

**PERFORMANCE AUDITING FOR GOVERNMENT FINANCIAL
MANAGEMENT**

By

**Mortimer A. Dittenhofer, PhD, CIA, CGFM,
Professor Emeritus
Florida International University**

**Florida International University
Sixteenth Annual Conference
Wednesday, April 10, 2002
Miami, Florida 33133**

**International Consortium for Government
Financial Management**

Introduction

Internal or performance auditing as a professional business type activity was formally recognized as a profession as a result of the creation of the Institute of Internal Auditors in the 1940s in the United States. The name was not descriptive of a unique method of auditing, but it was needed to identify a difference between it and the external practice of public accounting. At that time most of the internal auditing was also financial in nature and it was believed that such a descriptive identity was needed.

However, as organizations expanded to a greater extent, and as resources became more scarce, and as the size of organizations defied personal observation, the auditors were encouraged to broaden their investigations into efficiency in the use of the scarce resources. The auditing for compliance, a logical part of most financial auditing and the auditing for effectiveness came later; the latter still is in a continuous developmental stage.

Today most governments of any size use internal auditing by indigenous or external staffs and the auditing is generally the board scope auditing that is identified as performance auditing.

Uniqueness of the government operations

Governments, our current subject of interest, are creatures of law and as such, they can do only what the law allows, in contrast to organizations in the private sector that can do anything not prohibited by law. Also, we must keep in mind that governments are traditionally almost universally committed to fiscal accountability, a process that provides a visible trail as to where resources come from and where they go. However, development in the USA of the Government Accounting Standards Board tends to convert this strict fund accounting into an accrual accounting that will provide governments with more useful information as to the expenditures of government resources.

There are significant operational differences between the public and private sections¹

- *Performance criteria.* The private sector has customer satisfaction converted into profits as a measure of performance. The public sector tries to use efficiency, effectiveness, and conformance to budgets as performance measures. These criteria are subjective and, therefore, difficult to measure.
- *Accessibility of government decision making to external influence.* Most government work is open to the public, to interest groups, and to the media. Businesses, except in directors' meetings, can operate in reasonable privacy. Thus the public official may be responding to conflicting priorities and values.
- *Conflict between government policymakers and administration.* Elected officials usually make policy, and the administration carries it out. These two groups generally have different goals and objectives, respond to different interests, and are rewarded for different functions.

- *The employment contract.* Patronage and civil service systems in government reward employees for political activities or seniority rather than for efficiency and productivity.
- *Intense scrutiny by the media and public interest groups.* Since government resources come from the public in the form of taxes, the government is fair prey for the media and public-interest groups. Government officials, thus, exert much time and effort in protecting themselves, which is counterproductive to innovation and risk taking.
- *Emphasis on stability and reliability.* The emphasis in government is on reliability, accountability, and legality rather than on maximum effectiveness and flexibility.
- *Atmosphere of control and mistrust.* Since the government worker is subject to strict controls designed for the lowest common denominator in capability and trust, the capable and trustworthy employee may conform to these low expectations.

- *Difference in status.* Working for the government is, in many ways, considered a lower-status occupation than working for private-sector organizations. This situation is a morale problem in many government agencies.

The consideration of these factors is important, because they describe a series of unique, personal problems that affect the attitudes of government officials. The government manager is not only responsive to the usual personal and group behavioral pressures but also is influenced by reactions to many of these factors.

Basic premises

During the development of government performance auditing standards by a work group sponsored by the USA General Accounting Office, and later in revisions thereto, it was believed necessary to establish a series of basic premises to serve as a foundation. These premises follow.²

- Public officials and others entrusted with handling public resources are responsible for applying those resources efficiently,

economically, and effectively to achieve the purposes for which the resources were furnished.

- Public officials and other entrusted with public resources are responsible for complying with applicable laws and regulations.
- Public officials and others entrusted with public resources are responsible for establishing and maintaining effective controls to ensure that appropriate goals and objectives are met; resources are safeguarded; laws and regulations are followed; and reliable data are obtained, maintained, and fairly disclosed.
- Public officials and others entrusted with public resources are accountable both to the public and to other levels and branches of government for the resources provided to carry out government programs and services.

- Audit of government reporting is an essential element of public control and accountability.
- Public officials have a responsibility to provide audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. Auditors can assist public officials and others in understanding the auditors' responsibilities and other audit coverage required by law or regulation.
- Performance auditing contributes to providing accountability because it provides an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision making by parties with responsibility to oversee or initiate corrective action.
- To realize governmental accountability, the citizens, their elected representatives, and program managers need information to assess the integrity, performance, and stewardship of the government's activities.

- The comprehensive nature of auditing places on the audit organization the responsibility for ensuring that:
 - the audit is conducted by personnel who collectively have the necessary skills,
 - independence is maintained, and
 - applicable standards are followed in planning and conducting audits and reporting the results.

Visions and Missions

In the past, government performance auditing organizations believed it essential only that they had a charter. This document described such items as authority, responsibility, methods of operation, position in the organization a reporting structure. Current thinking is that this charter concept is not enough. Students of organizational operations find it defective because it is too limiting and because it not address the potential benefits that performance auditing can provide to all of its stakeholders.

It is now believed appropriate to establish a vision statement; a description of what the performance auditing organization will do and its contribution to the well being of the organization and to those other organizations and individuals associated on its periphery. This vision statement serves as an objective with a series of goals that will enhance its existence and service.

On the other hand, a mission statement is more concrete, it might be said that it is a description of how the vision is to be accomplished. Missions are descriptions of activities to be accomplished by the government performance auditing organization. The activities have a specific intent and a definable impact in a specific and demonstrable area of performance.

The government performance auditing organization should go through these exercises in order to establish the “big picture” of why it is in existence and what, ideally, it should and will accomplish. With these

pictures in place, the organization can develop congruent plans, policies and procedures.

A recommended plan for government performance auditing

In a recent monograph, “Recommended practices for state and local governments” (1999), the US Government Finance Officers Association put forth the following:

- Every government should use performance auditing to help management to maintain comprehensive internal controls -- especially for areas where there is a high degree of risk.
- The performance audit operation should be established formally by legal charter.
- The audits should be conducted in accordance with a body of professional audit standards such as the *US Government Audit Standards (Yellow Book)*.
- Performance auditors should report to the head or deputy head of the government or to an executive branch audit committee. (Note:

in many cases such reporting is made to a legislative committee or highly placed official.)

- The head of the performance audit function should hold a college degree, possess adequate experience, and have a professional certification.
- All performance audit reports should be available to a government audit committee.

Use of appropriate staff to conduct the audits

Because performance auditing was significantly different from the traditional financial audits of governments, it was necessary to modify the requirements for the competencies of the auditors who would perform the expanded audits. Two specific areas were concerned: qualifications and independence:

Qualifications

- the staff should collectively possess the knowledge and skills necessary for the performance auditing operation. For example: management principles, and interpersonal relationship.

- The performance audit staff should have a complete knowledge of government operations, accounting, and auditing procedures.
- Where specialized skills are not present, such skills should be obtained through the use of outside sources.
- The performance audit staff should be required to participate in continuous educational activities.
- The performance audit staff should be proficient in communication and in the behavioral aspects of the audit process.
- The performance audit staff should be computer literate.

Independence

- The performance audit staff and the individual staff members must be free from:
 - Personal impairments relating to: financial interests; biases and/or prejudices; previous positions of authority; or previous operations now being audited.
 - Organizational impairments relating to the place of the audit organization within the structure of the government.

- External impairments such as: external influences or limitations on audit scope; interference on audit procedures; time restrictions; interference in the personnel management processes; restrictions of available resources; authority to override audit judgment; jeopardizing continual employment of audit staff members.

On an overall basis, performance auditors should be removed from the political process. Politics can completely destroy the element of independence. Also, there must be a presumption of independence as well as to establish the credibility of the performance audit process.

Scope of the performance audit

Governments are not operated on a profit or loss basis. There is no direct relationship between the revenues received by a government and the various outputs and outcomes achieved by the government organization. Thus, there is no direct relationship between the input of resources by the government and the results of the government's operation as there is in the private sector. This phenomena was

recognized in the early 1970s when the US government developed its Government Audit Standards (*The Yellow Book*) and the governmental work group that generated these standards believed to expedient to substitute certain other relationships to replace the traditional profit and loss approach and to expand the scope of the usual audit process.

These expanded measures were believed necessary to determine the quality of government operations, namely efficiency, economy, and effectiveness (or program results). Thus, the performance audit examined these aspects and reported to government management, legislatures, and to the people the conditions under which their governments were operating.

Descriptive material from the *US Government Audit Standards* (1994, p.14) relative to this audit activity follows:

Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3)

whether the entity has complied with laws and regulations on matters of economy and efficiency.

Performance audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

These aspects of auditing also can be applied to organizations in the private sector. However, they are more diagnostic and indicative of problem areas. Thus in government they are substitutes for the well-being status of the government. The above includes an unique area of coverage. That is the attention by the auditor to compliance with statutes, laws, and regulations. Because the government may do only the things that it is authorized to do, and in many cases using the methods that are prescribed. Thus the compliance audit assumes a major part of the governmental audit activity, not necessarily replicated to the

same degree in the private sector. The compliance audit also applies to determining compliance with contracts, grants and other instruments both direct and indirect.

The audit of internal controls

An area of performance audit activity that is replicated from private sector auditing is the review of internal controls. This review may be even more important in government because of the predominance of statutes and regulations that are descriptive of the expected results but that are not explicit as to the methods to be used to achieve them and especially as to the internal controls that should protect the government. Some of the control-related matters that are identified in the *US Government Standards* (1994, pp. 56-7) include:

- Lack of segregation of duties;
- Lack of reviews of transactions, accounting and systems output;
- Lack of safeguarding of assets;
- Absence of control tasks such as reconciliations;
- Absence of control consciousness in the organization; and

- Deficiencies in design of control systems, e.g., internal check and documentary controls.

In addition, there are several other internal control elements that are important to the government operation. Three of these are:

1. lack of a system of authority and responsibility;
2. lack of a clearly defined organizational structure;
3. absence of an internal audit operation.

Analytical auditing

A fairly recent development in government performance auditing is the use of analytical auditing procedures. These procedures comprise the development of relationships between financial aspects, between physical or operational aspects, or between financial and physical or operational aspects. This procedure infers that there are normal relationships that exist or that should exist; and that unless they do so, that there must be mitigating circumstances, or if not, that an investigation should be made to determine why not.

This technique tends to identify areas that should be the subject of more depth of the investigative process. It also, conversely, can identify areas where little or no investigation, in depth, need be made. The concept of reasonableness is the key and it is evaluated by the auditor's judgment, experience, and intuition. Several examples would be

- The relationship of delinquent taxes to tax assessments
- The amount of fines paid as related to the number of traffic tickets issued, and
- Payroll fringe benefit costs compared with total employee salaries.

There is also a reverse aspect in this area. Where the auditor knows of variations that should take place, for example, resulting from new laws or procedures, if there are not the expected variations, the situation should be subject to review as to determine the absence of the expected variation.

The method can be used as an indication of potential areas of interest. However, it should not be used in a positive way, without further examination, to indicate an absence of problems.

Consider risk aspects

It has been conventional wisdom that performance auditing of various organizational functions such as purchasing, management of capital assets, cost distribution and motor pool operations be performed on regular cyclical basis. To a degree, risk and exposure were generally considered in establishing the timing of the cyclical audits. However, the cyclical auditing continued. The result was two-fold.

1. Many audits contained little in the way of substantive findings and were of little interest to management other than to disclose that things were seemingly under control.
2. Areas where there was considerable risk and exposure were given little attention because of the diversion of audit effort to the cyclical audit process.

Government management may have been aware of the risk of potential problems relating to financial risk, operational risk, sensitivity risk and objective risk. However, the audits were not programmed to

audit material risks in these areas, except as they might be the part of the cyclical audit engagement. Thus, audits were not productive in being responsive to material aspects of these risks and, thus, were not providing government management with information to use in the development of strategic direction of the organization.

An inventory of the organization's important risk areas should be worked out with various levels of government management and the audit effort should be diverted into those areas. Audit objectives and scope should be directed so that management is provided with early intelligence as to risk exposure so as to immediately initiate damage control procedures when the audit discloses problems, or to establish controls to preclude potential problems when the audit findings identify vulnerability to substantial problems in the risk areas. This type of performance auditing results in greater productivity in spending the internal audit dollar and provides a greater pay-back of the audit process.

The COSO (Committee of Sponsoring Organizations of the Treadway Commission, 1992), concept of internal control contains

among its five major elements, one element that is related to the assessment of risks. The risks are divided into two entity-associated groups. These are:

1. External factors:

- Technological development
- Changing customer needs and expectations;
- Competition;
- New legislation/regulations;
- Natural catastrophes;

2. Internal factors:

- Information systems design;
- Quality of personnel;
- Changes in management responsibilities;
- Nature of the entity's activities;
- The effectiveness of the legislative oversight committee.

To these factors might be added several more common factors that are operational in nature such as:

- Quality of internal control systems;
- Size of the entity in revenues and assets;
- Liquidity of assets;
- Complexity of operations;
- Rapidity of growth.

All of these factors are criteria that are used to identify the possibility that conditions in the individual or combined factor areas, could adversely impact on the organization. The auditor should evaluate the criteria to determine where audit effort should be directed. However, before making this decision, the auditor should determine which risks have a high priority and how to deal with them. Some considerations are (Daignault, 1996):

- How much do management and the auditee care?
- How can the conditions be changed, improved?
- How bad is the situation?
- How important is the situation to the organization
- What resources are available?

Subsequently the performance audit operation should follow-up the risk-oriented audit so as to ensure that constructive steps have been taken to contain the damage in the risk areas.

A new risk-associated area that should also be considered by the internal auditor is “risk management”. This concept is that some risk is organically advantageous to the organization; an example is the granting of credit relative to tax functions. The auditor should determine that the organization has a procedure to determine optimum risks and not the elimination of all risk.

E-business

Computers are being used almost universally in the governmental operational and business processes. The impact of this methodology is that electronics are taking the place of the time-honored paper trails to which we are all accustomed. The result is the loss of the paper trail, the basis of much of the current auditing process. For example, in an e-inventory operation the computer will:

1. Determine reorder points of inventory items based on the following information automatically fed into:
 - Planned usage;
 - Price fluctuations;
 - Delivery availability;
 - Current carrying costs.
2. Automatically create an electronic requisition.
3. Convert the requisition to an electronic purchase order by querying potential vendors' web sites for cost elements, e.g. price; discounts; delivery aspects (FOB points, delivery discounts, time, etc.).
4. Select an optimum vendor arrangement and electronically order the materials.
5. Accept computerized receiving and inspection reports.
6. Edit and audit the information so as to make payment to the vendor by electronic transfer to the vendor's bank.

No paper has been created except possibly receiving and inspection reports. Thus, the auditor is faced with the task of determining if there are controls in place to assure the validity of the transactions. Also, the auditor must determine the integrity of the controls and their susceptibility to tampering.

The e-business methodology is permeating the entire fabric of government operations, especially public safety, health, public finance, human relations, maintenance, capital asset management, risk management, and tax management. The performance auditor must blend the knowledge of accounting and management information systems with an extensive knowledge of controls and potential risk areas and with a sharply acute sense of innovation, intuition and professional skepticism.

Quality control

Standards of quality must be observed so that they will produce information that is dependable and appropriate for use by the government performance audit department's customers. However, reference to the Institute of Internal Auditors' *Standards for the*

Professional Practice of Internal Auditing (IIA, 1978) contains

performance standards that provide these elements:

- The auditing should be performed with objectivity by auditors who are completely independent in actuality and appearance.
- Audits should evidence the use of comprehensive planning and should show the consideration of allowing for contingencies.
- The auditing should reflect the application of appropriate skills, background and experience of the audit staff.
- Communications as described elsewhere, should be appropriate, both oral and written, to convey the audit message.
- Auditors should ensure the reliability and integrity of information resulting from the audit work and should demonstrate these characteristics in the audit work itself and the reporting of the effort.
- The auditing activity should reflect state-of-the-art analysis of pertinent information.

- Information collected should be analyzed and interpreted using sound logic and reasoning.

The government performance audit organization should “establish and maintain a quality assurance program ... that will ensure that quality work conforms to the Audit Standards and to good auditing practice” (IIA, 1978). Substandard work should be immediately identified and steps taken to remedy the problem and to prevent its recurrence.

Privileged and confidential information

Governments are unique in that there is usually information that is prohibited from general disclosure. The information is provided on a need-to-know basis only to persons authorized by law or regulation to receive it (US Government Audit Standards, 1998, p. 97). If the audit report omits such information, the audit report should state the *nature* of the information omitted and the reason why it is omitted.

Implied here is the requirement that the auditors who are working in the area where such information is available must be cleared for the exposure to the restricted information. It also means that the audit

organization must have secured areas for the storage of the restricted information. Where the transfer of information is necessary, adequate security provisions must also be provided.

Government performance audit reporting

There are some specific unique aspects relative to the reporting on the performance audits of governments (*US Government Audit Standards*, 1994, pp 88f). Obviously all audits should culminate in a report, occasionally oral but always finalized in a written document. Specifically audit reports should.

- Be available to the public³
- Be open to the media on a timely basis;
- Provide timely information to all appropriate levels of government management.

As to report content, the Standards state that the reports should include:

- The audit objectives.

- The scope of the audit as related to the depth of the audit and the coverage such as efficiency, economy, effectiveness, compliance, and management controls.
- The methodology used including comment on constraints that may be influenced the audit results.
- Significant audit findings including noncompliance and abuse.
- Conclusions or inferences about the subject matter of the audit.
- Recommendations as to actions that should be taken to resolve conditions reported as audit findings.
- The views of responsible officials of the auditee organization along with the auditors' comments pertinent to the auditee's views.
- Noteworthy accomplishments by the auditee.
- Items needing further study.

The audit reports should be complete, accurate, objective, convincing, clear, and concise and should be distributed according to law or regulation in a timely manner.

Conclusion

In conclusion, it seems appropriate to quote from an article by the State Auditor of Texas (*Internal Auditor*, 1992):

Government leaders are being forced to look at government spending in new ways. Because there are limited resources and unlimited needs, leaders must decide which programs to fund and which to cut.

Before setting spending priorities, government leaders need to know:

- Which programs provide the most for the money (economy).
- Which programs work well (efficiency).
- Who really gets the services (effectiveness).
- Which programs actually product (program results).
- Which program can be reduced or eliminated.

In today's economy, all levels of government face serious funding problems. Demand for government services continues to grow, but available funding is not keeping pace. Citizens are unwilling to tolerate tax increases, but the responsibilities of governments are increasing.

Performance auditing can contribute materially to the resolution of this situation.

Notes:

¹ The list of unique aspects of government are those used by the author in lectures, augmented by ideas contained from Eddy (1981).

² The premises are stated in abbreviated form. Reference to *Government Audit Standards* published by the US General Accounting Office, June 1994, pp 8-10 should be made for the complete explanatory language.

³ Except for classified or confidential reports or information that is excluded in compliance with statute or regulation (see previous section).

References:

Alwin, L. F. (1992), "Reinventing the government auditor", *Internal Auditor*, February, pp. 16-17.

Committee on Sponsoring Organizations of the Treadway Commission (1992), *Internal Control - Integrated Framework*, September.

Daignault, A. (1996) "Auditors and Reengineering", A talk at the conference of the National Association of Local Government Auditors, May.

Eddy (1981), *Public Organization Behaviour and Development*, Winthrop Publishers, Cambridge, MA

IIA (1978), *Standards for the Professional Practice of Internal Auditing*, Institute of Internal Auditors, Altamonte Springs, FL.

Recommended Practices for State and Local Governments, (1999), Government Finance Officers Association, Chicago, IL. Pp. 17-18.

US Government Audit Standards, (1994), US General Accounting Office, Washington, DC. P. 14.