

# DRAFT

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2. National Association of State Auditors, Comptrollers, and Treasurers
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## PURPOSE

This paper presents our position on the importance of the public sector audit function to effective government and defines the key elements needed to maximize the value the public sector audit function provides to all levels of government. The principles we discuss are relevant to national, regional (i.e., state, provincial, etc.), and local (counties, cities, or villages) governments, as well as quasi-governmental organizations, and inter- or multi-national government organizations and may also apply to other publicly-funded entities.

This paper is addressed primarily to elected and appointed government officials, as well as advocates of good government everywhere. Its purpose is to cause readers to reflect on the government audit functions that now serve their jurisdictions and evaluate how those audit functions can be supported to most effectively fulfill their highest role in the governance of public sector institutions. In those jurisdictions where a government audit function is needed, this paper can provide the initial guidance for decision-makers on what outcomes and services are to be expected, and what elements are needed to achieve the most effective audit function.

More detailed and specific guidance on the standards, model legislation, and other tools for creating and improving government audit services are available from any of the endorsing organizations.

Organizations endorsing this position are:

- The Institute of Internal Auditors
- National Association of State Auditors, Comptrollers, and Treasurers
- The U.S. Comptroller General's Domestic Working Group
- ***Your name here!***

### Terminology: Internal and External Audit

This paper is intended to address the *role* of government audit, regardless of its placement and reporting relationship. Globally, the terms “internal audit” and “external audit” have different meanings in different contexts. *Solely for the purposes of this paper*, we use the terms to denote *the reporting line of the chief audit executive*. In this paper, “internal audit” refers to the government audit function whose chief auditor reports to the executive head or an *appointed (non-elected)* governing body of the government or government organization subject to audit. “External audit” refers to the audit function whose chief auditor either is elected or reports outside the management hierarchy of the governmental activities subject to audit, such as to a parliament or legislature.

Outside the simplicity of the distinctions described above, can be found a myriad of government audit functions whose reporting relationships vary in some manner from this usage. Their reporting lines may have been designed to fit a specific governmental structure, or they may have been modified, expanded, or blended in response to specific needs and concerns. The wide variety of reporting lines and governance structures for government audit may ultimately lead to a blurring of the distinctions between “internal” and “external,” and could even justify the abandonment of the terminology altogether in the public sector context.

Moreover, this paper does not address the form of employment—contracting versus in-house hires. For instance, while the term, “external audit,” is commonly used to refer to financial statement opinion audits conducted under contract by commercial audit firms, where the audit is

provided for a government, it constitutes a government audit regardless of the mode of employment of those conducting it.

## **EXECUTIVE SUMMARY**

The government auditors' role is a combination of "oversight, insight, and foresight." Oversight ensures that government entities are doing what they are supposed to and also serves to detect and deter public corruption; insight assists decision-makers by evaluating what programs and policies are working; foresight identifies trends and emerging challenges. Financial audits, attestation, performance audits, **as well as** investigation, and advisory services are the tools auditors use to fulfill each of these roles. Audits have different objectives but share common elements:

- ◆ Independent
- ◆ Objective
- ◆ Systematic
- ◆ Evaluation of evidence (reports, condition, or accomplishments)
- ◆ Comparison to criteria (standards, goals/targets, benchmarks, laws)
- ◆ Reported to sponsor (such as the public or elected officials)
- ◆ Performed to professional standards

These elements are the foundation of the audit function's credibility, which is the primary value the audit function brings to government. Because auditors are credible, the audit function strengthens public governance by providing for accountability and protecting the core values of government—ensuring managers and officials conduct the public's business transparently, fairly, and honestly.

The government auditor's core function is to provide unbiased, objective assessments of the use of public resources—a role that helps maintain the public's confidence in the accountability and probity of government operations, and assists public officials in making decisions. The audit function counterbalances the moral hazards that are inherent in the access to resources and authority the public grants government officials to exercise in its service.

Because government's success is measured primarily by program delivery, government audit functions should have authority and the competency to evaluate both financial integrity and program economy, efficiency and effectiveness.

### **Recommendations**

Ideally, governments will have both an internal and external audit function. The internal audit function's focus should be to provide objective assurance and advisory services designed to add value and improve the government's operations. The external audit function's focus should primarily be to provide assurance to elected officials and citizens that the government is operating economically, efficiently, and effectively and in compliance with applicable laws and regulations.

*At a minimum*, every government requires one independent audit function. The government audit function's mandate should be as broad as possible to enable it to respond to the full scope of the government's activities.

Although the means to accomplish them will vary, all government audit functions require:

- Organizational independence
- Legal mandate.
- Unrestricted access.
- Sufficient funding.
- Competent leadership.
- Competent staff.
- Stakeholder support.
- Auditing standards.

Governments must establish protections to ensure that internal audit functions are empowered to report significant issues to appropriate oversight authorities. One means of accomplishing this protection is through creation of an independent audit committee.

Government auditors' advisory/assistance services should never assume a management role. Moreover, auditors must maintain independence and objectivity for any subsequent audits conducted where advisory/assistance services have been previously provided.

Government auditors work in different types of organizational structures and provide a variety of services. Auditors' scope of work may encompass all aspects of the organization, including governance and risk management systems, or may focus more narrowly on specific aspects of operations, such as contract or regulatory compliance. While auditors may be able to add value to any segment of the organization over which they can provide independent, objective assurance, our position is that, *at a minimum*, every government requires an independent audit function, headed either by a qualified elected official, or by a qualified official appointed by the legislature or other ruling body. Most governments should also have an internal audit function appointed by and reporting to management. The government audit function's mandate should be as broad as possible to enable it to respond to the full scope of the government's activities.

The key elements that support an effective government audit function are:

- Organizational independence
- A clear legal mandate
- Unrestricted access to employees, property and records
- Sufficient funding relative to the size of its audit responsibilities
- Competent leadership
- Competent staff
- Stakeholder support
- Professional auditing standards

Independence is the most fundamental element of an effective government audit function. Because government audit's role is to provide unbiased and accurate information on the use and results of public resources, auditors must be able to conduct and report on their work without interference and without the appearance of interference. Such independence is achieved by protections across three dimensions—structural, environmental, and personal. Structural independence requires the audit function to report outside the hierarchy of the organization under audit. Environmental independence requires auditors to be free to conduct their work without interference from the organization under audit such as could occur if the audited entity controls budget or staffing for engagements, restricts access to records or employees, or has authority to overrule or modify audit reports. Personal independence requires auditors to be free from conflicts of interest or biases that would affect how the auditor conducts the work or reports results.

## Examples of Audit Standards

### **In use by government auditors**

*Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors

*Auditing Standards* issued by the International Organization of Supreme Audit Institutions (INTOSAI)

*Generally Accepted Government Auditing Standards* issued by the United States Government Accountability Office

*Government Internal Audit Standards* issued by H.M. Treasury, United Kingdom

## PUBLIC SECTOR GOVERNANCE

*"Broadly speaking, corporate governance generally refers to the processes by which organizations are directed, controlled, and held to account."*

Australian National Audit Office, *Corporate Governance in Commonwealth Authorities and Companies*, 1999

Government auditors play an important role in effective public sector governance. To describe how the government audit function enhances overall public sector governance we must first describe and discuss governance principles. The term governance refers to how an organization makes and implements decisions—"the processes by which organizations are directed, controlled, and held to account." Because governments throughout the world are structured differently, with different and possibly overlapping mandates and jurisdictions, no single governance model applies to public sector organizations. Nevertheless, elements of governance are common across the public sector, however diverse their application.

### Elements of Governance

Some elements of governance are relevant to any private or public sector organization:

- ◆ **Setting direction:** Good governance establishes policy to guide an organization's actions. In government, policy may be directed through broad national goals, strategic plans, or legislative guidance. A government's policies—or at least its priorities—can generally be found in its budget, which allocates limited resources to specific activities.
- ◆ **Overseeing results:** Good governance requires continuing oversight to ensure that policy is implemented as intended.
- ◆ **Ensuring accountability:** Because executive organizations act as "agents" to use resources and authority to accomplish established goals, the agents must account for how they used the resources and what they accomplished. Accordingly, good governance requires regular financial and performance reporting that is validated for accuracy by an independent third party. Accountability also implies imposing penalties or sanctions against those who have misapplied the resources for purposes other than intended.
- ◆ **Correcting course:** When the organization has not achieved its financial or operational performance goals, a good governance system will identify the cause of the lapse and determine corrective actions needed.

In virtually all jurisdictions the public sector plays a major role in society, and effective governance in the public sector can encourage the efficient use of resources, strengthen accountability for the stewardship of those resources, improve management and service delivery, and thereby contribute to improving peoples' lives. Effective governance is also essential for building confidence in public sector entities — which is in itself necessary if public sector entities are to be effective in meeting their objectives.

International Federation of Accountants (IFAC) *Governance in the Public Sector, a Governing Body Perspective*, 2001

Other elements of public sector governance arise from the unique nature of government. Governments hold coercive (police, taxation, and regulatory) powers over citizens and economic enterprises, and therefore must enact protections to ensure accountability in the use of those powers. These protections are fundamental in democratic systems in which citizens endow the government with its powers. Non-democratic forms of government also find advantages in supporting accountability measures to ensure that officials use resources and authority to meet the aims of the ruling body, lending authorities, and alliances. Moreover, good public governance requires fair and impartially enforced legal frameworks.

## Elements of Governance Essential to Public Sector

Along with ways to direct, control and hold the organization to account, effective public sector governance encompasses the core values of transparency, equity, and probity:

- ◆ **Transparency:** The core value of transparency means that the government's decisions, actions, and transactions are conducted in the open—particularly in democratic forms of government. Many governments require public documents to be disseminated or made available on request or require meetings of elected officials to be publicized with prior information on the decisions to be taken. While the public's interest is sometimes served by protecting information from disclosure—such as instances where national security, criminal investigations, or the proprietary information of a private company would be compromised—the transparency of government actions and information plays a significant role in public oversight, and public sector governance.

The principles of good governance – transparency and accountability; fairness and equity; efficiency and effectiveness; respect for the rule of law; and high standards of ethical behaviour – represent the basis upon which to build open government.

Organization for Economic Cooperation and Development (OECD) Policy Brief: *Public Sector Modernisation: Open Government*, 2005

Auditors **can** provide a direct link between transparency and the credibility of the government. Lawmakers and the public look to audits for confidence that government actions are ethical, within the law, and that financial and performance reporting is accurate and reflects a true measure of operations.

- ◆ **Equity:** The core value of equity relates to how fairly government officials exercise the power entrusted to them. Citizens in democratic governments grant their agents—government officials—both money and power to carry out their responsibilities. Citizens are concerned with both the misuse of government power and waste of government resources.

Governmental equity can be measured and evaluated across four dimensions: service costs; service delivery; police power; and the exchange of information.

Service costs include direct taxes and fees charged by the government, but may also include indirect costs resulting from government action or inaction. Service delivery includes direct services such as transportation infrastructure, and indirect services such as financial stewardship and human capital management. Police power concerns the government's use of its coercive powers—arrest, property seizure, eminent domain, and various regulatory processes such as granting liquor licenses or building permits. Exchange of information relates to transparent decision-making including access to government officials and the ability to be heard.

The chief aim of the Lima Declaration is to call for independent government auditing...this independence is also required to be anchored in the legislation. For this, however, well-functioning institutions of legal security must exist, and these are only to be found in a democracy based on the rule of law.

Rule of law and democracy are, therefore, essential premises of really independent government auditing and are the pillars on which the Declaration of Lima is founded.

Dr. Franz Fiedler, Secretary General of the International Organisation of Supreme Audit Institutions (INTOSAI) 1998.

- ◆ **Probity:** The core value of probity calls for public officials to act with integrity and honesty. The erosion of public trust, if public information and actions are not reliable undermines a government's ability to govern. The principle of probity also applies when information is disseminated to lending authorities or other principals who have an interest other than an ownership share. The consequences of violating the expectation for probity can be swift and shattering.

## PUBLIC SECTOR AUDIT

### Definitions and Origins of Audit

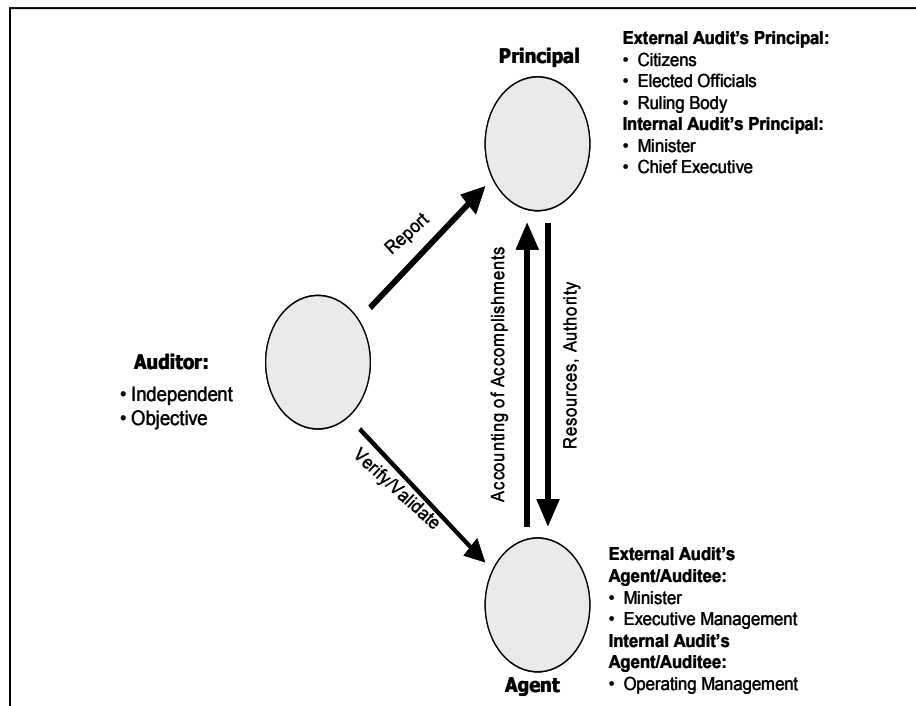
*"The need for financial accountability has existed ever since it became necessary for one individual to entrust the care of his possessions or business to another."*

--Wilson Committee, 1975

An audit function reduces the risks inherent in a principal-agent relationship, in which the owner of resources—the principal—must depend upon **another—the agent**—for the custody and use of the resources. The principal relies upon the auditor to **monitor, assess, and report on** whether the agent uses the resources in accordance with the principal's wishes. The public sector represents a principal-agent relationship. In democratic governments, citizens own the resources and authority used by government officials—elected or appointed. In monarchies, the ruler owns the resources and authority used by officials. In either case, the officials—acting as the principal's agent—must periodically account to the principal—the people, their elected representatives, or the ruler—for their use and stewardship of resources, and the extent to which the public objectives have been accomplished.

The auditor provides the principal an independent, objective evaluation of the accuracy of the agent's accounting. The need for a third party to attest to the *believability* (credibility) of the accounting arises from several factors inherent in the relationship between the principal and its agent:

- ◆ **Moral hazards--conflict of interest:** The agent may use the resources and authority to benefit his or her own interests, rather than the principal's interests.
- ◆ **Remoteness:** Operations may be physically removed from the principal's direct oversight.
- ◆ **Complexity:** The principal may not possess the technical expertise needed to oversee the activity.
- ◆ **Consequence of error:** Errors may be costly when agents are stewards of large amounts of resources and are responsible for programs affecting citizens' lives and health.



## DRAFT\*\*The Audit Role in Public Sector Governance\*\*DRAFT

Auditing has evolved as systems, transactions, and operations have become more complex. In its earliest origins (evidence points to audits conducted in Babylonia and Mesopotamia as early as 3,000 B.C.), auditing verified the existence of assets. Over time, auditing shifted from a detailed focus on confirming or validating individual transactions to evaluating the effectiveness of the systems that control transactions. In the 20<sup>th</sup> century, public sector auditors also began to concern themselves with types of transactions and conditions well beyond economics or finances. Since the introduction of social programs, **some** government auditors have been called upon to validate the effectiveness of the government services themselves. **Or, they may be required to determine whether the organization has established mechanisms to measure and report on its effectiveness.**

Some current definitions of auditing illustrate variability in the roles of auditors, while underscoring the fundamental elements of the profession. For example:

Audit serves an accountability relationship. It is the independent, objective assessment of the fairness of management's representations on performance or the assessment of management's systems and practices, against criteria, reported to a governing body or others with similar responsibilities.

--Canadian Comprehensive Audit Foundation, 1991

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

--Institute of Internal Auditors, 1999

While public sector auditing has broadened focus from individual transactions to control systems to program effectiveness, auditing retains the defining characteristics that are the basis of its credibility—the value it provides to the governance process:

- ◆ Independent
- ◆ Objective
- ◆ Systematic
- ◆ Evaluation of evidence (reports, condition, or accomplishments)
- ◆ Comparison to criteria (standards, goals/targets, benchmarks, laws)
- ◆ Reported to sponsor (such as the public or elected officials)
- ◆ Performed to professional standards

### Audit Roles

Auditing is an essential element of a strong governance structure because it strengthens accountability, seeks to improve services that people depend on, and serves as a check on public corruption. The role of government audit has been described as a combination of “oversight, insight, and foresight.” Financial audits, attestation, performance audits, **plus** investigation and advisory services are the tools auditors use to fulfill each of these roles.

The Baek-Du-Dae-Gan (BDDG) mountain range crosses Korea, and is the main source of most water resources in the Korean Peninsula. The Board of Audit and Inspection of Korea inspected development projects that might result in long-lasting damage to the ecosystem, and evaluated the effectiveness of various conservation programs. The audit found that of 72 roads built across the Trans-Korea Backbone, 30 have inflicted damage on the ecosystem. An additional 80 roads not crossing the ridge have been built without due consideration to the ecosystem. This imprudent construction has contributed to frequent occurrence of landslides and flood. Following the audit, the Ministry of Environment has begun devising management and conservation principles for the areas of the BDDG.

*Audit of Conservation and Management of the Baek-Du-Dae-Gan, May 2002, by The Board of Audit and Inspection of Korea*

## DRAFT\*\*The Audit Role in Public Sector Governance\*\*DRAFT

Because government's success is measured primarily by the success of its program delivery, government audit functions should have authority and the competency to evaluate both financial integrity and program effectiveness and efficiency. Moreover, auditors must also protect the core values of the government, as it serves all citizens.

- **Oversight.** Auditors assist decision-makers to exercise oversight by ensuring that government entities are doing what they are supposed to, spending funds for the intended purpose, and complying with laws and regulations. Audits focusing on oversight answer the questions, "Has the policy been implemented as intended?" and "Are managers implementing effective controls to minimize risks?" Audit supports the governance structure by verifying agencies' and programs' reports of financial and programmatic performance, and testing their adherence to the rules and aims of the organization. Moreover, oversight audits ensure public accountability by providing access to this performance information to relevant principals within and external to the organization under audit. Both elected officials and managers are responsible for setting direction and defining organizational objectives. In addition, managers have the duty to assess risks and establish effective controls to achieve objectives and avert risks. In their oversight role, government auditors test and report on the success of these efforts.

Oversight also serves to detect and deter public corruption. Auditors monitor the effectiveness of management's internal control structure to identify and reduce the conditions that breed corruption. In many areas of the world, public sector auditors are also responsible for responding to allegations of corruption in the government organizations they serve.

**Detection.** Detection is intended to identify fraudulent or abusive acts that have already transpired and to collect evidence to support decisions regarding criminal prosecutions, disciplinary actions, or other remedial changes. Detection efforts can take many forms:

- Audits or investigations based on suspicious circumstances or complaints that include specific procedures and tests to identify fraudulent, wasteful, or abusive activity. Alternatively, an audit may have been initiated for unrelated reasons, but red flags appearing during the course of audit work may result in added procedures to specifically identify acts of fraud, waste or abuse
- Cyclical audits testing an organization's internal control environment, such as payroll audits, accounts payable audits, or information systems security audits
- Law enforcement officials may call upon auditors to analyze and interpret complex financial statements and transactions for use in investigating and building evidentiary cases against perpetrators
- Review of potential conflicts of interest during the development of laws, rules, implementation procedures, or contracts

**Deterrence.** Deterrence is intended to identify and reduce the conditions that allow corruption. Auditors seek to deter fraud and abuse and other breaches of the public trust by:

- Assessing controls for existing or proposed functions
- Assessing organizational or audit specific risks
- Reviewing proposed changes to existing laws, rules, implementation procedures
- Reviewing contracts for potential conflicts of interest

Successful detection efforts may also have a deterrent effect.

■ **Insight.** Auditors provide insight to assist decision-makers by evaluating what programs and policies are working and which aren't, sharing best practices and benchmarking information, and looking horizontally across the silos of government and vertically between the levels of government to find opportunities to borrow, adapt, or re-engineer management practices. The audit function helps institutionalize organizational learning by providing ongoing feedback to adjust policies. Auditors conduct their work systematically and objectively to develop a detailed understanding of operations and draw conclusions based on evidence. Therefore, audits can provide a fair description of problems, resources, roles and responsibilities that, combined with useful recommendations, can energize stakeholders to rethink problems and programs. Not only can the performance of the specific program under audit be improved, but working through the issues brought to light by a particular audit can enhance the capacity of government and the public to deal with similar problems. Audits focusing on insight answer the question, "Has the policy brought about the intended results?" Concurrently with the accountability function, audits contribute to improving the operations of government.

Formal requirements on government auditing usually do not explicitly include provisions to stimulate learning behaviour on the part of the public bodies audited. However, in practice, many auditors would agree that the ultimate goal of auditing is to contribute to better performance of auditees. A government audit office can be considered as part of the institutionalised learning abilities of government (Van der Meer et al, 2000). In the traditional policy cycle of preparing policies, implementing them, evaluating them and feeding back the results to adjust policies, the audit function is clearly positioned in the evaluative part of the cycle.

Gerard Bukkems and Hans de Groot, Netherlands Court of Audit, *paper for the 5<sup>th</sup> biennial conference of the European Evaluation Society* Sevilla, October 2002

■ **Foresight.** Auditors also help their organizations look forward by identifying trends and bringing attention to emerging challenges before they reach crisis proportions. The audit function can highlight challenges to come (such as from demographic trends, economic conditions, or changing security threats) and identify risks and opportunities arising from rapidly evolving science and technology, the complexities of globalization, and changes in the nature of the economy. These issues often represent long term risks that may far exceed the terms of office for most elected officials, and can sometimes receive low priority for attention where scarce resources drive more short-term focus on urgent concerns. **Additionally, a more recent development in the profession, Risk-Based Auditing, focuses the audit on the organization's overall risk management framework, which can help in identifying and deterring unacceptable risks. Through risk-based auditing, the audit function helps the organization to manage its risks.** Audits focusing on foresight help answer the question, "What policy revisions or implementation would meet a future need or risk?" When the government auditors focus on trends and look forward they help to inform the political process. Government auditors also play a key role in helping management to develop and coordinate risk assessment. As well, audit's own risk assessment assures that audit resources are effectively used to address areas of greatest exposure.

The United States' long-range fiscal imbalance has been the subject of several reports by its supreme auditor, the Government Accountability Office (GAO). As the country's lead accountability agency, the GAO has undertaken the task of informing the Congress and the citizens of the United States about the serious financial challenges they face. To aid ordinary citizens in understanding the nature of the problem, the information is displayed in context relevant to individuals. For example, the federal government's obligation of \$43 trillion is presented in context of the total \$47 trillion net worth of all Americans. In another example, the burden for every citizen is calculated at \$145,000 or \$350,000 for every full time worker. The GAO has stated that initial steps to address this challenge include the need for a top-to-bottom review of programs, revisiting tax policy and enforcement and entitlement reform.

GAO-- "Saving our Nation's Future: An Intergovernmental Challenge", Outlook 2005 Conference, The National Press Club, Keynote Address by the Honorable David M. Walker Comptroller General of the United States, February 2, 2005

**Auditors protect core government values:** Government auditors help ensure managers and officials conduct the public's business transparently, fairly, and honestly—while conducting their own work transparently, fairly and honestly.

■ **Auditors can serve as a check on abuse of power.**

Government auditors, whether appointed by the legislative, executive, or judicial branch, or elected by the voters, must be prepared to recognize and report abuse of authority or failure to ensure due process in the exercise of a governmental police or regulatory activity. Because such reporting may challenge powerful or entrenched interests, auditors require some measure of job protection to be able to report independently.

■ **Auditors must not abuse their own power.**

The auditors' unique role in government confers power that could be susceptible to abuse. Therefore, auditors' own work must reflect the core values of transparency, equity, and probity. This means auditing issues that matter to people, writing accurate and balanced reports, and making government audit reports available for public examination. Some government auditors may even find themselves presenting their audit findings in televised hearings or committee meetings, contrasting markedly with the corporate world where only executive management or the board of directors are likely to see auditors' comments or reports other than the financial statement opinion. Such reports are unlikely to reach even the shareholders—the veritable owners of the corporation—much less made available for public scrutiny, unless specific legislation—such as the U.S. Sarbanes-Oxley Act—requires additional transparency for specific reports. And certainly, auditors must conduct their work with integrity and in full compliance with laws and regulations.

School bus safety in the U.S. State of Missouri relies on thorough driver screening. The State Auditor found significant weaknesses in this area. Background checks for bus drivers did not include criminal history information outside of Missouri or information from closed State records. Auditors identified 60 bus drivers who had convictions or charges for offenses that are not allowable. In addition, auditors determined that the State agency responsible for licensing bus drivers did not run applicants through the child abuse and neglect database used to screen child care workers. A review of 21,000 bus drivers found 330 had obtained licenses in spite of substantiated abuse and neglect cases. An additional 14 bus drivers had permits revoked based on information auditors obtained from Kansas City police officials. City police records in these cases had not been included in State records.

*Press Release, Report No. 2003-35, Office of the State Auditor of Missouri, April 15, 2003*

## Reporting Line of Government Auditors

Organizational reporting relationships affect the audit function's independence and scope of work. Reporting line or "placement" refers to the organizational structure under which the chief audit executive is appointed and controlled relative to the activities subject to audit. Auditors can be organizationally located any place within a government. However, auditors should only conduct audits of activities that are outside their own reporting line.

Public sector organizations around the globe are complex and diverse. A single governance model for support and oversight of the government audit function will not serve all government entities. Regardless of the governmental structure, the organizational placement of the government audit function should provide sufficient safeguards to prevent the audited entity from interfering with the audit organization's ability to objectively perform its work and report the results.

The audit function's appropriate scope of work also depends on the authority granted to it by its enabling legislation and the needs or risks the organization faces. The government audit function's mandate should be as broad as possible to enable it to respond to the full scope of the government's activities.

A broader focus allows the audit function to contribute more value to the organization. The narrowest audit focus involves testing individual transactions for errors or for compliance with contract terms, policies, regulations or laws. The broadest audit focus considers the organization's governance activities, which can assist an organization to achieve its objectives and priority goals and improve its governance framework, including its ethical code. The auditors' scope of work can also focus between these extremes, such as reviewing internal controls, processes and systems to identify systemic weaknesses and propose operational improvements.

## **Types of Audits**

Government auditors conduct audits with different types of objectives. Government auditors must understand more than accounting standards to assess the success or progress of government activities—they must also master the intricacies of performance measurement. In some cases, auditors can evaluate the reliability of existing indicators, but they must also be able to measure performance to independently evaluate achievements. Moreover, to make useful recommendations on how to improve performance, they must be familiar with best practices in managing the type of operation being evaluated. Performance indicators for government functions vary between different activities (e.g., public health, law enforcement, national security, environmental protection) and results may take years to materialize. Consequently, the means to evaluate government performance vary widely.

- **Financial.** Auditors express an opinion on the presentation of the financial statements in accordance with established or accepted accounting principles (regularity). Often referred to as the “external audit,” this type of audit focuses on the proper accounting for assets and expenditures as reported by the government.
- **Systems and controls.** Government auditors assess the adequacy of: the control environment; the identification, assessment and management of risks; control policies, procedures and activities; information and communication systems and practices; and management's monitoring and evaluation activities.
- **Performance.** Auditors systematically gather evidence to assess aspects of performance beyond financial controls and reporting. Because the types of government services are broad, the types of objectives appropriate for performance audit are broad. Performance audit objectives often assess:
  - Effectiveness – evaluates program accomplishments. Has a program achieved its objectives? What are the program's outcomes or results, both intended and unintended?
  - Efficiency – examines productivity, unit cost, or indicators such as such as utilization rates, backlogs, or service wait times. Do operations maximize outputs in relation to costs and other resource inputs (such as number of license renewals per staff-hour)?
  - Economy – examines the extent to which a government operation has minimized its use of inputs—money, staff resources, equipment, or facilities—consistent with the quality needs of the program. For example, an economy audit may evaluate the validity of a competitive procurement process to ensure that costs were controlled.

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- Compliance – tests the organization's conformity with some objective standard or criteria. Standards typically assessed in compliance audits include state, federal, or local laws and regulations; contract requirements; grant requirements; and organizational policies and procedures. *A relatively new service, environmental auditing, helps to examine compliance with environmental regulations.*
- Data reliability – assesses internal controls and reporting for non-financial matters, such as performance measures.
- Policy and other prospective (forward-looking) evaluations – assessing program or policy alternatives, forecasting potential program outcomes under various assumptions, or evaluating the advantages or disadvantages of various legislative proposals. Auditors may also compile benchmarking or best practice information to assist in evaluating program design or management practices.
- Risks – assist government managers in identifying, assessing and responding to risks that may affect achievement of an organization's strategic and financial goals and objectives. In government, risks go beyond normal financial and operational risks, and can include "political" and "societal" risks. For instance, some government risks involve the political and economic consequences of the public's perception of fairness and equitable treatment of citizens. Auditors also conduct risk assessments to select and plan audits.

- **Advisory, assistance, or consulting services:** Auditors may provide objective, expert advice in a range of areas in which they possess expertise. They may advise on issues related to good governance, accountability and ethical practices; effective risk assessment and management; internal controls; sound business processes; IT systems development and operations; project management; program evaluation; and other areas affecting the effectiveness, efficiency and economy of operations.

Government auditors may independently provide such services as control and risk assessment workshops, training in areas such as fraud awareness, performance measurement, or control design, or provide advice on implementing audit recommendations or other areas in which the auditor has expertise.

In providing advisory/assistance services, auditors should never assume a management role. While the auditors may, in an advisory role, make recommendations to management, they may not make management decisions. Moreover, they must remain cognizant of the need to maintain independence and objectivity for any subsequent audits conducted in any program that has received significant levels of advice or assistance in its formative stages.

### Conclusion:

#### Key Elements for an Effective Government Audit Function

An effective public sector audit function strengthens governance by materially increasing citizens' ability to hold their government accountable. In order to do this, the audit function must be empowered to act with integrity and produce reliable services. The specific means by which auditors achieve and maintain reliability and integrity vary. At a minimum, the following elements play a critical role in meeting these objectives:

- **Organizational independence.** The audit function should be organizationally independent from those it is required to audit (the chief audit executive reports to someone outside the line of authority of the audited entity). Organizational independence allows the audit function to conduct work without interference by the entity under audit. Consequently, the

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auditors' results and report can be relied upon by their users as unbiased, objective, and accurate.

- **Legal mandate.** The audit function's powers and duties should be established by the constitution, the charter or other basic legal document.
- **Unrestricted access.** Audits should be conducted with complete and unrestricted access to employees, property and records.
- **Sufficiently funded.** The audit function must have sufficient funding relative to the size of its audit responsibilities. *This important element should not be left under the control of the organization under audit, considering the impact of budget on the audit function's capacity to carry out its role.*
- **Competent leadership.** The head of the audit function must be able to effectively recruit, retain and manage highly skilled staff. Moreover, the chief audit executive should be an articulate public spokesperson for the audit function.
- **Competent staff.** The audit function needs professional staff that collectively has the necessary qualifications and competence to conduct the full range of audits required by its mandate.
- **Stakeholder support.** The legitimacy of the audit function and its mission should be understood and supported by a broad range of government officials—elected and appointed—as well as the media and involved citizens.
- **Auditing standards.** Professional auditing standards support the *implementation* of the other key elements and provide a framework to ensure audit work is systematic, objective and based on evidence. Just as many governments have adopted internal control standards, either as requirements or guidance for public sector managers, audit functions should conduct their work in accordance with recognized standards.
- **Audit Committees.** *Wherever possible and appropriate, an independent audit committee should be established to oversee the audit function and support its mission.*

In summary, government auditing strengthens public governance by providing for accountability and protecting the core values of government—ensuring managers and officials conduct the public's business transparently, fairly, and honestly. We encourage elected and appointed officials at all levels of government to support effective audit functions by establishing independent audit functions that meet all of these key elements.

### Significant Issues Surround Two Of These Elements

Although each of the elements discussed above are essential to an effective audit function, two—*independence and the audit committee*—require further elaboration. *Independence underlies and supports the audit function's ability to fulfill its accountability role in public sector governance. Unfortunately, internal audit functions in government sometimes struggle to maintain their independence when their duty to the citizens conflicts with the audited organization's desire to avoid negative public exposure. One means for protecting that independence would be the existence of an audit committee. However, it should be noted that the extreme variability of government structures in some cases prevents the ability to create an audit committee. Elsewhere, the governmental structure or other protections may render the need for an audit committee unnecessary. If the government's structure is not conducive to establishing an audit committee, compensating protections should be established to protect the internal audit's ability to fulfill its duty to the public.*

**Organizational independence**—wherein the audit function's reporting relationship is outside the agencies audited—at a minimum helps to ensure the objectivity of the audit work itself.

However, a more fundamental purpose of independence is to ensure that audit results can be communicated to someone who can ensure proper accountability and corrective action.

While government external auditors are organizationally separate from the programs they audit, many government internal audit functions do not have compensating means to protect the integrity of their results—which can jeopardize the integrity of government itself.

Globally, governments at all levels have created internal audit functions to serve organizations through their focused, real-time presence within the organization. Although the internal audit function can add significant value to the organization because of its detailed familiarity and understanding of operational conditions, it may be hampered in upholding the public trust if protections to independence are not established. Governments must establish protections to ensure that internal audit functions are empowered to report significant issues to appropriate oversight authorities.

When the internal audit function reports to officials who are also likely to be held accountable for any significant problems, the function needs safeguards to protect its independence. Examples include statutory requirements that:

- Prevent the audited organization from interfering with the conduct of audit work, the staffing of the audit function, and with the publication of the audit report; and/or
- Ensure the head of the audit function reports to the highest executive level in the government organization; combined with report distribution requirements that ensure transparency of the audit results;
- Require notification to an external oversight entity in the event of plans to dismiss the chief audit executive.

**Audit Committees**--The existence of an effective audit committee, providing independent oversight to internal and/or external audit, can greatly strengthen the independence, integrity and effectiveness on a government audit group. **Every government/public sector organization should consider whether an audit committee is appropriate for its particular situation.**

Public sector agencies with a Board of Directors or other governing body should consider establishing an audit committee that complies with recognized standards and guidelines for audit committees.

In many public sector/government organizations no equivalent to a Board of Directors exists. Where such an organization has an audit group reporting to management (eg. an internal audit group), then an audit committee is recommended if possible and if supported by the legislation and authority of the organization. If established, it should have at least one independent external member. **Another option is to form an audit committee of executives within a separate governmental agency that has oversight or governance responsibility over the organization in which the auditor is employed. For example, Central Harmonization Units, within the Finance Directorates of certain EU countries oversee the audit functions within other agencies, and may form an audit committee to which other agencies' internal auditors provide reports.**

Where the audit function reports to a legislature, an audit committee might or might not be appropriate. This will depend on the circumstances, the nature of the audit function, and the

State and local government retirement plans, participants, and beneficiaries have a direct interest in sound corporate governance, since they are major investors in securities markets. State and local retirement plans collectively invest over \$2 trillion dollars in the public markets. The quality and integrity of corporate governance directly affects the ability of retirement plans to meet their investment goals, and by extension, the ability to meet their long-term obligations to current and future retirees.

GFOA supports corporate governance reforms that enhance transparency and align management and the board of directors with the interests of long-term shareholders. These reforms include, but are not limited to: ...

...the appointment of a majority of independent board members, as well as audit and compensation committees comprised entirely of independent board members...

Government Finance Officers' Association  
Executive Board, March 2005

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decision of the legislature. Similarly, where an organization's auditor is appointed and reports externally, an audit committee may not be appropriate.

Where an audit committee is established, it should:

1. operate under a formal mandate, preferably legislation, with sufficient authority to complete its mandate;
2. include independent members who collectively possess sufficient knowledge of audit, finance, risk and control;
3. be chaired, where possible, by an independent member or the head of the organization, but not by any individual to whom a head of audit reports administratively;
4. assess the effectiveness of the organization's governance, risk management and control frameworks and legislative and regulatory compliance;
5. provide oversight to the organization's internal and/or external audit activity, including ensuring adequate coverage and resources, approving internal audit plans and approving the appointment or termination of internal and external auditors;
6. oversee the organization's financial reporting and accounting standards; and
7. provide a direct link and regular reporting to the organization's governing Board, Council or other governing authority or Head.

## ***Supporting Organizations***

Sponsors of this White Paper include:

### **The Institute of Internal Auditors**

As the only international professional organization dedicated to the practice of internal auditing, The Institute of Internal Auditors is the acknowledged authority on the internal auditing profession. Headquartered in Altamonte Springs, near Orlando, FL, The Institute represents internal auditors in business, industry, government, and education in more than 100 countries. Since its founding in 1941, The Institute has established a Common Body of Knowledge for internal auditors, a continuing professional development program, a quality assurance review program, a Code of Ethics, Standards for the Professional Practice of Internal Auditing, and the Certified Internal Auditor Program. The Institute is also the recognized leader in internal audit research, publications, and education. For more information about The Institute of Internal Auditors, contact:

IIA  
The Institute of Internal Auditors  
247 Maitland Avenue  
Altamonte Springs, FL 32701-4201  
(407) 830-7600  
FAX (407) 831-5171

### **National Association of State Auditors, Comptrollers, and Treasurers**

NASACT, a U.S.-based organization, plans and executes training and technical assistance programs and handles requests for information from state auditors, comptrollers, treasurers, and other government officials, as well as the private sector. The association also monitors information regarding federal legislation and agency developments that have an impact on state government and acts as a liaison with Congressional committees on issues of interest to members. NASACT uses its expertise to provide responses to technical standards-setting bodies, helping to ensure the highest standards of government transparency, accountability and integrity. Within NASACT, two "secretariats" serve members with a specialized focus: the National Association of State Auditors; and the National Association of State Comptrollers. For more information about the National Association of State Auditors, Comptrollers, and Treasurers, contact:

Headquarters  
2401 Regency Road, Suite 302, Lexington, KY 40503  
phone (859) 276-1147, fax (859) 278-0507  
Washington Office  
444 N. Capitol Street, NW, Suite 234, Washington, DC 20001  
phone (202) 624-5451, fax (202) 624-5473

Online

### **United States Comptroller General's Domestic Working Group**

David M. Walker, Comptroller General of the United States, convened the Domestic Working Group in March 2001 to facilitate the interaction of federal, state and local government auditors. The group of 18 top audit officials interacts on an informal basis to address topics of mutual concern. One of the topics of great interest to the group is the presence of effective governance structures within federal, state, local and quasi-public jurisdictions. Because auditing is a vital component of effective governance, the Domestic Working Group embraced the opportunity to participate in the development of this paper. For more information on the U.S. Comptroller General's Domestic Working Group, contact:

**CONTACT INFORMATION TO COME FROM EDITH PYLES**

### **OTHER**

***Principal Authors***

Joseph Bell,  
Director of Internal Audit, State of Ohio Attorney General's Office, USA

Jerl G. Cate,  
Chief Internal Auditor, State of Oregon Judicial Department, USA

Mark Funkhouser,  
City Auditor, Kansas City, Missouri, USA

Steve Goodson  
Chief Audit Executive, State of Texas Commission on Environmental Quality, USA

Jerry Heer,  
Director of Audits, Milwaukee County, Wisconsin, USA

Ann-Marie Hogan,  
City Auditor, Berkeley, California, USA

Jacques R. Lapointe  
Former Chief Internal Auditor & Assistant Deputy Minister, Government of Ontario, Canada

Robert Schaefer,  
Director of Internal Audit-retired, State of Wisconsin Department of Employee Trust Funds, USA

Dan Swanson,  
Director of Professional Practices, The Institute of Internal Auditors

Colleen Waring,  
Deputy City Auditor, City of Austin, Texas, USA

***Whose name is missing?***

***With Special Assistance From:***

Elizabeth MacCrae, CCAF-FCVI (formerly the Canadian Comprehensive Audit Foundation)

Amanda Noble, City of Atlanta, Georgia, USA

Kinney Poynter, National Association of State Auditors, Comptrollers, and Treasurers

Edith A. Pyles, United States Government Accountability Office

John J. Radford, Oregon State Controller, USA

Sharon Smith, retired from U.S. Federal Deposit Insurance Corporation

Bernice Steinhardt, United States Government Accountability Office

Paul Wallis, Government of Ontario, Canada