

Following the Enron and WorldCom experience, various governments, which up until now have allowed the auditing profession to be self regulated through the professional bodies, are now looking at putting in place a variety of measures. These include government appointed oversight boards and strengthening of shareholder relationship with auditors. Hopefully, this latter proposal will assist auditors to more clearly identify their true client and assist them when standing up against recalcitrant Boards and CEOs.

In addition to regulation, governments can promote good corporate governance and good financial reporting. Government can lead by example.

Auditing services are based on the application of professional judgment on a range of subjective matters. Auditing of financial statements require an auditor, whether in the public or private sectors to make an assessment as to the acceptability of the accounting policies adopted by management in the preparation of the statements. It is in exercising a professional judgment in this area that the auditors' independence can be most severely challenged. It is interesting that the importance of the auditing profession to the community has been highlighted by the recent failures of a relatively few members of the profession.

Audit Workloads and Performance Measurement

Coping with audit workloads while sustaining quality and meeting deadlines is an ongoing challenge for any SAI. For example, in a State with a population of approximately five million, the Audit Office had responsibility for the conduct of almost 600 financial statement audits. It also tabled 12 reports in Parliament, including 2 omnibus reports on the outcome of financial statement audits, special investigations, and performance audits. The Office also has the responsibility of reviewing the Estimated Financial Statements within the State Budget and reporting on them to Parliament.³

It measured its performance in terms of cost, timeliness, and quality. In the case of timeliness, 90% of audit reports

were completed within statutory deadlines compared to a 100% target.

Consequently, the SAI is not only advocating sound management practices but is also prepared to be transparent in publishing its own achievements against its targets. Its own financial statements are subject to audit and each three years there is a performance audit of the SAI by private sector auditors. These reports are tabled in Parliament. This may be termed 'good practice' as it is not yet applicable in many jurisdictions.

There is always an issue of adequacy of audit resources. This particular SAI completes its almost 600 audits with a staff of 127, and the use of 48 outside external audit providers. About a third of total expenditures are spent on using outside contractors. These professionals provide the additional capacity to cope with audit peakloads as well as providing a form of comparison with and competition for SAI audit managers.

Of course, some SAI's have much larger audit responsibilities and, private sector auditors are contracted to assist. However, the SAI remains responsible for the information supplied to Parliament, and for this reason, the SAI retains control of the audit including the planning and reporting thereof, and in some areas, the provision of audit manuals to guide the conduct of the audit.

Auditing Method Changes Have Improved Quality and Efficiency

Up until about the 1970s, at least in the public sector, the normal auditing function of expressing an opinion had been carried out after a comprehensive examination of the financial transactions. This approach had the effect of placing relatively more emphasis on the transactions and less on the system from which the transactions were derived. It was also labor intensive.

Increased complexities of government activities, coupled with the growth and expansion of advanced computer systems, necessitated the introduction of a more efficient and economical manner of conducting audits. Firstly, sampling of transactions rather than full inspections, reduced audit times. Then came the adoption of 'system based' auditing, a methodology largely developed by auditors in the private sector. Under systems-based auditing, greater emphasis was placed on the effectiveness of managerial controls. Of course, the traditional SAI responsibility of auditing the legality and regularity of financial management was maintained.

System-based auditing consisted mainly of two segments: a) study and evaluation of the system of internal control for the period subject to the audit; and b) actual verification of assets, liabilities, revenues, and expenses which, together with the assurance provided by the system of internal controls, provide sufficient evidence to support the expression of an opinion on the financial statements.

The use of system-based auditing enabled audit work to be reduced to the minimum level consistent with an effective audit, it provided management with an independent and objective analysis of any weaknesses in internal controls, and was particularly suited to the audit of computerized systems.

In the early 1990s, a risk-based approach was adopted for financial audits. This methodology provides a rigorous audit planning process enabling auditors to more directly and effectively assess the risk components of each audit. Extensive use of audit software in the planning, testing, and evaluation phase, plus the use of computer audit data analysis and extraction packages, have led to greater efficiency in the conduct of

financial audits and a corresponding increase in the level of audit assurance.

Whilst management is required to manage risk in an organization and, for this purpose identifies specific risks, such risks are not always audit risks. An example of an audit risk is false journal entries in the weeks before balance date, to inflate profits.

Audit Professional Networks

The position of Auditor-General is a very isolated one and there is a need to establish links with other SAIs to share experiences, knowledge, and methods. One very important role of INTOSAI is the international exchange of experiences. Apart from sharing new developments in the discipline, it provides the opportunity for one-to-one contact and support at the personal level. In the Asia-Pacific area are ASOSIA the Asian organization, which was founded in 1978, and SPASIA the South Pacific organization founded in 1978.⁴

In some areas, additional organizations have been established to promote cooperation. Such an example is the Australasian Council of Auditors-General, which promotes the development of public sector auditing in New Zealand and in Australia at the Federal, State and Territories level. Amongst other functions, it facilitates the setting of core strategic directions for Audit Offices and coordinating the development of a professional quality assurance program for participating Audit Offices.

One additional advantage of membership of these professional organizations is the opportunity for continuing professional development of staff. Highly motivated staff, having strong integrity and with the necessary professional skills, are essential in public sector auditing.

Emergence of Performance Auditing

By the end of the 1970s, there was increasing recognition worldwide that the accountability of public service managers must extend further than compliance with the laws and regulation governing the use of public funds. It was becoming obvious that whilst the system-based audit methodology provided a rigorous examination of financial systems, it did not produce information that enabled audit to report to the parliament on whether the organization's resources were being managed so as to give the community value for its money. And it was just such information that was needed to enable both parliament and the executive government— the primary decision-makers in relation to public funds— to make effective judgments on the quality and effectiveness of public resource management.

The solution was the development in the public sector of what today is generally referred as Performance Auditing, which the Lima declaration refers to being oriented towards examining the performance economy, efficiency, and effectiveness of public administration. It covers not only specific financial operations, but also the full range of government activity including both organizational and administrative systems (Section 4.2).

International experience has shown that, because of government sensitivity to performance audit reports to Parliament, at least in the early stage of their introduction, it is essential that the SAI have a clear mandate from Parliament to cover economy, efficiency, and effectiveness issues.

Also, such audits require rigorous planning with clear budgets for both human and other resources, and where nec-

essary, the use of skills from disciplines, other than in accountancy, and where necessary, use of persons outside the office of the SAI.

Performance auditing requires a different audit methodology to financial auditing although it retains elements of the latter. By way of example, the Audit Office in the State of Victoria, Australia has developed the Victorian Performance Audit Methodology (VPAM). It provides a framework for the conduct of performance audits and special reviews. It addresses both conceptual and policy issues, and establishes procedures for the planning, resourcing, implementation, and reporting phases of an audit. It also addresses management of communications with audited agencies and the engagement of special assistance.⁵

The relationship with audited agencies is one of the most difficult tasks when introducing such audits. Whilst public sector agencies are accustomed to auditors scrutinizing all financial and associated records, to have an auditor identifying matters of efficiency, economy, and effectiveness, can be quite a culture shock for many public service managers.

Unlike the confidentiality of private sector performance audits that are initiated at management request, the public sector audit bares all.

Performance audit reports are presented to Parliament and thus available to the media for publication and opposition spokespersons for comment. Potential embarrassment of such reports can lead to tensions between the Audit Office and the Executive but it should be noted that provision is made in the report for management response to be contained in the report to Parliament.

Audit and Management

In both the private and public sectors, it is management's responsibility to establish strong internal controls. Internal controls were identified in a USA study as follows.

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding objectives in the a) effectiveness and efficiency of operations; b) reliability of financial reporting; and c) compliance with applicable laws and regulations.⁶

Effective internal control requires a strong internal audit function. The SAI should advise on this and foster the establishment of internal audit but a charter defining internal audit's purpose, responsibilities, and authority should be approved by Ministries or for GBE's, the Board, and CEO.

The Charter should clearly recognize internal audit needs to have the necessary resources to address all of its responsibilities and accountabilities.⁷

Strong cooperation is essential between the external and internal auditors. For example, when developing the yearly audit plans, wider coverage of audit risk areas and containment of audit costs can be achieved, by agreement on areas to be covered. Where the external auditor relies on the work of the internal auditor in financial audits, he will need to test

such work to ensure it has been performed to his satisfaction.

In recent times in the private sector, there has been a tendency to outsource internal audit, with in some cases the existing external auditor being appointed. This created a conflict of interest in the audit firm between the partners responsible for each activity. Fortunately, this matter is being addressed, in proposals to strengthen auditor independence, by prohibiting such arrangements. Other weaknesses, created by outsourcing, are the loss of opportunity for training future executives, and the loss of a continuing audit presence, which is one of the key advantages of having an internal audit.

The Institute of Internal Auditors with more than 80,000 members in 120 countries, has developed professional standards for internal audit.

An Audit Committee consisting of a majority of independent/non-executive members of the Board of an entity should have responsibility for oversight of the financial reporting and audit processes. It is essential for achievement of the maximum value from the work of both external and internal auditors.

Diagnostic for Effective Government Audit

In seeking to improve the governance practices, strengthening the role of public audit is a step in the right direction. Typically, they suffer from a) insufficient independence that may show up in changes of appointment when adverse findings are mooted; b) lack of a supporting environment (opposition, public accounts committee, media, and a local accounting profession) to assist in getting their messages across; c) backlogs of audit work sometimes stretching back a number of years that negates the relevance of the office; d) inadequate remuneration to attract and retain caliber personnel; and e) poor organizational arrangements that do not recognize the need to invest in acquiring and maintaining the audit body of knowledge.

These impediments to effective governmental auditing are being addressed in a number of countries through technical assistance of the Asian Development Bank and other multilateral and bilateral agencies. One of the 2003 editions of the Governance Brief will provide an analysis of the experiences gained in the implementation of auditing projects in developing member countries.

¹ Ball, Dr. Ian (CEO, the International Federation of Accountants). 2002. Address to CPA Australia, 23 October.

² International Organization of Supreme Audit Institutions (INTOSAI). 1977. *Lima Declaration of Guidelines on Auditing Precepts*. URL: www.intosai.org.

³ Auditor-General. *Victoria Annual Report 2001-2002*.

⁴ For more details, see www.intosai.org.

⁵ Auditor-General. *Victoria Annual Report 2001-2002*, p. 58.

⁶ Committee of Sponsoring Organizations of the Treadway Commission. 1992. *Internal Control - An Integrated Framework (The COSO Framework)*.

⁷ NSW Treasury. 1995. *Statement of Best Practice Internal Control and Internal Audit*.

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For inquiries, comments, and suggestions, please contact Claudia Buentjen and/or Merly Mallion at RSGR. Previous issues of the Governance Brief can now be accessed through the Governance Website: <http://www.adb.org/governance>.