

Public Financial Management: Audit and Compliance

Unit 1 Public Sector Auditing

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Unit Overview

The purpose of this unit is to provide an overview of public sector audit and to clarify the similarities and differences between auditing in the private and public sectors. The module on the whole is designed to help you think critically about public-sector financial, compliance and performance auditing. You will reflect on the different approaches and the subsequent development of audit as a science.

Unit 1 will also consider fundamental issues regarding the position of public audit in a democratic, constitutional State.

Learning outcomes

When you have completed this unit you will be able to:

- describe the role of the internal and the external auditors within the public sector
- discuss the requirements for the internal and the external audit and the differences between the two
- outline the corporate governance requirements and their applicability to the public sector
- assess how the different aspects of corporate governance impact on audit activity.



Reading for Unit 1

Marlene Davies and John Aston (2011) Chapters 1 'Introduction to audit', 2 'External and internal audit', 5 'Corporate governance' and 18 'Public sector auditing'. *Auditing Fundamentals*. Harlow UK: Pearson Education Ltd.

Alan Millichamp and John Taylor (2018) Chapter 19 'Internal audit'. *Auditing*. 11th Edition. Andover UK: Cengage Learning.

European Court of Auditors (2013) *European Union Direct Financial Support to the Palestinian Authority*. Luxembourg: European Union. Special Report No 14.

1.1 Introduction to Auditing

In general terms, auditing is a social practice that is primarily concerned with the investigation, examination and assessment of objective evidence. Within the context of the public and private sectors, auditing is more specifically related to the carrying out of activities by experts and professionals on the basis of explicit and codified procedures about the conduct of organisations and individuals. Since a few decades ago, most industrialised countries experienced a sharp increase in the intensity and scope of auditing, which stimulated a broad scholarly discussion about the rise of the so-called 'audit society' (Power, 1994; 1999).

The phenomenon was especially prominent in the UK in the 1980s for various reasons, which included the relevance of New Public Management ideas in the public policy discourse, greater political demand for accountability and transparency of public service providers, and the diffusion of quality assurance technologies within the regulatory space. The increased relevance of audit attracted greater attention towards the social and institutional conditions that underpin the development of audit techniques and procedures on the one hand, and of the variety and dimension of the discourse about auditing itself within the society on the other.

Auditing is generally practiced within both the private and the public sectors. We should bear in mind that the two sectors differ in fundamental ways, and these differences matter in terms of institutional arrangements, organisational features, and substantive practices. It is important, therefore, to begin this discussion by highlighting the key differences between the public and private sectors. The private sector includes organisations that lack the 'legal monopoly of the means of armed violence', or what is called in state theory *potestas*. The public sector, instead, consists of a set of institutions which hold the legal monopoly over the means of armed violence, and which use that backing to offer a wide range of goods and services to the general public – services such as education, police and national security; local government services might include leisure centres, crematoria, schools, home helps; health services would cover hospitals and general practitioners; and central government would provide national security and executive agencies that do not operate on a profit basis but on a rate-of-return basis.

In both the private and the public sectors, stakeholders generally bear an interest towards the integrity and soundness of organisational and individual conduct. Professionals within the public sector are typically expected to behave according to canons of stewardship, accountability and capacity to deliver public services at a level of quality that is commensurate with the level of taxation required to finance them. This is very different from the private sector where the objective of profit maximisation is the central theme of the entity. Yet, professionals in the private sector are also typically expected to demonstrate their capacity to realise shareholders' interests while complying with ethical standards of conduct.

Both the private and the public sectors have a need for a sound system of financial, compliance and performance control and comprehensive risk assessment procedures. In this module, we will be especially concerned with auditing and compliance in public sector organisations. However, we will also place adequate attention to principles, techniques and procedures that are commonly followed in the private sector as well. This is because, on the one hand, part of auditing principles and practices are shared between the two sectors. On the other, in many countries nowadays some part of the public sector consists of corporate entities, which are typically subjected to audit according to private sector practices.

1.2 Accountability in the Public Sector

Accountability is an important concept in the public services as the electorate question how taxpayers' money has been spent. The concept of requiring public funds to be monitored and appropriately accounted for is an essential ingredient of public service.

The need to ensure that money is well spent in a transparent and acceptable manner is an essential element in the public sector. As the public sector is funded by taxation, both national and local government accountability exists when parliament undertakes a review or audit of expenditure to ensure that money has been spent in accordance with government policies. Public pressure, especially through the growth in pressure groups, pushes out the boundaries of accountability. The following points are important to consider in this sector:

- Public sector organisations must respond to public expectation. Higher standards of education, better communication links and the influence of the media means that the public are far more vocal in their complaints and their comparison of services, so service providers must be prepared to respond to public demands and needs.
- There are problems linked to the delivery and evidencing of accountability; documenting feedback or outcomes can be difficult as public reactions are subjective and non-quantifiable, as quality is difficult to measure.
- The role of audit in the accountability process is different from that of the audit opinion report that focuses on financial statements. An emphasis on validating data for indicating performance is an important role for audit.

The implementation of the principle of accountability can take at least two forms:

1. *Managerial Accountability* is concerned with demonstrating the attainment of value for money, by such means as, for example, performance indicators, league tables, indicators and targets.
2. *Financial Accountability* is concerned with demonstrating how financial resources have been acquired and spent, especially by such means as


financial statements and other documentation that provides evidence of the activities performed.

Both managerial and financial accountability are important in informing public debate on taxation levels and the quality of public services provided.



Reading 1.1

You should now study Chapter 1 in your key text by Davies and Aston, for getting an idea of internal and external *financial* audit. For an account of the public sector, please read the beginning of Davies and Aston's Chapter 18, pages 251–56.

 Make sure that your notes on the reading are clear on the essential differences between public and private sector auditing.

Davies & Aston (2011) Chapter 1 'Introduction to audit' and an extract from Chapter 18 'Public sector auditing' in *Auditing Fundamentals*. pp. 1–6; 251–56.


To this respect, you should know that there is a radical difference between audit in the private and in the public sector, which is that while the former stops at financial control, verifying the correctness and reliability of the accounts, the second goes on to verify the legality and regularity of the transaction that underlie those accounts. Besides, the public audit can also consider issues of performance, that is, the value for money of the activities realised by the public organisations.

Coming back to the distinction between internal and external audit, your next reading will introduce you to the difference between the two.



Reading 1.2

The audit function splits into external audit and internal audit. While these two functions should complement each other, they are very different, as you will see when you have studied Davies and Aston's Chapter 2, and the relevant sections of their Chapter 18, pages 261 from the section 'External audit in the public sector', to 273, which you should do now.

 After completing your reading, list the main differences between external and internal audit.

Davies & Aston (2011) Chapters 2 'External and internal audit' and 18 'Public sector auditing' in *Auditing Fundamentals*. pp. 2–24; 261–73.

Your answer should note that the statutory duty of external audit is to provide an opinion on whether the financial statements are presented fairly. External auditors also evaluate the performance of internal audit and carry out an overall risk assessment. In doing so, they expect proper records to be kept, and report directly to the public and its elected representatives. They provide cut-off tests to ensure that items are cited in the correct financial year, and verify the assets and liabilities which appear in the Statement of Financial Position.

Internal audit provides a more detailed risk assessment and evaluates the systems of internal control. This requires a substantial degree of testing. Internal auditors examine all aspects of the organisation's activities, including operational issues and compliance requirements.

In several countries external audit is performed by Supreme Audit Institutions, which may be variously denominated (*eg* Financial Controller, Comptroller General, or Auditor General). Internal audit, instead, is typically carried out by internal audit units (*eg* internal control offices) within public sector organisations. Generally, the work of the external auditors is largely dependent on the quality of the work done by internal auditors.

The UK is a fairly typical example of the global audit model. The office of Comptroller and Auditor General is prevalent in most countries and the work of external audit is underpinned by the reliance on the quality of work performed by internal audit.

1.3 External Audit in the Public Sector

External audit work is typically carried out by members of the accounting and legal professions. As qualified members of professional bodies, they continually have to be monitored and must demonstrate a portfolio of continuing professional development. They must follow a code of ethical conduct and their work and behaviour must follow acceptable standards. Some of these bodies have a global presence while some countries have their own equivalent professional bodies.

In England, for example, auditing work is carried out by members of the Institute of Chartered Accountants in England and Wales (ICAEW), while Scotland and Ireland have their own professional bodies. The association of Certified Accountants and The Chartered Institute of Public Finance and Accountancy are the main defenders and audit policymakers. They have traditionally upheld the integrity of the audit profession, and currently audit policy feeds into the Financial Service Agency. Recent years have seen a growth in the Institute of Internal Auditors, which has global reach, particularly in the USA and Canada.

In France, audit professionals are typically members of the *Compagnie Nationale des Commissaires aux Comptes* (CNCC). Many auditors in the public sector, especially of the National Audit Institution (*Cour des Comptes*) are graduates of the National School of Administration (*École Nationale d'Administration* or ENA). Other countries similarly have their own professional audit bodies.

External audit in the public sector is typically performed by Supreme Audit Institutions at the central level, possibly in conjunction with regional branches and additional statutory bodies. There exists, however, quite an amount of variation of institutions and organisational arrangements for the carrying out of external audit across the world (Dye & Stapenhurst, 1998), as listed below:

- Various countries (including France, Italy, Spain, Portugal, several Latin American countries, and some francophone African countries) follow the Napoleonic system of entrusting the Supreme Audit Institution (*Cour des Comptes*) with both judicial and administrative

powers, and of making it independent (typically on a constitutional basis) from the legislative and executive powers of the state.

- Other countries (including the UK, Canada, Australia, India, and various Caribbean, Pacific and Sub-Saharan countries) adopt the Westminster system of establishing an independent auditing office that reports directly to the parliament and holds no judicial functions.
- Other countries (especially in Asia) use the board system of appointing an auditing body that assists parliament to exercise oversight on public spending and revenues.

According to Davies and Aston (2011: p. 262), there are three fundamental principles that underpin public audit. These are as follows:

External audit in the public sector is typically performed by Supreme Audit Institutions at the central level, possibly in conjunction with regional branches and additional statutory bodies. There exists, however, quite an amount of variation of institutions and organisational arrangements for the carrying out of external audit across the world (Dye and Stapenhurst, 1998), as listed below

- The identifiable independence of the public sector auditor from the organisation being audited.
- The scope of public audit is much wider than that of the private sector, in that it not only undertakes the audit of financial statements, but is responsible for regularity (legality) audit, probity (propriety) audit and also value for money.
- The public sector auditor has an additional reporting arm as compared to the private sector auditor in that it can make known their concerns and findings in the form of reports in the public interest to the public and to democratically elected representatives.

External audit is far from a static body of accounting and legal practices. The following example from the UK and France shows that external audit institutions can be reformed under political and financial pressures and that their mandate can be significantly extended over time.

1.3.1 External audit in the UK

External audit in the UK centres around the National Audit Office (NAO), which is an independent parliamentary body responsible for auditing central government expenditure. Formed in 1983, the NAO is headed by the Comptroller and Auditor General (C&AG), who is an officer of the House of Commons. Reports of the C&AG are received by the Public Accounts Committee (PAC), which is itself traditionally chaired by a member of the opposing political party. The NAO is therefore totally independent of government and scrutinises public spending on Parliament's behalf.

Through the Comptroller and Auditor General, the first role of the NAO is to report to Parliament on the spending of central government money. Specifically:

- the NAO conducts financial audits and reports to Parliament on the value for money with which public bodies have spent public money
- its relations with Parliament are central to its work
- it works closely with the Public Accounts Committee, and with other public audit bodies that have roles in other areas of public expenditure
- around 50 Value for Money audit reports are presented to Parliament each year by the Comptroller and Auditor General.


Source: www.nao.gov.uk

In Wales, external audit is carried out by the Wales Audit Office (WAO). In Northern Ireland, departmental spending is audited by the Northern Ireland Audit Office (NIAO), apart from expenditure on law and order, which is controlled by a UK department and is audited by the NIAO as an agent of the NAO. External audit in Scotland has been carried out, since 2000, by the audit body Audit Scotland and specifically under the responsibility of the Auditor General for Scotland, which reports to the Scottish Parliament.



Reading 1.3

Turn now to Davies and Aston, and study pages 256–62 of Chapter 18. This explores the following in the context of the public sector: auditors, external and internal audit, and developments impacting on current auditing practices.

 Make notes on the role of the National Audit Office and the office of the Comptroller and Auditor General. Search online to ascertain how it compares with External Audit central institutions in your own country.

Davies & Aston (2011)
Extract from Chapter 18
'Public sector auditing' in
Auditing Fundamentals.
pp. 256–62.

1.3.2 Local government and specific services

In the past, the appointment of auditors responsible to the local government in England and Wales (drawn from the District Audit service or biggest five accounting firms, known as the 'Big Five') was carried out by the Audit Commission. However, from 2012, this duty of the Audit Commission was discontinued, and now large firms of Chartered Accountants carry out this work. The Accounts Commission has a similar role in Scotland, and in Northern Ireland the appointment of auditors is the responsibility of the Northern Ireland Department of the Environment.

National Health Service

The summarised accounts for the NHS are audited by the NAO in Great Britain, and the NIAO in Northern Ireland. Responsibility for the appointment of auditors to health authorities and NHS Trusts lies with the Audit Commission and Accounts Commission in their respective areas, in Northern Ireland, the Department of Health and Social Services in their respective territories. Firms of Chartered Accountants have taken over the audits and now carry out the external audit role.

Police Authorities

The NAO audits the Metropolitan Police in London and is responsible for the audit of the Police Authority for Northern Ireland (the work being undertaken by the NIAO on its behalf). Auditing of other police authorities is the responsibility of the local government.

1.3.3 The demise of the Audit Commission

In the past, external auditing of local governments and other public services (such as the National Health Service and Police Authorities) was performed by the Audit Commission, a statutory body established in 1982. From 2012, the duty of the Audit Commission was discontinued and its work was undertaken by large firms of Chartered Accountants (Grand Thornton, KPMG, Ernst & Young and DA Partnership among them). The contracting out of auditing services to accounting firms is expected to result in a reduction of audit fees for local public bodies by 40%, equalling about £30m a year. Savings from the demise of the Audit Commission are expected to be about £250m over five years. Local authorities are audited by Audit Scotland and by the Northern Ireland Comptroller in their respective jurisdictions.

The NAO retains some responsibilities for external auditing of the NHS and some public services like the police, however. The NAO audits the summarised accounts for the NHS (the NIAO carries out this task in Northern Ireland) and the Metropolitan Police in London (the NIAO carries this out for the Police Authority for Northern Ireland). Auditing of other police authorities is the responsibility of the local government.

In addition, the UK government set up the Public Audit Forum to review the integrity and the functionality of the audit role. It has the key principles of independence, objectivity and integrity as the essential components which underpin the organisation. There has been discussion about the level of non audit duties carried out by some bodies and how this impacts on independence. Similarly, a recent area under review has been the issue of audit rotation with firms expected to retender for their work at the end of their contract. The objectives of the Public Audit Form are as follows, to:

- bring consistency to the different approaches of the four audit bodies in the UK
- ensure that public sector audit operates in a consistent and more principled way
- support the improvement of public services, by improving co-ordination, setting common standards and minimising the burden of auditees
- ensure a high standard of audit services
- address the criticism of lack of uniformity in auditing standards across the different bodies
- help promote better management and decision-making leading to a better use of taxpayers' money

- play an important role in the corporate governance arrangements of public bodies
- ensure that the fundamental principles of public audit are underpinned, namely the independence of the auditor, the ability to make known the audit results to the public and elected representatives
- cover the wide scope of public sector audit of financial statements, regularity, probity and value for money.

1.3.2 External audit in France

External audit in France centres around the *Cour des Comptes*, a quasi-judicial body (originally established in 1807) that carries out the audit of most public organisations and some private ones. The mission of the *Cour* includes to:

- audit public accounts
- check the proper use of public monies
- evaluate the performance of the organisation being audited
- certify that accounting has been properly done.

A distinguishing feature of the French system of external auditing is that the *Cour* is required to certify accounts – that is, to officially sanction that accounting (and, related, financial reporting) has been conducted in accordance with laws, regulations, and accounting standards. This function of the *Cour* is especially related to the provisions contained in public finance legislation (precisely the *loi organique relative aux lois de finances* or LOLF – that is, the comprehensive legislation on financial laws, issued in 2001), which mandated the certification of the accounts of public sector organisations and of social security bodies. This function also includes the possibility for the Parliament to require the *Cour* to undertake specific inquiries or investigations.

Within the functions of the *Cour*, the evaluation of the performance of the organisation being audited is a relatively novel one. Indeed, it was the Constitutional Reform in 2008 that explicitly introduced a role for the *Cour* to assist the Parliament in the evaluation of public policies. In accordance with the extended mandate, the *Cour* currently audits agencies and other public bodies taking into consideration not only their compliance with laws, regulations and accounting standards (*régularité*), but also their efficiency, economy, and effectiveness in the attainment of public objectives (*efficience, économie, efficacité*).

At the sub-national level, external audit in France is carried out by regional and territorial chambers of audit (*Chambres régionales des comptes* or CRCs) formed within the decentralisation policies initiated in the 1980s. In the past, local authorities were subjected to strict administrative supervision of representatives of the State. At present, the CRCs hold the investigative powers to carry out inspections, hearings, and inquiries that serve the audit functions. As for the national *Cour*, regional External Auditors also carry out the audit of public accounts, the check on the proper use of public monies, the evaluation of organisational performance, and the certification of accounts.

Exercise 1.1

- How is external audit carried out in the country where you are from or where you currently live? (Search online if you are unsure how to answer the question).

You are invited to post your answer on the discussion forum on the VLE.

1.4 Internal Audit in the Public Sector

Internal audit plays an important role in both private and public sector organisations. In the private sector, there is no compulsory statutory requirement for internal audit, although there are mentions of the function in some of the various corporate governance reports. In fact, the development of corporate governance as a subject has enhanced the role of internal audit as the ‘internal policeman’ or ‘internal watchdog’. Because of the corporate governance statements in the private sector, the Board of Directors must state in the Annual Report that the issues of governance are delegated.

In the public sector, specific requirements are in place for the establishment of internal audit. In the UK, for example, the chartered Institute of Public Finance and Accountancy (CIPFA) published a code of practice for Internal Auditors in Local Government. This fits in with Section 151 of the Local Government Act 1972, which clearly states that:

Every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that one of their officers has responsibility for the administration of those affairs.


Source: legislation.gov.uk (1972)

This is reinforced with Regulation 6 of the Accounts and Audit Regulations 2003, which requires local government to have an effective system of internal audit and an effective internal control process.

Taking this further, the HM Treasury Government Accounting Manual sets out the need for internal audit in all central government departments. In the National Health Service (NHS) an Internal Audit Manual exists which lays out the benchmark or the minimum level of internal audit cover. Successive Corporate Governance reports are clearly just as applicable to the public sector as they are in the private sector. Due to the responsibility for internal control, the prevention of fraud and the abuse of office lies with the highest level of management, it is clear that the responsibility for this authority is delegated to internal audit. The Head of Audit therefore has the responsibility to report to the highest level of management unedited in his or her own name. This reporting process and the drive towards clarifying risk, compliance and assurance is an essential ingredient and a core requirement for modern public service.

**Readings 1.4 and 1.5**

Study the article on the internal audit in Millichamp and Taylor (2018). In the context of this section, you should also look again at Davies and Aston's pages 262–73 already discussed previously in this unit.

 Look at the literature and list the changes that have shaped the modern internal audit section. This reading and previous notes in the unit will guide your thinking.

Millichamp & Taylor (2018) Chapter 19
'Internal audit'. *Auditing*. pp. 295–302.

Davies & Aston (2011)
Extract from Chapter 18
'Public sector auditing' in
Auditing Fundamentals.
pp. 262–73.

Your answers should contain some of the following:

- a higher profile for internal audit based on the audit committee
- clearer reporting lines to politicians via the audit committee
- assurances that internal audit reports and recommendations will be acted upon
- independent monitoring of audit performance
- the reliance placed on internal audit in respect of providing assurances on the existence of risk management policies linked to corporate governance.

As Davies and Aston note:

The changing face of internal audit in local government has created a more diverse internal audit service that incorporates the internal control review and the assurance role on risk management. There has been a progression from the conventional, basic and traditional minimum audit service as required by statute to the more corporate image of advisor, business consultant and assurance provider as part of the control mechanisms and risk management linked to corporate governance.

Source: Davies & Aston (2011) p. 263.

For a clear diagrammatic account of the changing face of internal auditing in local government, look again at Davies and Aston's Figure 18.1, on page 264 of *Auditing Fundamentals*.

1.5 Political Power and Control

The functioning of any institution in charge of exercising a public power is subject to control. This statement is true for public management as for any other human activity: the control is necessary in order to ensure that the activity in question is achieving the pursued objectives. Every rational human activity has to undergo control procedures, either explicit or implicit. Control means analysing the reality and verifying whether it indeed corresponds to what was expected, and is therefore inherent to the activity of every rational being. The etymology of the word control comes from Old French *contrerole*, a word that comes from the Latin *contrarotulum*, which referred to a counter-roll or register used to verify accounts.

On the other hand, it has to be considered that the institutions exercising public power in modern societies hold fiduciary powers. An actor with

political power is ultimately exercising a type of power that should be directed not to its own benefit but to the benefit of its stakeholders (in a democracy, the people). Control mechanisms are inherent to the rule of law (considered as a model of social organisation where the functioning of public agencies must fully abide by democratically enacted law): for the rule of law to become effective, there's the need for a verification of the compliance of the law by public agencies, and this requires the existence of control mechanisms.

The exercise of political power in a democratic state implies that the state operates, by its very nature, as an agent. The historical architecture of modern social systems makes it difficult for the people to act directly on all matters. The democratic state would therefore be an agent at the service of a principal, which is the people, and like in all principal-agent relationship, there is a risk that the agent will not reflect the wishes of the principal, escaping from its designs, especially when the agent has more information than the principal.

In this case the citizen is in a situation of information asymmetry, where it can be considered that there is not only a need to adjust the course of the activity to the intended objectives, but a need to ensure that the political agent meets the intentions of the principal and thereby ensures a harmonious functioning of the political representation mechanisms on which the democratic government relies. Responsiveness and mutual trust are thus erected as the two fundamental objectives of public control.

How to execute the public budget is determined by legal and political factors. Public finance control involves a comparison between the *be* and the *must be* in order to generate a judgement between the two contrasting dimensions. To the extent that the law is the main instrument for projecting the exercise of the power of the people represented in Parliament, the subjection of public expenditure to the rule of law eventually implies the democratic empowerment of the citizens regarding the exercise of financial power, on free and equal terms.

1.6 The Control of Public Spending in the Genesis of Constitutionalism

Democratic political systems are based on the general principle that the sovereign power resides in the people. Realising this principle requires the creation of control and accountability circuits. The clearest accountability circuit in democratic systems is that of free and fair elections in order to form a Parliament (in parliamentary systems), or to form a Parliament and elect a President (in presidential or semi-presidential systems). Additionally, once the popular will has been expressed through free and periodic elections, operational control mechanisms will be put into place that ultimately seek to ensure that political action coincides with the will expressed by the people.

These mechanisms may provide the basis for the eventual implementation of other mechanisms of accountability articulated through instruments of political confidence or legal responsibility. In parliamentary systems there will be mechanisms of political confidence (through which the Parliament can withdraw its confidence from the Government), as well as other mechanisms of coordination and control (*eg* parliamentary questions and interpellations, or the reports of the Ombudsman); whereas in presidential systems there are no instruments of political confidence, only control mechanisms designed to ensure both the balance of power and the coordination between legislative and executive.

An essential control mechanism in both presidential and parliamentary systems is the budgetary control, articulated mainly around the approval by the Parliament of the execution of public expenditure by the Executive. It is evident that the consequences, in terms of accountability, which are derived from such controls can be more radical in the case of parliamentary systems.

In its general design the public finance control system is configured according to a pyramidal structure with superimposed control subsystems: internal, external, judicial, political and social. At the bottom of this pyramid of budgetary control lies the layer of internal control: performed by the executive itself to verify that the public administration is spending its budget legally and regularly, and is complying with the guidelines set by the government.

Upon the basis of the internal control operates the external control, composed of external audit services (Supreme Audit Institutions – SAI) to verify that the budget is implemented in a legal and regular manner. The external control of public expenditure helps the legislative power in its control over the executive. The SAIs are specialised bodies to assist the legislative in the highly technical competence of public expenditure control. In this regard the SAI is responsible for reducing the information asymmetry between Parliament and Government, in the same way that the Parliament, in its public discussions, manages to reduce the information asymmetry between government and society, and the bodies of internal control on their part try to reduce the information asymmetry between Government and Public Administration.

It is interesting to analyse why the Parliament delegates on a specialised institution the responsibility for controlling the budgetary execution made by the Government. After all, audit activities could be entrusted to private audit firms, or to ad hoc parliamentary commissions (as it was done in parliamentary systems before SAIs were created). The main reason is that the Government has more resources than the Parliament, as well as a greater specialisation among its staff: it is therefore necessary that the Parliament has an expert body to help to face the Government in a situation of ‘equality of arms’. However, this ‘equality of arms’ could well be achieved by commissioning private audit services to specialised companies. Hence, there is a second reason that justifies the existence of specialised bodies of public audit: independence. Indeed, creating a body of external control with a public legal guarantee of reinforced independence helps avoid scenarios of

conflicts of interest that may occur in the case of services provided by private auditors. This guarantee of independence achieves a vital importance in a scenario of pre-eminence of political parties, with a tendency towards the collusion between legislative and executive powers.

Political and external control subsystems are characterised by their constitutionalisation – that is, they are envisaged in the constitutional charters. Most countries provide in their constitutions certain fundamental rules that must meet both external control subsystems (the existence itself of SAIs and the minimum guarantees of their activity), as well as political control subsystems (providing for periodic budgetary review and approval procedures, and more generally, legislative control mechanisms over the Executive). Indeed, the Lima Declaration of the INTOSAI (International Organization of Supreme Audit Institutions) holds as one of its fundamental principles that ‘The Supreme Audit Institutions and the degree of their independence shall be laid down in the Constitution’ (art. 5.3).

1.7 The Purposes of Budgetary Control

According to Art. 1 of the Lima Declaration of INTOSAI, the purpose of external control of public expenditure is composed of three elements, that can be seen in a consecutive or concatenated perspective:

1. Illustration, understanding: involves determining the meaning of the reality of public expenditure, providing transparency. A transparency that aims to shed light on the mistakes and failures, in order to provide confidence to the respective stakeholders.
2. Accountability and assumption of the corresponding responsibilities.
3. Feedback or improvement, which conceives the ultimate goal of control as a contribution to a greater effectiveness and responsiveness of Public Administration.

By itself, budgetary control creates a situation of transparency, which might enable processes of accountability, which ultimately might lead to a better responsiveness (that is, better public goods and services). These three elements of transparency, accountability and responsiveness are precisely the three elements that underpin the output legitimacy of the State, in a situation of rule of law. Transparency is the immediate objective of public audit. The other two objectives, accountability and responsiveness, are carried out by other constitutional actors. Except in those cases where the SAI has jurisdictional functions, then the SAI would also be involved in processes of jurisdictional accountability.

These three control objectives also apply to internal control subsystems. However, the position of the internal and external control is very different in the constitutional architecture. Just as much as the historical journey that they have undertaken. The external control emerges as a control circuit in the services of the Parliament, being therefore external to the public administration; its main value is to provide confidence, in the same way that a

private auditor works to provide confidence to shareholders about the management of a corporation. The constitutional position of the external control bodies implies that their main purpose is to promote transparency.


Transparency is a basis for subsequent accountability processes developed in the Judiciary (in cases where fraud is suspected), in the Parliament and in the Society itself (through elections and other channels of participation). Therefore, the external control opens a general transparency exercise that serves as a basis for three processes leading to accountability (judicial, political and social) that, ultimately, will tend to promote a general improvement in the responsiveness of the Government, which shall have to take note if it wants to continue staying in power.



Reading 1.6

An example of external audit

Read the report '*European Union Direct Financial Support to the Palestinian Authority*' issued by the European Court of Auditors (2013). Please especially focus on the section 'Conclusions and Recommendations' on pages 33–35.

 Your notes should enable you to answer the following questions:

- Who are the stakeholders that are interested in the findings of the European Court of Auditors?
- What are the organisational and managerial implications for the administration of the Pegase DFS programme entailed by the recommendations of the Court?

European Court of Auditors (2013)
European Union Direct Financial Support to the Palestinian Authority.
Special Report No 14.

Your answer to the first question should take into consideration that the very nature of the EU programme of assistance in the occupied Palestinian territory (the Pegase DFS) entails the use of EU financial resources to help the Palestinian Authority to meet its obligations to civil servants, pensioners and vulnerable families, maintain essential public services and improve public finances. Stakeholders who are interested in the findings of the European Court of Auditors, therefore, may include the EU citizens, the EU institutions (especially the EU Commission and the EU Parliament), the Palestinian Authority, and Palestinian citizens including the beneficiaries of Pegase DFS-funded actions. All these stakeholders, in fact, are interested in knowing that monies are spent in an efficient and effective way and that any fraud that might occur is timely detected. The report should be of interest to the same European External Action Service (EEAS), however, because it provides an independent view of how well programme implementation works and how it can be improved.

Your answer to the second question should highlight that the Court recommends that various aspects of the Pegase DFS are strengthened. These include improving the planning cycle and monitoring (especially with the development of performance indicators), reducing the cost of administering the programme (especially with greater use of competitive tendering and bringing back some outsourced activities), stimulating the Palestinian Authority to

undertake civil service reform, eliminating salaries to beneficiaries who did not actually work, and developing more collaboration with Israel.

1.8 Conclusion

This unit has provided an introduction to the principles of audit and to the kinds of audit. It discussed the role of accountability, and it drew a clear distinction between external audit and internal audit. There is considerable amount of variety of audit institutions and practices around the world.

We have outlined the crucial role played by public audit institutions in the democratic architecture of contemporary states. SAIs are narrowly linked to the Legislative power, and aim to increase transparency in the management of Public Administration. This exercise of transparency is a necessary prerequisite for accountability and responsiveness, becoming the foundation for the output legitimacy of democratic systems.

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