FOREWORD

This edition of the *Public Fund Digest* focuses on ***New Dimensions of Accountability in Government***. It features a paper by Dr. Elmer B. Staats, Former Comptroller General of the United States of America and Honorary Chairman Emeritus of the Consortium to begin this issue. Notable government chief financial managers, auditors and educators have contributed to this edition.

Accountability in government must keep pace with the times and the changes we are experiencing in governance around the world. The concept of ***accountability*** has been evolving and broadening over the years from a rather narrow focus on financial record-keeping at the account level to a broader concept of integrated financial management and stewardship over the effective and efficient use of financial and other resources in all areas of government operations. Nevertheless, the word ***accountability*** itself is subject to various translations and interpretations from one language or cultural group to another and the evolution of the concept of governmental accountability has been quite uneven from region to region. As an organization, the Consortium is well-equipped to monitor and assess the importance and relevance of these changes and events throughout the world. This is particularly the case, because as an international umbrella organization, the Consortium is well-represented in each of the regions of the world. Our members include some of the most influential membership organizations of professional government financial managers and government institutions throughout the world.

In these articles, most of which were presented at recent conferences which the Consortium has sponsored, we evaluate the changes and suggest ways in which financial managers in audit, budgeting, accounting, cost-control, tax and revenue management, treasury management, etc. might adapt and adjust to the changing environment in which we work.

We hope you will find these articles informative and helpful in your professional endeavors. We would like to invite you to contribute articles for future editions to the attention of Ms. Virginia Robinson at the Consortium address and to provide any comments you may have. We would also like to invite you to participate in our international conferences held in Miami, Florida and in Washington, D.C. each year as well as our regional conferences which have been held in India (1994), Pakistan (1995) and Hungary, to be scheduled in 1997. We are proud of the wide range of our organizational and individual members geographically and by profession within the government financial management community. Please take this as an invitation to join and participate. Our membership application is on the back page and our annual dues are in the affordable range. Please register for our ***New Developments*** conference in Miami from April 29 - May 3, 1996 with follow-on seminars on ***Forensic Auditing*** and ***Environmental Auditing***.

Virginia B. Robinson
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President

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The International Consortium on Governmental Financial Management is an international grouping of organizations and people involved in governmental financial management. The Consortium represents over 250,000 government financial managers, accountants, auditors, etc. from all parts of the world. The Consortium encourages its members to work together to promote a better understanding of professional financial management among public officials at all levels of government through:

- the exchange of information and ideas—providing an international clearinghouse of information relevant to governmental financial management.

- research, training, and publication of results;

- development of guidelines and reporting standards;

- liaison between our individual organizations to better promote mutual objectives;

- maintenance of high professional standards among governmental financial managers;

- stimulating government to recognize the critical importance of improved professional management of public financial resources; and

- collaborating in development programs which channel technical assistance in higher developed technologies to developing countries.

The Consortium expects to limit the range of the aforementioned activities to governmental financial management disciplines. The following areas constitute the disciplines of governmental financial management: accounting, auditing, budgeting, data processing, debt administration, tax administration and treasury management. These areas provide the general frame of reference for the programs, activities, and operations of the Consortium.

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NEW DIMENSIONS OF ACCOUNTABILITY IN GOVERNMENT

Elmer B. Staats
Former Comptroller General of the United States and
Founding Director of the United States Financial Accounting Standards Advisory Board

I am pleased to have been asked to serve as the first Honorary Chairman and now the Honorary Chairman Emeritus of the International Consortium on Government Financial Management (ICGFM). I have noted with great satisfaction the contribution the Consortium has made to public financial administration. This is especially so because officials of the U.S. General Accounting Office played an active role in its establishment during my term as Comptroller General. Jim Wesberry and Mort Dittenhofer in particular have contributed much to the success of the Consortium.

The basic objective of the Consortium has been to bring together public officials concerned with all aspects of financial administration—budgeting, financial reporting, accounting, debt management, revenue administration, and stewardship of resources. All are interrelated and included in the program of this Symposium.

This interrelationship needs more emphais than it has received in the past. That is why I encouraged the establishment of the International Consortium. All are aspects of accountability for the way in which taxpayers can be assured of the effective use of their money.

Since my appearance here five years ago, the recognition of the need for good financial management has dramatically increased. You meet at a time of growing concern, not only in the United States but throughout the world, of the need to conserve resources to meet the highest priority needs. In the U.S., the federal budget has not been in balance for twenty-five years. An increasing percentage of the budget now must be devoted to pay for the interest on past debt. Yet, the demands for governmental resources continue to grow. This concern has caused both our Congress and the President to emphasize the importance of improved financial management and greater accountability for the U.S. public resources.

* Presented at ICGFM's IX Annual Conference on New Developments in Government Financial Management for Government Financial Managers, Miami, Florida, March 28, 1995.

Let me underscore this by citing several developments which are either new or are receiving additional attention since my last appearance here in 1990.

- Establishment and updating of the auditing standards for federal activities first issued by the GAO in 1972 and updated three times since that time — most recently in the past year. Bill Broadus, who played a major role in the preparation of the original standards and who has been following developments closely in the application of these standards, is on your program at this conference.

  The GAO's auditing standards, more popularly know as the "yellow book", is now almost universally accepted as the standard for auditing governmental activities throughout the world. It has been embraced by the Internationl Organization of Supreme Audit Institutions (INTOSAI). It has been accepted by the American Institute of Certified Public Accountants, and has now been translated into several different languages, including Spanish.

  The "yellow book" standards are now required by law as the basis for auditing of federal programs. These standards embrace financial accountability, compliance with rules and regulations, and accountability for program performance or effectiveness.
- Following the issuance of these standards, our Congress has enacted legislation requiring the U.S. General Accounting Office to evaluate performance and effectiveness in carrying out the objectives and goals of Federal programs set forth in statutes. This requirement was included in legislation enacted in 1970 and 1974.
- Our Congress has also now established positions of Inspector General and Chief Financial Officer for all the major agencies in government. This legislation strengthens the position and responsibilities of the Inspector General which embraces investigation and audit as well as the Chief Financial Officers.
- Our Congress has enacted legislation requiring the major agencies to prepare financial statements beginning in fiscal year 1996 to be audited by the U.S. General Accounting Office or by an outside auditor.
- Basic to the preparation of auditable financial statements is the establishment of improved accounting and financial reporting standards. With this in mind, the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General agreed to establish a Financial Accounting Standards Advisory Board (FASAB) to recommend standards required for the preparation of auditable financial statements. This work is now in its fourth year. Basic standards needed for auditable agency financial reports will be completed by the end of the next calendar year.
- More recently, the Congress has passed legislation entitled the Government Performance and Results Act (GPRA) which initiated a series of pilot tests to test or demonstrate the feasibility of measuring performance of government programs against predetermined objectives. The expectation is that at some point each agency will be required to report to the President and the Congress on its ability to both measure and achieve the results of the expenditure pro-

vided by the Congress for each program. Importantly, good cost data will be required to achieve meaningful results. The development of standards for cost measurement is a current activity of the Federal Accounting Standards Advisory Board.

- At a State and local government level, there was established in 1984 a body entitled the Governmental Accounting Standards Board, which issues standards applicable for activities at the State and local government level.
- Finally, the Vice President of the United States initiated a major effort entitled "The National Performance Review" (NPR) with a broad objective to "create a government that works better and costs less." The National Performance Review has emphasized the importance of both improved budgeting and accounting as basic to the success of the endeavor.

From the foregoing, I believe that you will agree that improved financial management is now receiving renewed high level attention in the U.S. Government at all levels. There is growing recognition that accountability for the management of the nation's financial resources is fundamental if democratic institutions are to survive. This is in furtherance of the provision in our Constitution which states in Article I, Section 9, as follows:

> "No money shall be drawn from the treasury, but in consequence of appropriations made by law; and a regular statement of account of the receipts and expenditures of all public money shall be published from time to time."

I have been asked many times why our Congress chose to use the term "General Accounting Office" to describe its responsibilities. In reading the specifics of its charter and its legislative history, the word "accounting" easily translates into the word "accountability" — accountability for the way the Executive Branch accounts for resources appropriated by the Congress and the performance of these agencies in achieving the results intended by the Congress in making financial resources available.

I am pleased to note in passing that similar titles and charters have been established by many other coutnries, including most Latin American countries.

Webster's dictionary provides several definitions of the term "accounting and accountability" but the most widely recognized perhaps is "to furnish a reckoning to someone of money received and paid out." This is the definition associated most directly with the traditional role of the accounting and auditing professions. But there is another which I believe more encompassing in today's complex society which is "to give satisfactory reasons or an explanation for 'one's actions' and to give a good account of one's self." To be accountable is an obligation to account for one's acts in a responsible manner. Accountability, therefore, becomes the basis for the rule of law, the Constitutional framework of our system of Government, the rights of our citizenry, and assurance that government and non-government organizations discharge their obligations in a responsible manner.

The importance of financial management is stressed in a recent report of the U.S. Commissioner of Social Security, one of the most important programs of the federal government. The Annual Report of the Commissioner states:

> "I am pleased to present the Social Security Administration's (SSA) annual financial statement for the F.Y. 1994. It reflects SSA's commitment to hold itself accountable to the American public for administering its programs effectively and efficiently."

This report can be described as something of a model in that it not only includes financial data but greatly detailed information on progress in meeting performance goals.

The problems of achieving accountability are multi-faceted and complex. An agenda for challenging the talents of all of us who are concerned with improving the processes by which accountability is rendered would be a long one indeed. But let me suggest a few which seem to me to be central to the broad issue.

In spite of the changes which have taken place in recent years, the conventional definition of the role of the accountant and auditor still tends to be one of the technical accounting and auditing for the accuracy with which funds were received and expended. Having said that, I should stress that there has been a tremendous change in the role of the auditor. The Auditing Standards promulgated by the General Accounting Office in 1972, with the help of the accounting profession and auditors at all levels of government, have now been widely accepted, not only in the United States but in other countries. The terms, "operational," "performance," and "economy and efficiency" auditing are now synonymous with the extension of the auditor's role to include the manner in which programs are carried out and whether the programs are achieving the results which are intended. At the central auditing level in the Federal Government today, 90 percent of the General Accounting Office work is now concerned with matters relating to economy, efficiency and effectiveness of programs administered. To a lesser extent, this trend is noted in the work of the internal auditors in the agencies of the Federal Government and in many of our State and local governments as well. In Canada, Sweden, Australia, and many other countries, "value of money" and managerial and program effectiveness auditing are now well recognized and supported.

For those of us who are concerned with behavioral sciences, the extension of the work of the auditor is an interesting case study. The recipients of the audits — the legislator, the agency head, and the corporate official — would have found the concept either unclear or unwanted just a few years ago. The fact that the auditor has demonstrated that he can produce a product of value has done much to dissipate this fear or concern lest the auditor be moving into troubled and stormy weather. The legislation which has been enacted in many countries broadening the scope of the audit supports this point.

Broadening the scope of the audit has brought with it a change in the makeup of the audit staff to include individuals with a wide variety of disciplines — engineering, operations analysis, economics, international relations, public health, and many others.

Teaming together individuals with a wide variety of disciplines improves the product and provides for innovation in the way that auditing is carried out. With it has come a new and satisfying challenge to the individual trained in accounting, namely that his skills can be brought to bear upon problems of current and long-term concern, suggesting solutions to the decisionmaker.

In the public accounting profession, we have seen his development take a somewhat different form, with the expansion of the management consulting services offered by most if not all of the major accounting firms. The best result is one in which the financial audit function and the management consulting function interact with each other, each retaining its independence but recognizing that the financial audit may serve as one of its most important purposes the identification of problems which challenge the skills of the managment consultant.

The internal auditor—certainly in the major commercial corporations—has shown a similar disposition to expand the scope of his product for management. I recently inquired of an outstanding internal auditor as to how much of his operational audit work was self-initiated and how much of it was requested by management. His reply was that in the beginning virtually all of it was self-initiated; now he finds the reverse to be true. I believe we could recite a similar experience within the Federal Government. The challenge to the internal auditor is to assure that his product is one which is relevant, objective, and sets forth options which are useful to management. One of the areas in which the internal auditor can play a particular role is that of the adequacy of internal control systems. In part, responding to the enactment of the Corrupt Practices Act of 1977 and the extended use of computers in all phases of corporate work, the internal auditor is called upon to assure management that internal control systems are in place and adequate to prevent loss of financial control. Audit Committees of Boards of Directors now routinely probe the internal auditor as to the care which he has exercised in assuring that these controls are in place.

One of the more intriguing possibilities for the internal auditor is to include information in public financial statements to describe the operating results of the agency or corporation. For example, if a unit within a government agency has a mission to plant a certain number of trees in a fiscal year and does it for a specified number of dollars, it would be possible for the agency's financial statements to note that the trees were planted at that cost or less or that fewer trees were planted or that it cost more than planned. This type of supporting data in government financial statements could prove quite useful to management, to the legislature, and to the taxpayer. We will be seeing this type of data in government—and perhaps in corporate— financial statements within this decade.

Complicating the work of the auditor has been the sharply increased use of instrumentalitites not directly administered by government employees to carry out government programs—the private corporation, the quasi-governmental organization, non-profit groups, and international organizations. These take the form of subsidies, contracts, grants, cooperative agreements and other arrangements. But they all have a common denominator in that they share accountablility to their own management and government. The real question is how we can build accountability into these organizations in such a way that government can be assured that funds are used wisely, at the same time avoiding direct governmental intervention and control. This concern about accountability versus independence is a real one for which to date no good answers have been supplied. The acceptance of high professional audit standards by external auditors is, of course, important. Here is an area which challenges the ingenuity and innovativeness of government and nongovernment auditors alike.

Related to this point I was much interested in the draft report of the Consortium Research and Education Committee entitled "Financial Management Aspects of Privatization." One needs only to read the daily newspapers to recognize that there is a world-wide effort to capitalize on the benefits of competition and innovation in the private sector. But as this trend goes forward under government sponsorship and assistance, financial managers must play a role in insuring that internationally-accepted accounting principles are observed. As the draft report indicates, some of these principles are not new; however, there can be wide differences in application to meet differing circumstances. Governments concerned must be assured that privatized enterprises have adequate systems of internal controls and auditing systems capable of monitoring these controls.

As more and more financial transactions are handled by automatic data processing, a major problem the auditor of the future faces is the virtual disappearance of paper transactions. Already such innovations as electronic funds transfer are becoming commonplace in the banking industry. What will auditors do when this paperless state becomes complete? Without records of paper transactions that occurred weeks or months ago, auditors require new audit procedures to decide whether financial transactions were handled properly.

It is inevitable that these new procedures must allow auditors to perform their tests of transactions as they occur, since there will be no papaer record to examine. And if that is the case, better audit planning will be needed so that the many tasks now performed sequentially can be performed more or less simultaneously.

Auditors will also have to rely far more on the effective functioning of systems than they do now. So better techniques than we now have for testing such systems must be developed.

The challenge for all of us to bring about this evolution within the framework of international cooperation and interdependence. The enormous impact of international interdependence on government auditing around the world provides natural incentives for the development of an international audit community. It also poses serious questions which must be resolved before the profession of government auditing can grow in the ways I have described. Problems plaguing national governments today—pollution, population growth, and disease, for example—often bear international ramifications and require a concerted effort from national governments. Programs which are developed by any one country quite often contain a foreign component. Just as intergovernmental audit cooperation is essential among audit groups within a country, so auditors from each nation must work together to upgrade our profession.

There are three areas where we must concentrate our efforts if we are to succeed in meeting the challenge of interdependence. These are:

- Development of international accounting and auditing standards;
- Better accountability by international organizations; and
- Improved training and professional development opportunities for government auditors.

The first challenge is to develop uniform accounting and auditing standards. Before an international audit community can become a reality, standards must be promulgated and adopted by all nations. The benefits in terms of better cooperation and understanding among all nations will make the effort worthwhile. Already there are indications of the kind of cooperative benefits that can be achieved when government auditors work together across geographic lines.

But, for such cooperation to be extended to more countries, it will be necessary to develop accounting and auditing standards which are accepted by those countries. Speaking from my own experience in developing our Standards *for Audit of Governmental Organizations, Programs, Activities, and Functions*, a publication which I hope is familiar to many of you, I can predict with some certainty that this will not be an easy task.

Our experience parallels that of many other governmental organizations which have attempted to establish common standards for accounting, auditing and financial reporting. I refer here particularly to the efforts of the United Nations, the Organization for Economic Cooperation and Development, the European Economic Community, and the African Accounting Council. These agencies have sought to formulate financial and non-financial reporting requirements in a governmental context. All have had the benefit to some degree of the advice and assistance of private standard-setting groups who have shared a similar objective of harmonization of accounting standards on a regional or international basis. I refer here particularly to the International Accounting Standards Committee (IASC), the Asian Nations Federation of Accountants (AFA), and most notably, the work of the International Federation of Accountants (IFAC).

In concluding my remarks, I return to the developments which I referred to in my opening remarks. Concerns about accountability of individuals and institutions — public and private—will not diminish. They will continue and grow because accountability is basic to democratic society. The accounting and auditing profession can provide much of the creativity and innovation to assure that these concerns are met.

GOVERNANCE AND THE LEGISLATIVE AUDIT FUNCTION*

Muhammad Naseer Ahsan,
Auditor-General of Pakistan

Governance may be defined as an act or manner in which public policy is formulated and delivered. The extent of control exercised on public policy by executive governments varies due to diverse socio-political, economic and cultural environments. Governance is usually divided into three phases: formulation, legislation and execution of public policy. A review by or a feed-back to the legislature is an integral part of this process as success or failure of public policy can not be gauged in isolation.

History has taught us that good governance should have two basic characteristics: firstly, transparency of decision making and execution and, secondly, reasonable controls on unbridled authority of the executive. The focus of the modern state thus revolves around these basic precepts.

State audit in this situation should be viewed as an institution which, acting on behalf of the legislature, unveils the mystery of executive decisions and probes into the implementation of public policy to verify if it was carried out in accordance with legislative intent. In this manner, state audit makes the process of governance transparent and brings out instances of misuse of authority.

Legislative audit, therefore, provides a concurrent critique of the governing process in a civilized society. The role of legislative audit, in many countries of the world, is limited to a review of financial statements. This role is not in line with the comprehensive and dynamic character of today's state audit institutions.

An important feature of democratic societies is a well defined distribution of power among the three arms of state—legislature, executive, and judiciary. It provides a workable system of mutual checks and balances. Auditors may flatter themselves to surmise that they do not truly belong to any of these arms of state, and that their real place is somewhere between the executive and the legislature, if they do not constitute the fourth arm.

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* Presented at ICGFM's on Governmental Financial Management's International Financial Management Conference, Washington, D.C., September 22-24, 1994.

State audit in the past was a part of the executive government in most of the countries and there was no realization that it had an independent entity. It is now gradually becoming an independent and autonomous institution. But there are societies where state auditors are still dependent on the executive for resource allocation and support. Audit reports are, however, not subjected to executive scrutiny in any democratic society. Despite the fact that auditors all over the world are technically free to report their findings to the legislature, the control of executive government on their resource allocation and management does affect their capability and will for an independent and objective assessment. It is, therefore, imperative that if state audit is to work as an efficient and competent tool of legislature, it should not be dependent on the executive for support.

The point that I am trying to make here is that as the government executes public policy, it is only logical that the auditors be distanced from it, if they are to give an independent, objective an competent opinion as to the economy, efficiency and effectiveness of the policy implementation.

The independence of state audit is impaired not only by its financial and administrative dependence on the executive, but certain other important factors are also involved. A major issue in this area is that of built-in contradictions in the charter of state audit in certain countries. For instance, in many common-wealth countries, Auditors-General are required to supervise compilation of accounts of the federation as well as of the states/provinces, and as such act as auditors to as well as functionaries of the executive government. All such situations which have a bearing on the independence of state audit, of whatever type they are, and in whatever form they are, must be rectified by the legislatures of the respective countries, to ensure independence of audit.

An important area of attention is the communication between audit and the legislature. In a number of countries communication between the two is not as regular or prompt as, for instance, in the United States, where a continuous dialogue goes on between the GAO and the legislative bodies. In many countries of the world, audit submits its reports to the legislature through the executive government. This restriction not only affects the efficiency of audit but also deprives the legislature of timely information on public policy implementation. Unless audit institutions have an un-hindered access to legislatures, the desired level of effectiveness will remain elusive and the principle of parliamentary accountability will not be enforced in letter and spirit.

With growth of government activity in areas of public welfare, there has been a visible change in the role of audit. Till recently, audit was restricted to the legality and regularity aspects of expenditure. It has now explored new avenues of examination in performance or value for money audit. As a result, audit coverage has not only been extended from expenditure to revenue, assets, and liabilities; but more importantly, the purpose of review has undergone a material change. State audit is no more a tick audit but is a more creative and broad-based exercise. It now examines not only the regularity of expenditure and maintenance/custody of public assets but also the manner in which public resources are deployed and the kind of results that they produce. This role is significantly different from the audits being performed by the chartered accountants (CAs) or the certified public accountants (CPAs) who restrict their scrutiny only to see if a business entity meets the criteria of adherence to generally accepted accounting principles.

The legislatures have traditionally been charged with one basic authority, the power of the purse. This power implies that legislatures not only appropriate money for various services, they also have to ensure that the moneys appropriated by them were spent according to legislative intent, in an economic and efficient manner, and had produced intended results. The allocation of money by legislatures in many countries, who follow an incremental budgeting process, has gradually become a routine and un-productive exercise. This means that the budget has ceased to be an instrument of legislative control. There are only a few countries where the budgeting process is really meaningful. A consistent review of activities of the government by state audit for the legislature has, therefore, assumed more importance in democratic societies. As a matter of fact it is becoming a compulsion due to increased consciousness of people about the use of public money, and increasing demands on the scarce resources of the government.

Significance of state audit which is the only independent agency to conduct such a review, and by relationship, is the only reliable source of information to the legislature, has increased under the circumstances. Elected representatives of the people may be very knowledgeable but it is not necessary that their knowledge about the governing process and executing agencies is always current, objective, reliable and relevant, and even if it is so, it is also not necessary that they have the competent evidence to support it. They also do not have the time and resource to delve into meticulous details which may be necessary to form an opinion on an issue. State audit is, therefore, to provide information to the legislature as promptly and accurately as possible to enable them to know how the programmes, functions and activities of the government are being conducted or to put it in more simple words, how the executive government is performing and providing the value for money to the tax payers.

I may, therefore, submit that while state audit generally follows the some practices, procedures, techniques and other analytical tools as are being employed in the private sector, their mandate is no more the same. The mandate of state audit is in fact, much broader and comprehensive than that of audit in the private sector and it will continue to grow and expand further with the changing role of legislatures in our societies. For instance, a major social concern today is environmental protection. Who would report whether the policies of government in a society are helping or hampering the preservation and improvement of environment? The voluntary organizations are trying to do their own bit, but is that sufficient and adequate?

Growth of the modern state has led to a proliferation of para-statal and autonomous organizations, which were initially set up to avoid bureaucratic control and interference. The intended objectives of setting up these agencies have hardly been achieved mainly because the legislatures have not been able to establish their control on these organizations with the result that the bureaucracy has appropriated unbridled authority to intervene in their management.

The parliaments in general, and the public accounts committees (PACs) in particular, have not been able to develop an adequate monitoring and evaluation mechanism in respect of these organizations. For instance, in Pakistan and India, state audit had been preparing special evaluation reports on performance of public sector enterprises, and this work has been equally appreciated by the management of these enterprises, government and legislature but it has not been able to help in improving the efficiency and productivity of these organizations in measurable terms. The end result is that all governments the world over are now trying to disinvest their assets in these enterprises. Privatization will certainly relieve the governments of some of their fat, but it may not be possible to transfer all the socio-economic functions to the private sector. The legislatures and state audit both owe it to the society to provide a workable mechanism to ensure elimination of bureaucratic intervention in this area of public policy implementation.

In some countries, expenditure on certain services and activities is excluded from audit purview by law. In these countries the President or Head of the State is empowered to classify allocations for certain activities as secret and this outside the purview of audit. Although the quantum of such expenditure is usually not significant, this provision in itself appears to be an impediment in the role of effective legislative audit.

Another important constraint on state audit in some of the countries is curiously not legal but conventional. For instance, in a number of countries, the issue of defense expenditure is paraded as a sensitive matter. No independent analysis of such expenditure is socially acceptable to the pressure groups and the government. The auditors merely walk through the defense expenditure and do not question the validity of decisions. They merely perform a ritual. The result is that the legislative control on defense expenditure in most of such countries is nominal. This issue not only involves the question of authority of audit to prove the implementation of public policy, but it acutally reflects a much bigger issue of governance i.e. lack of legislative control over the executive government.

In some of the countries, state audit has not been provided working conditions conducive to its growth and effectiveness. Such conditions include giving to audit the status, powers, access, funds and personnel. This virtually deprives state audit of its independence, competence and authority in a very subtle way.

The change in the emphasis of state audit from regularity to the three Es (economy, effectiveness, and efficiency) has posed new challenges to all of us, and we have to come up with a proper response if we have to survive as living organizations. The economy audit looks at things from the input side whereas efficiency and effectiveness audit looks at the problem from the output side. Thus state audit is now concerned if a given output could be attained by a smaller input of resources and if a greater output could be achieved with the same limited input.

The audit of governance has thus become complex under these circumstances. In traditional audit of regularity and appropriation, the laws, regulations and established norms and standards of probity and propriety were known to all and were generally acceptable. Measuring of performance of an organization against these standards was thus a relatively routine job. In performance auditing there are, generally, no recognized performance indicators available against which minimum efficiency or economy achieved or the degree of effectiveness of a project or a program could be assessed. There are too many variables in this form of audit rendering it difficult to lay down norms and standards. The objectives to be achieved must be considered in the backdrop of prevailing social consitions, economic or political constraints and other impediments.

Absence of generally acceptable standards and norms of auditing makes the job of a performance auditor more difficult, but it also gives him a degree of discretion, which implies additional authority. It gives him an opportunity to express an opinion on such vague and non quantifiable matters as mismanagement, dis-economy, and improper decision making. In the case of large organizations, projects or programs, it is extremely difficult to identify causes of non or inadequate performance. Yet this is exactly what the auditors end up with in fulfillment of their mandate. It is for this reason that the executive often tend to be impatient of auditor's conclusions and regard them as theoretical.

The continuing dialogue on the efficacy of the performance audit results have not yet been able to resolve this issue satisfactorily from the point of view of all concerned. One of the reasons for this may be that performance auditing in most of the countries is still in its infancy. The other reasons could be that the auditors are not sure if their review of public policy implementation should be addressed to the management or to the owners (the legislature). Hesitation on their part is a legacy of the private sector auditing, where an auditor gives an opinion on the financial statements of a concern, to the owner, but all other evaluation reports are prepared for the consumption of the management. This is an issue on which the state auditors will have to decide in very clear terms if they are committed to make value for money audit a success.

In bringing about good governance, the auditors will have to play an increasingly important role. State audit constantly brings to light administrative lapses, indiscretion and abuse of power and thereby questions the process of governance on moral grounds, suggesting norms of administrative behaviour to prevent such lapses in the future. Thus it gives auditors an opportunity to sit in judgement over others from a lofty moral pedestal.

A balance must be maintained between going too far on a high moral pitch and maintaining the minimum acceptable moral standards of the society. Governance depends upon established morality. Audit can only be as effective as the demands placed on it by the existing socially acceptable moral code of financial and general ethics.

To sum up, I must say with a fair degree of confidence that if the legislatures are serious in providing an efficient government to their people, they will have to learn how to use audit to their advantage. In the continuing tussle of power between executive and legislature, the legislature can only keep its authority intact if it ensures transparency in the implementation of public policy and makes the government accountable for what it does and how it does it. State audit is the only institution available to the legislature to establish its writ. The democracies of the developed countries have already learned this lesson, and it is in the interest of the democracies of the developing world to learn it as early as possible.

GOVERNANCE AND THE LEGISLATIVE AUDIT FUNCTION

Isaia Vakabua
Deputy Auditor General of Fiji

The Concept of Governance

At its broadest level, governance refers to the authority, control, and management functions of government. The purpose of governance is sustainable human development.

Four issues relating to governance in the Pacific merit highlighting:

- The first relates to management; i.e., the establishment, mobilization, and allocation of resources. Such management systems need to operate with a reasonable degree of independence form the political (legislative) arm of government. Indeed an important function of such a system is to provide independent advice to the political (legislative) arm of the various options.
- A critical related issue is that of accountability. Systems of accountability are essential to assess results of government actions. Accountablility requires not only good reporting and monitoring systems but freedom of information and freedom of the media.

  In a small island situation such as ours in the Pacific, and in a number of developing nations as well, the limited number of people with skills necessary to interpret government actions, will dilute any effective system of accountability. There is a need, therefore, for the free media to operate without government influence to actively promote and protect accountability. The focus must be on areas such as the management of economic and financial resources, particularly where the line between **"political"** and **"market-based"** objectives can become blurred.

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- The third issue relates to the co-existence of Western political, legal, and administrative systems, with traditional systems of property rights and conflict resolution.
- The fourth is the interface between national and community systems of governance which poses considerable challenges to many island nations in the Pacific. (UNDPs Pacific Human Development Report, p. 50)

Elements of Accountability

The elements of accountability exist in any relationship where one party (an agent) performs some functions on behalf of another party (a principal). An agent is someone to whom the principal delegates power and entrusts resources for safeguarding (stewardship) or to carry out specific tasks on the principal's behalf. As holders of delegated power, agents owe duties to the ultimate powerholders.

Accountability in this context means that the agents have to properly demonstrate that they have exercised the power conferred, achieved the agreed goals and objectives, and used the resources provided, effectively and efficiently. The auditor, acting on behalf of the principal, is required to undertake a review role necessary to provide independent assurance to the principal on the performance of the agent. The auditor is required to review the statement of account prepared by the agent, and the auditor by giving an opinion on the content of the agent's statement of account, provides the assurance to the principal of whether or not the agent's statement is true of fair.

The auditor may be required by the principal not only to give an assurance on the agent's statement, but also to give an assurance on the agent's performance in managing, allocating and utilizing resources efficiently and effectively.

Legislature's Role in Public Sector Accountability

The same features that apply in the general accountability model also apply to the legislature. The principal and agent are determined primarily by the constitutional make-up of the system of government.

Legislature (i.e., Parliament) is the principal. As a result, Parliament determines public-sector accountability arrangements. Parliament also determines the nature and extent of the audit arrangements that exist as part of the accountability of the Executive to Parliament. Parliament is the principal because it gives public sector organizations the authority to operate, to tax and to spend. In effect, the authority or resources used in the public sector are conferred by Parliament to which the Executive government is accountable.

The Auditor General as Parliament's Agent

Among the earliest audits of which we have written records are manorial audits of the period between the thirteenth and sixteenth centuries in Great Britain. In the manorial household, the auditor was a person of considerable importance. Some of his authority came from the party by whom he was appointed, the nobleman he served; and additional authority came from statutes. Probably the earliest statute of this kind was one passed by Edward I in 1285 which read:

> *"Concerning servants and bailiffs, Chamberlains, and all manners of Receivers, which are bound to yield Accompt,...when the Masters of such Servants do assign Auditors to take their accompt. and they be found in arrerages upon the Accompt, all Things allowed which ought to be allowed, their Bodies shall be arrested, and by the Testimony of the Auditors of the same Accompt, shall be sent or delivered unto the next Gaol in those Parts..."*

About the same time the practice of submitting trusted servants to an audit was extended to certain public officials, particularly tax collectors.

These early audits were intended to provide an independent review of the accounting records and reports and of the work of those subjected to audit.

Parliament as principal, determines the audit arrangements for those entities which are accountable to it, and on which it requires independent assurance. Historically, it has appointed the Auditor-General to provide that assurance.

There are three substantive practical reasons why Parliament appoints the Auditor General as auditor:

The Office of the Auditor General offers statutory independence.

- Parliament obtains the benefit of a specialist professional agency devoted principally to serving Parliament's interests.
- Parliament obtains the administrative convenience and economy of having to appoint and deal with only one auditing agent.
- Parliament is thus saved the tasks required to establish and manage the audit arrangements for the various public sector entities, such as engaging auditors, specifying the terms of their engagement, monitoring the auditor's performance, and dealing with the auditor's reports.

Must the Auditor General Do the Audit

No! It means that the AG is responsible for the oversight of those audits on behalf of Parliament. The AG has the right to appoint his own agents or audit service providers to undertake auditing duties on his behalf. These audit service providers are effectively sub-agents of Parliament's agent.

Independence

An essential feature of any audit role is the independence of the auditor from those being audited. In the public sector, it means that the auditor, acting on behalf of Parliament, must be independent of the executive government.

It means that the auditor must have an independent mental attitude. It means that the organizational and accountability arrangements for the AG must be such that they allow his role to be discharged in a manner which is free form direction that could reflect any political bias. If any direction is to be allowed, it should be limited to those given by Parliament.

The AG is not independent if he enjoys his appointment or those of his staff on the generosity of the executives. Likewise, he is not independent of the executives, if the executives determine and allocate the resouces with which the AG carries out his functions.

Functions

As the AG is an agent of Parliament, his functions must be determined so that they allow for the provision of assurances as Parliament may require. Limiting the functions of the AG is in effect, limiting the assurance required by Parliament, or limiting the ability of Parliament to use its agent to enquire into matters on its behalf. It is often asked whether the AG should be the auditor of all public sector bodies, particularly bodies that have their own boards or councils.

Proponents of the suggestion that the AG should not be appointed in some instances have generally overlooked Parliament's constitutional position as the sources of authority and resources for the entities concerned, and it is Parliament that has the right to determine the accountability and audit arrangements for those entities.

Because Parliament defines the role of the AG and his functions, just as it defines the powers and responsibilities of public sector entities, much of the audit process is compliance audit. But since the early 1980s, performance audits gained prominence particularly when the audit functions in most state legislations were extended to include economy, efficiency and effectiveness in the use of public resources.

The Audit Report

The Audit Report is the means by which the AG's opinion is conveyed to Parliament either through a government minister or the speaker of a house of Parliament. Any member of the house may move a motion to debate part or the full report itself. But in most cases, the Audit Report is transmitted to a Parliamentary Committee of public accounts. It is indeed a dreadful experience for some members of the Executive to be called to the Public Accounts Committee. But that is his role in the accountability process to give an account of the resources allocated to him, and the exercise of the powers given by Parliament. The AG attends meetings of the Committee, not as a member, but as an adviser, to give that assurance which is entrusted to him, also by Parliament.

ACCOUNTABILITY: ITS IMPORTANCE TO DEMOCRATIC SOCIETY*

by Felix Pomeranz, Ph.D., CPA

March 30, 1995, A.D., Shawal 29, 1415, A.H.

You must approach me on a road that's straight.
My verse will then uncover all that's hidden.
You will not understand it right away
Since 'tis the first time you have heard such words.
How queer it seems to me that people who cannot understand
Immediately ask another kind of words.
—Abaj Qunanbayev—

Introduction

Traditionally, persons entrusted with the custody of property owned by others are required to account for their actions in regard to the status and valuation of that property and the manner of its use. Effective practice of accountability is related to the prevention and detection of fraud; some believe that employee and management fraud has reached an epidemic stage. According to a 1993 survey by a major public accounting firm, 76 percent of the largest US companies acknowledged having been victimized during the previous year; no less than one third of those frauds involved sums in excess of one million dollars.

The situation calls for a timely and worldwide societal response; I will explore the subject in terms of accountability and ethics. We will consider the need for action on several levels: at the macro/professional level, which focuses on the ethical rightness of the system itself, at the level of a private or governmental agency with reference to

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those of its decisions which impact others, and, most importantly, at the level of the individual decisionmaker himself/herself.

Our objective is to examine concepts of accountability and ethics, to focus on “internal control,” which has virtually become a surrogate for accountability, and to update you with respect to current developments bearing on fraud and corruption.

Concepts of Accountability

I have already quoted a traditional definition of accountability. The importance of the concept was highlighted by Antonio Sanchez De Lozada, former State Comptroller of Bolivia. Bolivia has been ruled (or misruled) by a succession of military dictatorships, until the restoration of democracy some six years ago. Antonio believes that democracy and accountability go hand in hand, that is, that you can’t have democracy without accountability. Internal control is the bedrock of accountability.

Dr. Elmer Staats, former Comptroller General of the United States, has pointed out that the term accountability has to be interpreted broadly. Dr. Staats believes that a manager is responsible for preserving and maintaining resources entrusted to his care; the manager is also responsible for executing programs efficiently and economically, and for ensuring the effectiveness of programs.

Concepts of Ethics

Ethics are concerned with developing reasonable standards of moral conduct that are universal. Ethics are not culturally relative; in other words, ethical standards do not vary with geography; the canonical laws of the major religions are very clear on this point.

Today most ethicists advocate a rights-driven or Kantian model for ethical decision making. Such a model is similar to the religious models in that it rests on the assumption that every person has basic rights in a moral universe and that an action is morally correct if it minimizes the violation of the rights of all stakeholders.

Many perceive that people in business are less ethical than they used to be. A human resources person with an accounting firm has tried to put the matter in perspective:

> It’s not that they are less ethical, it’s that there is more pressure. Decisions aren’t black and white....Our hope is that some background and training will make the difference between a sound and foolish judgment when an ethical dilemma comes up.”

As pointed out previously, we will discuss ethical issues on three levels, beginning with the national/professional level. For example, the Financial Accounting Standards Board (FASB) the top rule maker of the US profession, has issued a series of conceptual statements. According to these statements, accounting principles are to be determined on a basis of decision usefulness; the FASB identified the primary decision makers as investors and creditors. The FASB’s determination barely mentioned such stakeholders as employees, customers, competitors, the environment, and the community. Although the focus on investors and creditors was supported by only about one third of certified public accountants, FASB board members have diligently pursued the "new" direction. In other words, in light of U.S. conditions the FASB did not choose a broad stakeholder approach which would have seen corporations as involved in a network of relationships and mutual responsibility. (Of course, in Kazakhstan local conditions would govern the approach.)

When considering the second, or corporate, level, it is apparent that a comprehensive corporate ethics program should *begin* at the top of the corporate structure and should be integrated with the organization's systems of rewards and punishments. For example, Westvaco Corporation is one of America's largest integrated paper companies and, I might add, a long-time client of Price Waterhouse. David L. Luke, Jr., late Chairman of Westvaco Corp., set examples of personal conduct which provided both inspiration and aspiration to his executives.

Here is one instance: when labor unions called a strike at the paper supplier of a (non-customer) magazine, Mr. Luke was asked to send a few tons of paper to avoid a press stoppage. He was told by the publisher of the magazine that, if he complied, he would become the magazine's exclusive future supplier of printing papers. Mr. Luke decided to deliver the emergency tonnage, but declined the opportunity of trying for mega profits. In his words "a businessman who deserts his troubled supplier today, would do the same thing to us tomorrow; that's not the way to grow our business."

In a corporate sense, ethics and controls should permeate an organization. The accounting profession has advocated the idea of an (ethical) tone at the top of a corporation. In my view, this yields a partial answer only. The propagation of awareness of ethics, at the *top, middle, and bottom*, is an important management task. All levels of management should see that awareness of fraud exists and should monitor transactions at levels below their own. By taking steps to monitor the activities of those reporting to them, managers can reduce their own exposure to legal actions and undesirable publicity.

The individual is responsible for his actions. In the words of the late U.S. President Harry Truman, "the buck stops here"; i.e., with the individual. Our hope is that individuals' personal values will transcend the laws and rules of institutionalized ethics. Any departure by an individual from what he knows to be right tends to have a corrosive effect. In other words, departures in small things are likely to lead to escalation in improprieties.

The Nature of Internal Control

I recently developed the following definition of internal control for a new textbook:

Internal control represents a series of procedures, actions, and techniques which may be computer-based, manual, or physical. The primary objective is to ensure compliance with corporate policies; moreover, controls also serve to protect assets from waste or diffusion. Internal control is designed and maintained by management; nonetheless, it may serve the purposes of others, such as external and internal auditors. Auditors may evaluate the functioning, effectiveness, and design of controls to determine how much testing of a substantive nature they should perform.

Internal control should serve the information needs of all stakeholders as identified in our discussionof the FASB. On the basis of Statement on Auditing Standards No. 1, individual controls can be slotted into two broad categories: operational controls and internal accounting controls. Typically, an operational control provides information that enables managers to plan for the future, or to ensure compliance with operating plans, budgets, standards, or other targets. An internal accounting control sees that financial information, often provided to persons outside the corporation, is timely, complete, and accurate. Internal accounting control also bears on the physical protection of resources and on the related record keeping.

The all inclusive view of internal control is important, especially from the perspective of management. For a variety of reasons, attempts have made from time to time in the United States to restrict the scope of controls considered by external examiners. (For example, from 1949 to 1988 external auditors were directed to concern themselves almost exclusively with internal accounting controls; this limitation was vigorously opposed by some, including Paul Grady, a senior partner of Price Waterhouse.) The reason for the concentration on internal accounting controls can be rationalized: in the United States protection of individual shareholders is considered important enough to warrant special efforts by management. The current (broad) view of control can be said to have been restored with the issuance of Statement on Auditing Standards (SAS) No. 55. Nonetheless, I would like to point out to you that alternative classification of controls are possible and permissable. For example, you might wish to classify controls into (1) transaction related controls, and (2) environmental controls. The later type of control bears on the prevention and detection of management and employee fraud.

U.S. legislation has influenced the perception of internal control. For example, the Foreign Corrupt Practices Act mandated the maintenance of a system of internal accounting control, defined in terms of professional standards. In addition, the Act also prohibited bribery of foreign officials. While the FCPA has arounsed some controversy, it has also been recognized as a significant success. Indeed, several countries have introduced their own cloned FCPAs. Mention should also be made of another federal agency, the U.S. Sentencing Commission, a body created by Congress in 1984. This Commission exerts enormous enfluence on the maintenance of anti-fraud controls in U.S. companies. Among other things, the Commisssion’s directives issued to federal judges relative to sentencing, the so-called sentencing guidelines, allow companies to accrue credits against potential penalties by showing due diligence in seeking to prevent and detect criminal conduct; the point to remember is that the diligence must be shown before rather than after, the illegal conduct has taken place. In 1988, the Commission recommended to judges that the introduction of corporate codes of ethics be viewed as a mitigating circumstance in sentencing corporate offenders; the contents of these codes have been well defined. (Incidentally, the Commission plans to introduce coverage of environmental matters in 1995).

Many laws have also been enacted intended to strengthen the financial management function within federal agencies. One law, introduced by Senator Helms, set up the offices of inspectors general in certain federal departments. The role of the inspectors general included auditing plus investigation of irregularities. Although I initially opposed the Helms Law, since I was concerned with "overkill," I am pleased to report that it has been a substantial success.

The point is that accounting rule making is heavily influenced by the cultural and social traditions of each society. In general, and subject to minor exceptions, U.S. standards for accounting principles as well as disclosures are among the highest to be found. Any nation may wish to modify disclosure requirements on the basis of its cultural, social, legal, and technological circumstances. (These factors were identified by Dr. V. Baladouni in early and seminal comments on the subject.)

I started my remarks with a reference to Abaj, one of your nation's intellectual greats. Abaj endeavored to synthesize Kazakh, Islamic and Russian cultures; it is possible that a similar mindset could be helpful to you in your disclosure rule making.

There are additional resources you may be able to draw on. The United Nations has an international group of intergovernmental accounting experts. In recent years the group has coordinated its efforts with IASC and IFAC, and has emphasized governmental accounting and auditing issues. But, the United Nations Center of Transnationals also conducts active research, and maintains comprehensive files and records of accounting information. The Organization for Economic Cooperation and Development (OECD) has advocated disclosures relating to the effects of a company's actions on employees, environment and community. The United Kingdom has, with the leadership of Lord Henry Benson, drawn up rules that regulate the conduct of "whistleblowing" by public accountants; these rules seem simple and reasonable.

The Concern Over Internal Control

The AICPA in combination with other groups of financial professionals has twice in recent years convened commissions to study the problems confronting the profession. Both commissions focused on internal control and highlighted management's responsibilities in this area. The first group, the Cohen Commission, generally recommended a broad approach to internal controls (i.e., concern with both operational and financial controls) and suggested documentation of systems of internal control. The second group, the Treadway Commission, urged clarification of public accountants' responsibilities, together with the issuance of auditing standards intended to close the "expectation gap" said to exist between the profession's and the public's expectations for the prevention and detection of fraud. And, Treadway's sponsoring organizations, set out in the "COSO Report" to specify internal controls standards and practices.

Currently, intense discussions are going on as to what and to whom private organizations are to report on internal control. The issue has three aspects: (1) what controls should be reported on; (2) who should do the reporting; and, (3) to what extent the public accountants should participate in the reports. The basic problem involves the identification of what is to be considered an acceptable practice. In my opinion, the practices recommended by COSO have not been vetted adequately; there has been no agreement as to acceptable standards for internal control.

You may wish to review the COSO report. My personal feeling is that a simplified approach to controls, focused on areas of particular exposure, would represent an attainable beginning, one that would be particularly useful to managements of Kazakhstan enterprises. (Areas of particular exposure include protection of assets, computer access, and management representations.) A selective approach to controls should be preceded by the promulgation of internal control standards.

The important facet is how management reacts to and corrects an internal control weakness. The elements include

- immediate investigation of unfavorable variances from plans, targets, or budgets;
- immediate corrective action to stem dissipation of resources;
- corrective action to introduce control techniques or to repair existing controls; and
- modification of audit programs as needed.

Privatization

Privatization has been defined as including the transfer of property rights from the state to enterprises and individuals, contracting out the delivery of public services to the private sector, or initiating other cut-backs in state activities to allow greater room for private initiative.

Fear has been spreading that privatization may contribute to the incidence of fraud. A recent report observed that nearly two thirds of the United Kingdom voters were worried about corruption in local government; concern was expressed that "opportunists were taking advantage of an entrepeneurial culture in which the pace of reforms had outstripped the development of safeguards." A U.K. public accounting firm asserted that the currently popular practice of contracting out public services to private firms could trigger an "explosion in fraud and corruption." The firm worried that "backhanders and slush money" might flood public agencies in endeavors to cut themselves into lucrative government contracts.

The basic exposure starts with the accuracy and completeness of the assumptions which should underlie an outsourcing study. Exposure continues with choice of inappropriate contracting approaches, poor drafting of contracts and poor monitoring of execution. Some years ago a public accounting firm found that 95 percent of savings in a construction project could be attributed to improved drafting of the contract. Incidentally, it should be noted that "big-ticket" contracts are likely to create fewer problems than apparently minor contracts, such as those for body repair to public vehicles.

The role of a governmental audit agency with respect to privatization is likely to involve (1) a pre-privatization review, (2) a review of the privatization process itself, and (3) a post-privatization review. With respect to the review of the process, considerable attention should be paid to the underlying assumptions, which adduce to the determination of the value to be paid for the enterprise. Among other aspects, the study should address the viability of the operation, its contribution to national development, its future earnings potential, industry trends, and the effect on the national budget.

National Action on Corruption

Some have speculated that there has been an upsurge in fraud, while others perceive the perpetrators of irregularities as having recently “come out of the closet.” In any event, fraud is believed to be of archaic origin. The present day causes of fraud include recession, a possible erosion of business ethics, difficulties in teaching ethics, technological complexity of transactions, and employee dissatisfaction. Approaches to fraud prevention and detection should focus on controlling the apparent causes and specific threats. Ways must be found to close the time gap which exists between innovative types of frauds and eventual regulatory, professional, or governmental elimination of the weakness. In the meanwhile, it should be possible for heads of entities and their security experts to brainstorm prime opportunity areas for graft and corruption. Such areas include the awarding of contracts, purchasing of equipment, and financing of large projects.

Elements in a war on corruption include:

- development of long term strategies;
- identification of priority areas for action;
- constant review of operating procedures and processes;
- breaking up known syndicates;
- upgrading the professional competence of financial managers;
- participation of the national leadership;
- creation of a watchdog organization;
- use of cross-disciplinary task forces;
- dissemination of accomplishments to increase public support; and
- development of a national database on fraud.

Summary and Prognosis

To quote from U.S. President William Henry Harrison’s 1841 inaugral address: “A decent and manly examination of the acts of government should be not merely tolerated, but encouraged.” Kazakhstan’s financial experts, sited at the crossroads of three cultures, are well positioned to make an outstanding contribution.

SYSTEM LINKAGES FOR ACTIVITY COSTING OF PUBLIC SECTOR OPERATIONS*

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Introduction

Slowly, inexorably, managements of public sectors, both political and public service, are coming to recognize that budget management is only an invitation to spend money, and cost management, properly designed and operated, is an open invitation to save money. Only by public sector institutions embracing the latter can their public ever begin to be assured of getting value for money from the sector. Therefore, activity costing of public sector operations must be seen to be of paramount importance. This paper emphasizes the role of activity-based costing and typical system linkages associated therewith.

But first, a definition of costing as a technique for determining the cost of a task, product, process, or project (an activity) which requires multiple inputs for its formation or construction. Inputs may be described as direct and indirect. Direct inputs are those which are precisely measurable on incorporation in the objective. Indirect inputs are those which cannot be accurately measured and are applied by commonly accepted procedures, such as apportionment or allocation on the basis of gross wages, primary material inputs, floor area, the objective's weight or capacity, etc.

Costing is also highly dependent on the integrity of information which it records and assembles, and on the efficiency of the system or systems, whether manual, mechanical or electronic, which are used to assemble its results. But activity costing is also highly dependent on information linkages with the many elements of a typical institution and its systems. This paper addresses these latter features, but references to the other dependencies will figure in this paper.

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Activity Costing

But first more definitions. Costing systems have been around for a long time. They have accumulated, or become subject to, various approaches and methods, each with its own definition. It must be made clear that costing is not the preserve of private sector manufacturing industries only (which is where it began) but, from experience, any activity in any sector can be meaningfully costed. What is required is a determination of the most appropriate costing technique or techniques to measure the performance of an activity.

It must be recognized that public sector activities embrace virtually every known activity from parastatal organizations such as steelworks, oil and natural gas exploration and development, textile manufacturing industries; and cement works, to central ministries, provincial departments, agencies of governments, even mail services. From aircraft manufacture and maintenance to the publication of documents; from cleaning museum displays to maintaining inventories for a navy; and from running a concert hall, or a hospital, or a school, or an electricity generating plant, to operating a zoological gardens. All are subjects for costing—and what is more important, by using techniques such as ***Activity-based costing*** (***ABC***), can be used to identify the primary and secondary cost drivers.

So what is a "cost driver"? It's an activity or element of an objective which attracts a volume of indirect costs which may particularly influence the cost of an objective, and which should be a subject of management attention to manage, reduce or even eliminate. An example is cost of cooling water for an electricity generating plant, which is sometimes regarded as an overhead, and is allocated on the basis of mega- or gigawatt production or coal/oil/gas inputs. These are high measurement levels, which typically inhibit a detailed examination of actual costs of inputs to cost drivers. The cooling water costs may include costs of extraction, recirculation, cleansing, and disposal. Detailed examination and reformation of these indirect costs could result in a substantial reduction of an indirect cost, and subsequently of a cost driver. This is further discussed later under the definition of ***ABC***.

Each of the definitions discussed below are applicable to public sector operations (unfortunately few are actually applied).

Process Costing is used if you wish to determine the cost effectiveness, for example, of a steel mill. You could adopt this form of costing which assembles the costs of production by department or cost centers. Cost centers are usually sub-divisions of departments. Process costing can recognize that parts of a process may be incomplete at the beginning and end of a costing period (work-in-progress). Costs are usually the accumulation of direct wages, direct material and total factory overheads. Process costing can provide the costs of multiple processes to determine the final cost of a product.

Direct Costing is used when manufacturing a product such as housing with labor representing a major component. Cost accountants would tend to favor this method which is more comprehensible to production, marketing and senior managers because it emphasizes a direct comparison between the major input component and volume of sales. Direct costing includes labor, direct materials, but only the variable element of factory or site overheads. These are typically allocated on the basis of gross wages.

Absorption Costing (or conventionaly costing) would be used where the mix of inputs is more heavily weighed towards material inputs, with labor of less significance, such as in electricity generation. In this case, the method absorbs all forms of overhead (fixed and variable) normally allocated by reference to volume or costs of key inputs.

Standard Costs or scheduled or specification costs are not costing methods but are a means of performance measurement in a product or process production operation. They do not substitute for actual costs, but are used to compare actuals with predetermined unit costs. Their use gives rise to the use of the term variances which identify the differences between standard costs and actual costs. Standard costs must not be regarded as fixed. They must be consistently amended to reflect changes in the basic costs of all elements of the product or process production in order that they may be used as the standard by which actual production can be measured.

ABC requires a very different approach from other costing methods, and is applicable to all forms of activity, whether they may be labor, material or overheads intensive. It was a long-held belief that direct elements (labor and materials) were the factors to control, whereas recent developments in use of ***ABC*** have demonstrated that control of overheads can be more critical in product and process costs of pricing.

This is because ***ABC*** takes each indirect cost and earmarks its relationship with specific activities in the production of the product or process. The objective is to identify those elements of the production process which attract the highest, intractable overhead costs and where appropriate either seek to reduce the associated overheads, or to eliminate the high-cost production element concerned. The arbitrary allocation of overheads on the basis of gross wages or materials can obscure an overweighted bias of overheads towards one or more elements in production of the process or product.

System Linkages

A costing system is a tool for managers. Therefore the primary linkage must be with the manager(s) and persons for whom the costs are to be prepared and by whom they will be used. A costing system should not be designed in isolation from the potential users. Human beings all have different ways of conducting their daily activities and fulfilling their responsibilities. Therefore, one set of data provided to one manager could be almost meaningless to another. The linkage must be established between the manager and the staff who will use financial and statistical information, particularly to understand and define their needs for data, and the construction of the costing system, its form, content and reports.

A second key linkage must be with the activity or process, product or project which is to be the object of the costing process. Costing of construction of a factory or of housing units will require a completely different form of costing approach to that for determining the costs of products of a textile mill or of operations in a car assembly plant. Again it is critical to understand the nature of the subject to be costed and to determine the optimum form(s) of linkage. This linkage will call for an examination of the various forms of costing described earlier in this paper, in order to determine the most appropriate method or methods (because multiple forms may need to be used to better control each type of production process). If overheads are ill-defined and constitute a sizeable proportion of total costs, the use of ***ABC*** to determine precisely which are the cost drivers may constitute the most constructive linkage for that particular operation, or part thereof.

A costing system consists of two key elements, namely the planning and control functions. The *planning function* is made up of historical costs (where these are available) and an estimate if direct and indirect costs based on (a) historical costs relating to the production, (b) the current costs of production and (c) historical and current production data (quantities, volume, lengths, etc.). These estimates and actuals are used to establish a plan of action using these data to establish standards or comparables with which to measure ongoing and future performance of projected outputs.

The *control function* constitutes the mechanism to establish actual future costs, to compare these with the planned standards of performance, and the variances (or variables) from the standards. The variables need to be carefully examined to determine underlying causes. For example, a change in output statistics without a significant change in value and amount of inputs can signal various concerns, from a slow down or an acceleration in labor input; the improvement or decline in the quality of material incorporated in an activity; a change in the opening and closing inventory of partly finished activities; etc.

The more current, or up-to-date, the circumstances in which the costing system operates—and assuming data used are accurate—the greater the opportunities presented to management to change the amount, or volume, etc. of the mix of inputs in order to achieve a match with the established standards and eliminate any variances. Therefore, one of the key linkages is to a facility, or facilities, to quickly record, assemble and report costing data. This facility is likely to include time recording data (for labor and machines), consumption data (for materials and other consumables such as electricity, gas, etc.), opening and closing inventories of partly finished objectives; and allocations of overheads such as production, factory, site, management, institutional, etc.

The data collection facility will require linkages with all sources of data, and it is important to identify and understand the precise nature of each source and the nature and form of the linkage. Labor, materials, other consumables and overheads all require very specific forms of linkage with the costing system. Space and time do not permit an exhaustive discussion here of the many different sources of data and their linkages with a costing system. Therefore only a limited reference is made here to these features before discussing the key features of activity-based costing linkages.

While electronic systems (computers, electronic recorders, etc.) are commonly used today to collect, assemble and transmit data, it is frequently the case that prime data are recorded manually, based on the mental and manual dexterity of the human recorder. Manual time recording systems often are inefficient, particularly in the public sector, often by reason of management neglect to control such systems. Time recording machines in the private and public sectors are frequently targets for abuse, ranging from one person recording the presence of multiple persons (by stamping multiple cards), to vandalism to disrupting the actual recording process.

Time recording in terms of daily or periodic attendance may be successfully achieved but accurate recording on actual processes within a working day or period often can be a less-than-accurate process. This will frequently reuqire operatives to record times as they change activities or processes. While this may appear to be a reasonable proposition, constant repetition of activity changes, boredom and monotony, will inevitably affect the reliability of the human recording.

Materials consumption can often be the most reliable source of data, particularly with the use of computers to record withdrawal of stocks and returns to stock. However, one of the more frequent failures is in the area of waste of materials. In this case, production is frequently charged with materials which are, in practive, not consumed but are lost through damage, wastage, etc. This charging may occur through incorrect direct materials charging or be loaded by meas of production overheads, that is, a linkage is constructed between wasted material and the assembly of production overhead costs.

Linkages to determine the consumption of other consumables, typically utilities services, are subject to metering, but in many cases these are bulk metering systems which cannot provide accurate allocations to individuals' productions. Engineers are know to assess electricty consumption by the rated efficiency of electric motors, pumps, etc. but they frequently fail to establish the rate of decline in efficiency ratings of such equipment—a factor which causes higher consumption of power for declining output. Here again the costing system linkage can be suspect unless its linkages for measuring the inputs are accurately established, regularly tested and efficiency-rated.

It is vitally important to establish the correct linkage with machines which are used in process or project. Where a machine is engaged solely for a process or product, the linkage is simple, albeit one of the key costings should be the extent of machine time usage and its efficiency. However, where a machine or machines are used for multiple purposes, it is critical to ensure that an efficient time allocation and associated materials consumption are established to record each and every use of each machine. Here again, machine efficiency needs to be costed to form an efficient basis of charge. Machines which have significant down-time, either through breakdowns or lack of demand for use, still consume overheads, not least in the form of depreciation. Some managements may fix a machine rate on the basis of consistent running, whereas, in practice, this may not occur, and the actual operating costs of a machine may be continuously variable, usually higher than forecast, according to its operating capability and the demand for its use. Therefore, where machines form part of the direct costs, their individual costs need to be developed and controlled as key linkages with the costing system.

The linkage with overheads is often the least well-thought out element in the costing chain. Because direct costs (salaries, wages, direct materials, direct vehicular, plant and machinery) can be readily identified as chargeable against an activity, these typically are the focus of attention. Indirect costs, or overheads, are frequently difficult to identify, and even more difficult to allocate. This is a primary reason for the recent growth in the use of ***ABC***.

Overheads are often categorized, typically as production, factory, work supervision, factory management and business management. The latter is frequently not loaded as an oncost to production, but is charged in the Profit and Loss account of an organization. But the remainder are normally estimated at the beginning of a production run or process, and are recovered by adding proportions in relation to specified direct inputs, sometimes on all direct inputs, sometimes on labor only, sometimes on direct materials, sometimes by reference to other factors such as the superficial area of occupation of the process, etc. When overheads constitute 30 to 40 percent or more of the cost of a product, it should be a major responsibility of management to establish the linkage between the overhead cost drivers of the product or process and those elements which are the actual drivers. Failure to establish these linkages probably can result in an expensive cost driver not being either eliminated, or produced or operated more efficiently.

Performance Measurement

Reference was made earlier to determinations of cost variances and use of these to control costs. It should be recognized that the use of costing data will require that cost performance be linked to the actual measured performance of the product or process; a measurement which most likely will not be in financial terms, but is other statistical terms, perhaps volumes, lengths, numbers of visits, mileage travelled, kilowatts, cubic meters per second, etc. These linkages between the financial data and the physical output data of an activity are vital when generating meaningful information for managers, who are probably equally, if not more, concerned with the actual output, rather than the cost thereof. When the cost of output can be linked to the actual form or nature of the output, the costing system may provide its most useful information for a particular manager.

Summary and Conclusions

One of the many problems facing public sector operations is that their financial information systems are rarely geared to producing data in the form and of the nature required for accurate costing purposes. The typical standard chart of accounts used by public sector institutions needs to be substantially disaggregated to allow efficient costing to take place. A typical budget line item may embrace 15 or 20 tasks or processes, each of which may need to be costed in detail. The typical governmental accounting system does not allow for detailed allocation of costs by processes or products, and until this can be achieved accurately and on a timely basis, public sector bodies are unlikely to embrace modern costing methods.

A further difficulty arises when a public sector organization attempts to identify its overheads. Precisely where does local management begin and end in a public sector institution? It is certainly more easily identified in a parastatal type organization such as an electricity or water utility, but costing should not be limited to these types of public sector institutions. It should be used throughout all operations in order to measure particular sets of costs and to use the derived measurements to test both their reliability and the reasonableness of similar operational costs in other parts of an organization, sector and government by comparative statistics.

Finally, perhaps one of the most important links which sound costing should enjoy is its link with *time*. Costing should be designed as an early warning process. It is no use finding out, after passage of several weeks or months, that an activity is loss-making, exceeding its budget, etc. Time is of the essence when remedial decisions are required, and unless the costing system can provide the earliest possible warning of danger, it is of little value to a management. Therefore, any public sector institution which is considering embarking on a costing scheme should establish the feasibility of being able to generate actual costs with the minimum of delay, and to estimate costs with a high degree of accuracy, preferably using the most recent actual costs as surrogates. And the most recent should preferably be last week's costs and not last years!

Activity based costing must be seen as an essential tool for all public sector managers, and those charged with governmental financial management should insist that this technique be made widely available. To achieve this will require extensive training of managers to enable them to understand the benefits of costing, and more importantly, to understand that cost management should be their objective—not budget management.

DESIGNING FINANCIAL STATEMENTS FOR MANAGEMENT*

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I am indeed privileged to stand here amongst the most distinguished people in the accounting profession in the Public Sector. Last year, I spoke at this conference for the first time. Since then our relationship with the Consortium has grown stronger. In February this year we had organised an International Conference on 'Financial Management and Accountability in the Public Sector' in association with the Consortium at Delhi. The Conference was attended by almost 400 delegates including nearly 100 international participants from 20 countries. I can see several distinguished friends in the audience who came to Delhi and favoured us with their participation. We are indeed grateful to the Consortium to ahve helped in making the Conference a success. I hope that this relationship will grow in the years to come.

I have been asked to speak today on designing financial statements for management. I have no doubt that there are many experts here who would do a far better job on this subject that what I can offer. More often than not I just seem to accept a statement that has already been designed. The philosophic inputs have already been given, sparing the likes of me of avoidable exposure! Nevertheless I shall try and share with you my perception of the subject based on the Indian experience.

The Reforms of 1976

The financial systems which we inherited in India were largely based on the Government of India Order of 1936 issued by the British Government. The bulk of the financial provisions of the Indian Constitution have been adopted from this Order. Prior to 1976 the accounts of the Federal Government were maintained by the Comptroller and Auditor General of India. Although some Departments like Railways and Defence were

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compiling their own accounts for quite a few decades, the responsibility for the presentation of the final consolidated accounts of the Government to Parliament was that of the Comptroller and Auditor General.

While the function of the Auditor General is more or less the same around the world i.e. to function as the Supreme Auditor of Government Accounts, the responsibility with regard to maintaining accounts varies from country to country. In many countries where the accounts are maintained by the Auditor General, he functions closely with the Ministry of Finance or the Executive on matters relating to accounting and expenditure control. In our country also this was the situation until Accounts were separated from Audit in 1976. A Commission constituted by Government for suggesting administrative reforms had recommended that the Comptroller and Auditor General should be relieved of the responsibility of compiling the accounts and that accounts should become an integral part of management. The Government accepted these recommendations and with some further refinement undertook one of the most major reforms in the field of administration in 1976. This reform was in the field of financial administration and covered two aspects.

a) Separation of accounts from audit and introduction of a system of what we call "Departmentalisation of Accounts" under which the ministries of the Government compile and maintain their accounts and

b) integration of the functions of secondary financial scrutiny and financial advice with the line ministries.

These two reforms have had a far reaching impact in the field of financial administration in our country and my talk to you today would have to be seen against this background.

The major objective of departmentalisation of accounts was to improve the financial competence of the ministries and to make accounting an effective tool of management. The timely and accurate flow of financial and accounting information was to be used for programming, budgeting and evaluation of various activities and for optimum utilisation and efficient monitoring of resources. The availability of reliable data was expected to help the Ministries in framing the budget estimates more accurately as well as in helping with better exchequer control.

Financial Statements - Statutory

The financial statements which we present to Government and Parliament could be described as statutory and non-statutory. There are basically three statutory financial statements which we present. They are (i) the Budget and the Demands for Grants, before the commencement of the financial year (ii) the Finance accounts of the Union Government which is the principal account of the Government of India and (iii) the Appropriation Accounts which is an account with reference to each of the appropriations sanctioned by Parliament. These statutory statements, provide a fund of information and hopefully lead to transparency and accountability with regard to the functioning of Government; hence, I would like to briefly touch upon what they reveal and what they conceal!

We have an elaborate written Constitution which lays down the broad features of the budget statement to be presented to Parliament. Our Constitution describes this statement as the 'Annual Financial Statement'. The format of the Demands for Grants as presented for appropriation by Parliament are in a format different from the Annual Financial Statement. The format of our accounts, as a corollary, kept up with the Constitutional stipulations on the Annual Financial Statement and Demands for Grants.

The Finance Account is broken up into two parts: Part I shows the summarised accounts and Part II shows the detailed accounts and other statements. Part II is again broken up into two parts; the first part dealing with receipts and expenditure and the second part dealing with debt and other transactions.

The Appropriation Accounts are prepared by the Ministries themselves. However, a summary of these accounts bringing out the important highlights are prepared by my office and presented to the President of India and Parliament after audit certification. The appropriation account is essentially intended to meet the objectives of Parliamentary financial control. These objectives could be summarised as:

- Whether Government's control over expenditure has been adequate;
- Whether money has been spent on the intended purpose;
- Whether there has not been undue and unjustified savings; and
- Whether there has not been excess expenditure over what Parliament has voted.

Let us see now how these documents are inadequate from the management point of view.

The Budget

Let me take the budget first. While we have adopted a functional system of classification as in other countries, the Accounting Heads are drawn up in such a way that the capital expenditure and the current or recurring expenditure components for the same function or programme are not reflected at one place. There are other segregations as well, as required under the Constitution. Thus, the formal budget statements do not bring out expenditures on functions and programmes as neatly packaged as modern managers have come to expect or demand.

Accounts

Similarly in Accounts, in 1962 the then Comptroller and Auditor General of India presented his case for simplification of the Appropriation Accounts before the Public Accounts Committee of Parliament, which is the most important Financial Committee in our country and said

"If mere increase in bulk had added to the usefulness of the publication, there would be little to say against it. What has actually happened however is that we have gone on according to old methods; and so great is the mass of details given in the Appropriation Accounts that it is literally true to say that one cannot see the wood for the trees."

Thirty years later statutory accounts statements continue to be somewhat rigid, stultified and opaque. Some marginal changes have been made recently, but to my mind, they have not been dynamic enough. One of the reasons is that the auditors do not share the accountant's enthusiasm for change and since, under our Constitution, the auditor has to be consulted before any change is introduced, this becomes that much more difficult and prolonged in coming. It is not surprising therefore that only an odd administrator reads the appropriation accounts and the Member of Parliament, for whom it is meant, is frightened of its mystique which deepens every year in proportion to the growing bulk of the document.

1976 and After

The real change that we brought out in India since 1976, that is, since the creation of the office of the Controller General of Accounts, has been in the non-statutory statements. Let me try and blow a little of our trumpet in this regard.

Budget Documents

As I said, prior to 1976, the budget documents contained a plethora of information but it became difficult to sift important segments of information when the need arose. Between 1976 and 1986 there was some effort made to change but it was a half-hearted and somewhat lazy effort. First of all it was decided to change the classification to relate as close to the functions as possible. This was a big and reasonably successful effort. We then produced new and extremely useful documents containing expenditure and receipt budgets. I believe these documents were highly welcomed in all the Administrative Ministries. Finally, we started showing in the budget documents a simple one stage comprehensive statement indicating how the fiscal deficit had been arrived at. To make the budget look very simple for the interested laymen and hopefully for the parliamentarians we also started producing what we call "Budget at a Glance". This document contains broad features of receipts and expenditures of Government but two extremely interesting graphs were added to show where the rupee comes from and where it goes. I can tell you without hesitation that this simple document would top the popular ratings in the financial circles in India, both in Government and outside.

Accounts at a Glance

On the accounting side we bring out a sister publication called "Accounts at a Glance" which carries highlights of the accounts along with trends in Government revenues and expenditure. Since Accounts as a Glance cannot be estimates and have to contain figures of the moneys actually spent, the data contained in it is of the moneys spent during the previous year. This documentation is not a statutory document and does not carry any audit certification with it. However, it is as authentic a document on accounting in the Central Government as you can get.

The Accounts at a Glance has undergone many changes during the past few years. We bring about some welcome change or other every year. It is our endeavour not to get stuck with a rigid format. We receive a large number of innovative suggestions from diverse user sources and every such suggestion only gladdens our heart and reinforces our belief that this kind of innovative financial statement is actually being used by some senior managers. Ours is a federal country and the Controller General of Accounts only looks after the accounts of the Central Government. But I am glad to say that as a result of some of these financial statements that we produce, I am being asked by more and more of our State Governments to help them to update their skills and systems also.

Emboldened by the success of this financial statement called Accounts at a Glance, each Ministry of the Government of India is now bringing out a similar document highlighting their accounting performance. Needless to say that the Ministries and the heads of organisations in the Ministries have lapped up this new innovation.

Experience With Designing Financial Statements

While designing the financial statements, particulary those like the supporting documents to the budget and Accounts at a Glance, it has been our endeavour to ensure its comprehension by the user. On the other hand, those which are required as an input for management decisions need to be drawn up in close consultation with the users so that we do not end up generating reports which are just confined to the files. In a few cases, however, we have not been able to provide the extent of details the user departments demand of us as it invariably pertained to information not maintained in the accounts offices.

One major concern to us, both at the macro level and at the level of the Ministries, is to ensure transparency of the accouunting data. This is easier said than done. For instance we have a system of Government accounts where we dump a number of transactions under the heading ‘Suspense Accounts.’ This heading was initially intended to account for inter-departmental transactions or as a transitory heading until the exact details of the transaction became clear. Over a period of time, ‘Suspense’ headings have become a fertile playground. It has become an axiom that whenever something is to be concealed put it in ‘Suspense’. This technique hides several sins not the least of which is inefficiency. I suspect that this or some similar technique is widely used in corporate accounting also. My organisation has been struggling to get out of this attractive habit of inducing deception and make financial statements more transparent, more reliable and more credible. We have not fully succeeded yet, but we can at least see that we are getting there.

Public Enterprises

We face a similar problem of inadequate or incomplete disclosure by financial statements furnished to my office by some of our public enterprises. As you are aware, our country has embarked on a process of economic reform which directly impinges on many of our state run Corporations. A large number of them, some efficient and some very inefficient, require to be financially restructured to meet the challenges of a liberalised atmosphere. The report by my office on such cases forms one of the most crucial inputs in the deliberations of a Cabinet Committee headed by the Finance Minister. In quite a few cases, we have come up with the finding that the data had been selectively presented leading to erroneous conclusions. For example, in some cases our analysis of financial statements of holding companies showed that they lead to a conclusion quite different from that revealed by the accounts of subsidiaries. Similarly, a deeper analysis of the financial statements could show the need for discontinuance of some product lines despite the seemingly convincing argument by the management. In another case, a major corporation at first gave a five year projection which looked quite rosy. But when a ten year projection was insisted upon, it was discovered that the corporation would have run into a Rs. 20 billion deficit. I rather suspect that this corporation considers my office as a bit of a pain in the neck. The central point that I am making is that the same tests of transparency and accountability are relevant for financial statements produced by Corporations. And this does not include disclosures on subjects like Environment which is acquiring growing emphasis.

Receipt Accounting

I guess designing statements to show income has never been a serious problem in the corporate sector. But in Government this is a bit more complex. Some kinds of income like borrowings or interest are easily depicted. The complexity comes in the area of taxes.

In a country like ours which is huge and is not yet a charmed member of the advanced group of nations where modern information technology has overtaken everything else, collection, reporting and final reconciliation of taxes is a big exercise. There are in India, over 10,000 bank branches all over the country involved in collection of Central taxes. The money that they collect has to be deposited immediately into the Government account maintained by the Reserve Bank of India, which is our Federal Bank.

Prior to 1988, we had an archaic system regarding collection and reporting of taxes. We discovered that there were enormous delays in the final accounting or correct accounting of these receipts. In 1988, we undertook a major exercise in overhauling the system. I discovered during this overhauling that there was a need for a large-scale change in the statements designed for the system. And these statements needed to be changed at all levels, from the base, that is the bank branch level, right up to the Federal Bank level and finally at the Government level, that is in the Ministry of Finance. I recall vividly the resistence that we encountered to such changes by the banks, by the tax authorities and sometimes even within my own office. Needless to say that we overcame that resistence. We are relieved that the change has worked but, even more, we are happy that we have induced management at all levels to look at financial statements as friends. The same people who were obstinately resisting to changes are now inundating us with more ideas, more food for thought. This was, in fact, one of my most rewarding experiments of designing user friendly financial statements. In the process we also pushed ourselves a little further into partaking of the benefits of the rapidly advancing Information Technology.

The Future

What we have done in recent years is to at least start the walk of the long trek. My immediate objective is to see the feasibility of bringing out a provisional account for Government much before the final audited accounts are presented to Parliament. At present, the finalisation of annual accounts take nearly nine months for finalisation and by the time they are audited and placed before Parliament it is nearly a year old. Public memory is short and hence there is very little interest in these accounts that we present before Parliament. If we bring out a provisional account, covering all aspects, at least a couple of months after the annual year is over we would have inched closer to greater accountability of Government.

Similarly, on the accounts presented to the programme managers for decision-making, I would like to see a much faster reaction time. This is possible given the current advances in the field of Information Technology. Our accounting organisation has made large and rapid strides in computerisation and I see the need for much accelerated activity in this area.

When I look at the task of the accountants, I am reminded of the poem of Robert Frost of which our Prime Minister Pt. Jawaharlal Nehru was fond of:

> *"The woods are lovely, dark and deep, and I have promises to keep,*
> *And miles to go before I sleep, and miles to go before I sleep."*

ACCOUNTABILITY RELATIONSHIPS IN PROGRAM DELIVERY: A CANADIAN PERSPECTIVE*

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Introduction

As I stand here before you, a high-level group in our Canadian federal bureaucracy is engaged in yet another program review that has many of our public servants in Ottawa and around the country on the edge. With increasing cost of government services and the people's unrelenting demand for services, governments in our country and around the world have no choice but to find ways in reducing costs and to explain what it costs to provide services effectively. In this last round of cost-cutting, every single federal program must meet the most basic criteria of cost-effectiveness if it is to survive:

- Does this program provide an essential service?
- Is its effectiveness demonstrated?
- Is there any duplication with other levels of government?
- Can the service be provided in a more cost-effective way e.g. through privatization?

If they survive, programs, agencies and whole departments will have to fight for resources. It is my guess that those that are most accountable and have processes to support their effectiveness will have a much better chance of survival. Fact unthinkable some years back: unionized groups of public servants have mounted massive public relations exercises throughout the country in an effort to gather support from the public they serve.

As in other industrialized countries, there are at present a number of forces at play that are putting much more pressure on transparency, accountability and governance in

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both the private and public sectors. The tight budget constraints in many countries is forcing a careful review of what programs work and why. Although Canada has started to crawl out of a deep recession, the economy is not expected to perform at the level of the buoyant 80's in the near future, and all levels of government faced with enormous financial burdens are reorganizing, merging, restructuring in an effort to "right size."

The people are annoyed and disillusioned with governments. Taxpayers in Canada, like elsewhere, want to know how their money has been spent, and how effectively it has been utilized. They are attacking the political process and are increasingly demanding of politicians, and politicians in turn are putting tremendous pressure on the system. Managers are under pressure to show results, but ultimately, political leaders are accountable to the people for their government's actions. Governments therefore, have a moral and often a legal obligation to report on their performance. But the public has been frustrated by the lack of transparency on the business of government and the authorities and funds entrusted with those who are charged with the responsibility for their proper use. Put simply, there is a crying need for accountable, open and effective management of public expenditures.

We have heard in this Conference how financial managers in various countries are coping with change. The focus of my presentation today will be how financial management professionals in Canada are coping with the public demand for more transparency, accountability and effectiveness for public expenditures, in particular where programs are delivered through an intermediary or third party rather than directly by public servants.

Why is the Concept of Accountability Significant?

There have been steadily increasing concerns in many countries regarding the overall results and impacts achieved from the large amount of resources consumed by the public sector. There is now ample evidence in many countries of significant structural and management reforms including the delegation of authority to newly created executive agencies and greater use of the private and not-for-profit sectors for program delivery. Accompanying these reforms has been corresponding pressure for more comprehensive and explicit definitions of the respective roles and responsibilities of the various new players to ensure that the integrity of the accountability relationship to Parliament or the governing bodies is maintained.

Much of the debate in Canada has been focused on accountability to Parliament when program delivery is through an intermediary or third party rather than directly by public servants. This growing practice of third party delivery is most evident in the areas of grants, contributions and other types of transfer payments. Development aid, from a donor perspective, falls in this category.

What de we mean by "Accountability"?

There are many valid definitions of the concept in the literature. The definition that was given by the Royal Commission on financial management and accountability appointed in Canada in 1979 is one of the more creative:

> *Accountability, like electricity, is difficult to define, but possesses qualities that make its presence in a system immediately detectable. A light wire in a circuit is enough to establish the presence of electricity without further need of definition. The sock of recognition that attends the presence of accountability in a system of government may not be quite as direct, but it is nonetheless detectable. We see accountability as the activating, but fragile, element permitting a complex network connecting the Government upwards to Parliament and downward and outward to a geographically disperse bureaucracy grouped in a bewildering area of departments, corporations, boards and commissions. Accountability moves through this network like a current in a circuit, but always in some sort of relation to the control centre, which is the cabinet.*

Another definition I would bring to your attention comes from the Office of the Auditor General of Canada. In 1975, the report of the Independent Review Committee on the Office of the Auditor General defined accountability as follows:

> *Accountability in its simplest terms means the obligation to answer for a responsibility that has been conferred. It presumes the existence of at least two parties. One who allocates responsibility and one who accepts it with the undertaking to report upon the manner in which it has been discharged.*

In other terms, accountability means holding managers answerable for the quality of the discharge of responsibilities that have been conferred by the governing body and accepted by management, including the provision of appropriate information to the governing body and other stakeholders.

What is the nature of the current accontability issue in Canada?

In our system, ministers are individually and collectively responsible to the House of Commons for the activities of government including the management and conduct of public service.

The doctrine of ministerial responsibility imposes obligations on public servants as well as on ministers. Ministers depend on the quality and continuity of advice and information from their officials in order to fully exercise their responsibility to the House. Public servants must therefore ensure that their conduct will not get their ministers into difficulty, and they must ensure that the minister is fully aware of any significant matters that could give rise to public comment. “Why was I not told?” is one of the most serious indictments of an official that a minister can make.

Despite the basic tenet of ministerial accountability, we have noted that it is principally public servants who are involved in the dialogue with the Auditor General and the Public Accounts Committee when questions of accountability arise. Ministers have not been involved in any substantive way. In a June 30, 1992 Report

("Progress Report on Public Service 2000") special note was made of the "apparent widespread misunderstanding as to the meaning and consequences of ministerial responsibility" resulting from a Canadian cause celebre, the so-called Al-Mashat affair (an Iraqi high-level official was allowed to obtain an immigrant visa to Canada during the height of the Iraqi war).

In the Canadian context, recognizing the basic principle of "ministerial accountability," the discussions and criticisms have often been confusing regarding the respective roles expected of ministers, public servants, and third parties in the accountability chain.

In addition, senior officials have responded to criticisms of both the Auditor General and the Public Accounts Committee independently without reference to any common government position and often without the benefit of any direction from their minister.

A publication entitled "Effectiveness" by the Canadian Comprehensive Audit Foundation (CCAF), a think tank promoting comprehensive auditing in the public and private sectors in Canada and abroad notes that in the context of accountability at the federal and provincial level, the term manager includes Ministers:

> *The term manager refers to those individuals who are the full-time executive heads of the public sector organizations... For example, at the federal and provincial levels of government, Cabinet Ministers have specific management responsibilities, assigned by law, which they fulfill in collaboration with their deputy ministers and public service management teams ... governing bodies demand the ultimate accounting from managers...*

Despite this clarification, no practical guidelines existed to clarify accountability relationships in program delivery especially when third parties were involved. The lack of clarity in roles and responsibilities is in our view further clouded by the lack of consensus on what is meant by "results" or "effectiveness" of programs. There is much literature and documented debate on the meaning of "effectiveness." Terms such as outputs, outcomes, impact, performance and results are used or promoted by various practitioners in varying contexts.

The extensive research work supporting the Canadian Comprehensive Auditing Foundation (CCAF) publication entitled "Effectiveness" states that:

> *No agreed meaning of the term effectiveness emerges from the literature. There appears to be a broad agreement that part of what constitutes effectiveness is achievement of goals...Neither in practice nor in the literature is there overall agreement on what the term effectiveness means. How effectiveness is understood seems to depend largely on who is looking for it.*

What are the Views of the Financial Management Community?

The Perspective of the Legislative Auditor

First, I will present the perspective of the legislative auditor, whom I represent here today, i.e. the Office of the Auditor General of Canada.

Auditors General around the world have serious concerns over the adequacy of accountability to Parliament for the effectiveness of programs delivered through third parties, e.g. development aid.

In our country, the Auditor General and the Public Accounts Committee have been quite vocal on the need for improved accountability to Parliament. The issue identified is the lack of adequate information on results achieved in relation to the resources consumed, with a particular emphasis on program effectiveness.

The Canadian government is using a wide range of mechanisms to implement its programs including the delivery of grants, contributions and other transfers through third parties. These mechanisms have been the subject of fundamental questions regarding ministerial and bureaucratic accountability.

For example, critical comments were made by the Auditor General and the Public Accounts Committee on the Canadian International Development Agency's (CIDA) accountability when using third party mechanisms for delivering its programs. In its December, 1991 report to the House, the Public Accounts Committee stated that "It is unacceptable that CIDA does not acknowledge its share of accountability on the ground that it does not control all aspects of a project." Furthermore, in its 1992 Report, the Auditor General stated that in respect of CIDA and the Regional Development Banks that "the matters for which the Minister is accountable to Parliament need to be clarified."

Many other transfer programs in Canada have been facing serious accountability challenges since the early nineties.

For example, the 1991 Report of the Auditor General on the Department of Indian Affairs and Northern Development states that "Whatever the fiscal and funding arrangements in the future, an appropriate accountability framework will be needed. The resolution of the long-standing dilemma of reconciling the Department's accountability to Parliament with the funding arrangements for First Nations is overdue." In his 1992 Report, the Auditor General reinforced that "I am concerned that this dilemma remains unresolved."

This dilemma remains largely unresolved to this day, despite initiatives by our central agencies and some individual government departments and agencies to develop accountability frameworks. More about this later. The Public Account's Committee has recently voiced concern that the new trends in management reforms and program delivery run the risk of significantly weakening the accountability chain leaving Parliament with no one to hold responsible.

How has our Office as the legislative auditor contributed to the clarification of accountability relationships in a pragmatic way?

We saw earlier that accountability at its simplest calls for holding public officials answerable for their actions, including the provision of appropriate information to Parliament or governing bodies. This has been a long-standing position by Auditors around the world. However, under the able stewardship of our Auditor General, Mr. Denis Desautels, we have adopted the more modern view that the objective is not so much to attach blame when something goes wrong, as to find why it went wrong, or what can be done to rectify it and guard it against recurrence in the future.

Our 1993 report to the House of Commons on the Canadian International Development Agency's Bilateral Economic and Social Development Programs adopted this philosophy—quite unusual for an audit institution. As an example, we included in the report a section on constraints to good management as identified by the Agency itself. This in turn allowed us to elaborate on the challenges facing the Agency to overcome these constraints in the future and not to repeat its mistakes. (Copies of the 1993 report are available upon request).

The Minister, as head of a department or agency, without question is accountable to Parliament for measuring and reporting on the results of the organization's programs. The minister's accountability must of course take into account that, in practice, an organization such as a donor agency cannot be expected to be successful in every activity it undertakes. The operating environment is such that controls over the ultimate result of its efforts is often limited by the fact that it works in partnership with the sovereign recipient states. Similar limitations exist in the case of federal transfer programs to the provinces or to the First Nations.

We wanted to further the debate and obtain a more precise answer to the following question (illustrated on page 319 in our above mentioned Report): Who is accountable to Parliament for managing results and obtaining value for money — especially in multi-party delivery arrangements?

We dealt with this question in three ways:

- We defined the manager's accountability in relation to managing for results.
- We promoted the measurement of effectiveness at the program level i.e., beyond the activity or project level.
- We specified the various levels at which accountability must be satisfied when several parties are involved in program delivery.

We defined management's accountability for results.

In the course of our audits we found that mangers' accountability with respect to achievement of results were not spelled out in terms that were both reasonable (i.e., management could agree with the terms) and measurable (i.e., the terms could be easily understood and evaluated).

By accountability of managers with respect to managing for results, we mean:

- actively pursuing well-defined policies and specific strategic objectives;
- assessing and managing the risks associated with the programs and activities undertaken;
- operating and using relevant information on performance;
- understanding and evaluating to what extent programs and activities are meeting the organization's performance expectations;
- continually learning from their experience and redirecting resources more productively among programs and projects;
- reporting on cost and accomplishments in terms of results; and
- creating an action-oriented organizational environment that promotes learning by doing, an innovative style of management and an openness to differing viewpoints.

We promoted the measurement of effectiveness beyond the activity or project level.

Using again as an instance the fertile field of development assistance, we found the state of the art in measuring aid effectiveness not to be at the cutting edge. Other than at some multilateral institutions such as the World Bank, there are preciously few impact evaluations beyond the project level to the best of our knowledge. Certainly, numerous evaluations are undertaken by donors and recipients, but these are mostly at the project level and most are not evaluating project impact. It is only recently that the World Bank has instituted procedures for looking at portfolio performance, that is, the portfolio of projects in a sector or in a country.

There is a growing realization that translating economic growth to human development and reduction of poverty at home and abroad requires more effective policy management and more measurement of results. Human rights and democratic development issues have surfaced, and aid effectiveness is now linked with issues of good governance. The need to moderate defense expenditures is as an example in the implementation phase at the Bretton Woods Institutions, particularly the IMF.

Time will tell whether aid effectiveness will improve and what kinds of techniques will be used to measure and report on aid effectiveness beyond the project level. Our experience has been that the only measure of effectiveness that we could independently audit was at the project level. And measurement at that level posed its own challenges for the audit profession. Indeed, in recent years, the emphasis has shifted for some donor countries particularly in the area of bilateral aid from large-scale capital infrastructure projects to human resource development. Policy Management programs are now entering the core of development work undertaken in some countries. Such newer projects are often of a very long-term nature, and the results are difficult to quantify. In that regard, we explored what kind of yardsticks could be used to monitor the progress towards results of specific projects in terms of self-sustainability i.e. we developed key indicators of the potential of a project to promote enduring self-sustainable benefits after the termination of aid funding. An example is the target group involvement in project design and evaluation, and the value it places on the development benefits. However, we were unable to audit programs at the country level, for instance, because of the lack of measurable goals at the level.

We propose for both the recipient country and the donor country to try and establish a mutually agreed goal for development in the country that can be pursued by both partners as realistically and effectively as possible. However, since the agreements that have been reached for bilateral economic and social development between countries do not specify measurable goals for development, it is premature to try and develop an audit framework. We recommended in our report to Parliament that the Canadian International Development Agency come to clearer understandings with recipient governments on what specific objectives can be realistically pursued, what the Agency can reasonably be held answerable for, and those aspects for which recipient governments or others will be held to account i.e. the division of accountability for achieving objectives.

At a Conference on Aid Effectiveness and Accountability hosted by the Auditor General of Pakistan last February, we expressed the need for the Supreme Audit Institutions to examine effectiveness beyond the project level. We expressed the need to satisfy accountability at various levels. A government department or agency enters into varying types of delivery mechanisms and financial arrangement where other partners are involved. We found that in such circumstances government departments and agencies did not fully acknowledge their accountability to Parliament for managing in a way that would produce desired results - that is, for obtaining value for money. Their reluctance arose from a keen awareness of uncertainties and risks that are common in areas where multiple jurisdictions are involved. For bilateral development assistance, we found that agreements with partners are not enforceable in practice. The Canadian agency had not focused on the results that were to be achieved. The "audit trail" often ended with intermediate organizations funded by the agency. Neither the general memorandum of understanding for the country program signed with recipient governments nor the memoranda at the project level with appointed bodies of recipient governments spell out specific development objectives or results are to be pursued, or how accountability will be served.

We recommend six levels at which accountability must be satisfied in program delivery:

- Government to Parliament;
- Legislative auditor to Parliament;
- Donor (e.g., country, organization) to Recipient (e.g. country, province, organization);
- Recipient to Donor;
- Executing Agency (Host) to Host Country Administration or Institutions;
- Executing Agency (Donor) to Donor Administration or Institutions (e.g. Aid Agency).

An Initiative by Central Agencies

Senior financial managers of the central agencies, supported by several departments and agencies, recently concluded that the reinforcement of the basic principle of ministerial accountability is an appropriate starting point for clarifying roles and responsibilities. Although no new definition of accountability was proposed, the following fundamental underpinnings of accountability to Parliament were noted:

- The formal accountability link with Parliament is the responsible minister.
- The accountabilities of the minister to Parliament include the obligation to report on the manner in which responsibility has been discharged.
- Effective accountability to Parliament requires that public servants support their minister through their actions, advice and information.
- Public servants appearing before parliamentary committees do so at the discretion of their minister and under his or her directions.

Central Agencies also concluded that the accountability concept was further clouded in the case of projects or programs delivered through third parties or intermediaries. They saw a need to develop a common understanding of accountabilities for grants, contributions and other transfer programs delivered through third parties and have in 1993 established the following six guiding principles:

Principle 1—Ministerial Accountability

The responsible minister is accountable to Parliament for the use of public funds when third parties are used for program delivery.

Principal 2—Role of Management to Assist the Minister

To assist in this accountability to Parliament, information on achievement of objectives and the discharge of responsibilities by the third party must be available from departmental or agency management and, as appropriate, reported to the minister.

Principle 3—Defining Information for Each Activity

The information to measure achievement of objectives must be defined for each specific activity.

Principle 4—Assessing the Capability of the Third Party

Before entering into an agreement with a third party, reasonable assurance must be obtained of its capability to fulfill all the requirements placed upon it.

Principle 5—Third Party Agreements

The formal agreement between the Crown and the third party must clearly outline the objectives of the transfer payment, how achievement of the objectives will be measured, the conditions respecting the use of public funds, and the obligation of the third party to collect, provide and otherwise disclose the necessary accountability information.

Principle 6—Cost-effective Control

The extent of monitoring and independent validation should be cost-effective taking into consideration the nature and capabilities of the third party, and the materiality and risk of the activity.

The first two principles are fundamental to understanding respective roles and responsibilities and are to be included in any communication material or training programs.

Principles 3 to 6 are operating principles that all have significant implications for departmental management.

The Perspective of the Canadian Comprehensive Auditing Foundation (CCAF)

The Foundation has been promoting discussion on good governance and the related concepts of accountability and effectiveness. Amongst other principles, the Foundation promotes that governing bodies acting as stewards of public resources must have a responsibility to fulfill accountability obligations to those whose interests they represent by reporting periodically on their organization's performance. It has stressed the importance of management's responsibility in reporting on effectiveness, and has provided twelve attributes of effectiveness which can be used in doing so. These include the relevance, appropriateness and acceptance of a given program, the organization's responsiveness to change, and the relationship between costs and productivity.

During a Conference on Accountability organized by the Foundation in 1992, a key recommendation was the need for legislative and regulatory reform to ensure enduring accountability regimes.

The Foundation considers the principal elements of reasonable and well functioning accountability regimes as follows:

- First, is the dialogue between management and governing bodies and indeed other stakeholders about the quality of the discharge of responsibilities that have been conferred by the governing body and accepted by management.
- Second is the audit requirement to reinforce that accountability relationship through an independent, objective assessment of management's representations on performance or, in the absence of these, assessing management systems and practices against agreed criteria. The argument made was that the accountability legislation now in effect at the federal and provincial levels in Canada and in some larger municipal governments largely ignore the need for management

reporting, especially in relation to effectiveness, and is to some degree limited to a focus on systems and practices. The Conference participants emphasized that fact that much of the reporting and audit requirements in the private sector are legislated, and that the Canadian Institute of Chartered Accountants' audit and accounting standards are in effect part of the law through legislation. In addition, rules are issued by many regulators such as the Ontario Securities Commission. The requirements for management discussion and analysis in annual reports is a good example of enhanced reporting on effectiveness through legislation or regulation.

Such arguments are no doubt forceful. Financial reporting and audit in the private sector are critical to the integrity and effective working of the capital markets. Effective capital markets are fundamental to our free market system. One could argue that what is happening in Eastern European countries is a result of the lack of reliable financial reporting and auditing. It is slowing their movement to a free market system and accountants and auditors are in enormous demand to aid in the development of their economies.

Conclusion

The perspectives of various financial management professionals in Canada that I presented on the issue of accountability relationships in program delivery clearly show the importance of first clarifying the notion of manager in the delivery chain and his or her roles and responsibilities. Next, the viewpoints presented are common in highlighting the significance of clarifying who does what to whom and why when a multi-party delivery arrangement exists. Accountability must be satisfied at various levels of intervention by the different parties involved in the delivery of a program, project or activity. This means that the lead organization or agency needs to come to a clear understanding with the other parties on what specific objectives can be realistically pursued and on the division of accountability for achieving them, measuring them and reporting to the governing bodies on results and costs.

FORENSIC AUDITING

by Robert W. Ford, CFE, CGFM
More than 40 years government service with the U.S. General Accounting Service and the IRS. Currently an Educational Consultant with the Interagency Auditor Training Center, the Department of Heath and Human Services, the Universities Research Corporation and the Government of Taiwan.

A Matter of Focus

"Forensics" is modern terminology for locating and for effectively and convincingly presenting evidence. The term has long been applied to medicine, pathology and investigatory matters. We are exposed to forensics in the news when applied to determinations of time and cause of death, identification of victims of accidents and in criminal cases. Courtroom scenes on television have furthered our exposure. Less well known perhaps is the use of the term in connection with such undramatic things as accounting and auditing. Forensic auditing could be used in any country and is so interesting from an accounting and auditing perspective, that experiences should be shared with international audiences.

Yet, accountants and auditors have consistently practiced the art of forensics (arguing) when "selling" audit findings. While many may not look on audit findings as particularly spectacular, substantial improvements in government and business have been accomplished, with related savings to the public.

It may be a little vague as to when auditors began to make arguments for improvement. Some say it began with Colonel Ross, who as a partner in Lybrand Bros., Ross and Montgomery (now Coopers and Lybrand) exhorted his staff to make at least one recommendation with each audit. The practice has indeed grown. However started, audit recommendations are apparently here to stay. This may be particularly so when auditors engage in assignments directed at identified objectives. Auditing by objective focuses on specific aspects of government and business rather than on the whole. For example, an audit may have as its objective "procurement in general" or only one function of procurement like advertising for bids. Audits may derive from routine sched-

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* Presented at an ICGFM Post Conference Seminar on Forensic Auditing, Miami, Florida, March 30-31, 1995.

uling based on periodic assessments or from concerns of resource providers, media attention or awareness of public concern.

Whatever the source or reason, auditing by objective takes on a forensic character when focusing on a particular question or questions. Resolving the questions makes for a high degree of a well defined scope. The scope may be narrow or broad but the auditor should completely understand what is sought. The resolution of issues in such audits requires considerable forensic skill. Findings and arguments by forensic auditors need to be not only convincing but be able to withstand attack. Opponents are expected to present convincing arguments of their own.

Forensic Auditing and Fraud

While forensic auditing has become an important aspect of fraud examinations, what we are discussing primarily in this article is not fraud *per se*. The public is no doubt more familiar with forensics in cases of illegal acts than with "auditing by objective." We know that trained investigators are most adept at ferreting out evidence and some of their methods are quite foreign to the general auditor. Such methods as "interrogating" rather than "interviewing," "putting a tail on suspects," "surveilance" and "eavesdropping" are not commonly used by auditors in general.

Often, however, investigations of fraud will involve intricate accounting and auditing procedures. Some involve lengthy and sophisticated accounting examinations more typical of auditing. Also, the scope and nature of both government and private business has become global. There are multicultural considerations, varying codes and laws to be dealt with. It is only natural that criminal and illegal acts investigations call for both investigative and forensic auditing skills.

It has been this writer's observation that a substantial number of fraud, waste, abuse and mismanagement cases derive from allegations or complaints. Dealing with them calls for focus. In regards to management, the special ability of auditors to analyze admininstrative and accounting controls influences the percentage of successfully concluded cases.

The combination of administrative and accounting controls into what has become known as "internal" or "management" control structures are vital sources of information. A brief description of these structures, which will be referred to simply as "control structures," might be helpful at this point.

Control Structures

Over the past several years, auditors have become quite familiar with control structures. Sufficient understanding of the auditees' controls has long been required by generally accepted auditing standards. Thanks to the dedication of auditors in both the private and public sectors and their writings, the design and evaluation of controls as a concept is widely available.

The modern conceptualization of controls, at least in the United States probably began with legislation of the 1950's and the 1980's. This required federal departments and agencies to establish and maintain control structures. Legislation aside, it is just plain good common sense to establish and maintain control structures and to promote the understanding of them. In this respect, it is accepted that the primary responsibility for controls is with management. At the same time, management relies on the knowledge and expertise of its audit organization to provide guidance and assistance. Management and the auditor work very well together.

For an understanding of what a control structure is composed of, we can look to the 1994 revision to the U.S. Comptroller General's Government Auditing Standards. This description is excerpted below:

Program Operations

Controls over program operations include policies and procedures that management has implemented to reasonably ensure that a program meets its objectives. Understanding these controls can help auditors understand the program operations that convert efforts to output.

Validity and Reliability of Data

Controls over the validity of data include policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, and fairly disclosed in reports. These controls help assure management that it is getting valid and reliable information about whether programs are operating properly. Understanding these controls can help auditors (1) assess the risk that the data gathered by the entity may not be valid and reliable and (2) design appropriate tests of the data.

Compliance with Laws and Regulations

Controls over compliance with laws and regulations include policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations. Understanding the controls relevant to compliance with those laws and regulations that auditors have determined are significant can help auditors assess the risk of illegal acts.

Safeguarding Resources

Controls over the safeguarding of resources include policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and abuse. Understanding these controls can help auditors plan economy and efficiency audits.

Auditors in the course of planning for and implementing audits by objective, concern themselves with those elements of the control structure pertinent to the objective. To forensic auditors this direction of effort is of paramount importance since it will lend emphasis to the scope of evidence needed for resolving issues. Auditors have also learned to devote considerable attention to the environment within which the controls are designed and operate. The quality of management's environment tells a great deal.

Forensics and Risk Assessments

In a growing economy, wider markets and increasingly complex systems, government and private business managers are more conscious of the need for detecting and controlling risks. Essential to top performance are the efforts to monitor activities, functions and systems. Vital to these efforts are risk assessments. The value of educated risk assessments is that they present opportunities for well trained evaluators to examine policies, procedures, practices and performances.

Particularly skilled at assessing risks are those auditors who specialize in forensics. Not only are they equipped with special auditing skills, but they possess the sharpness and vision to pursue specific objectives. Successful forensic auditors, drawing on their audit training, are accomplished in the review and testing of systems and transactions. They know how to measure performance and how to apply accounting, auditing and control standards. They are adept at gathering evidence to support arguments for improving management and the detection and avoidance of costly mistakes. Within their range of knowledge are all aspects of management, and they are aware of the consequences of poorly designed or poorly operating control structures.

Timely, well-chosen and well-presented evidence, gotten through the control structure can and should be of great service to the multitude of private and public enterprises. Risk assessments and the development of evidential matter to determine whether problems exist, relate closely to auditing by objective.

Forensic Evidence

Gathering evidence is at the very heart of auditing. In the case of forensic auditing, it is even more so. A special talent of the forensic auditor is the possession of an inquisitive mind. An inquisitive mind is a strong factor in choosing the right path to the objective on which the audit is based.

The types of evidence and their standards are familiar to the practicing auditor but for the general reader, a brief review at this point might be helpful. The review will be in the form of an example. It is again well to remember that the quality of evidence is nearly always dependent on the quality of the environment within which the control structure operates. The manner in which management manages and how it supports staff and how staff supports management, reflects directly on output and the audit trail.

The quality of environment is directly affected by the manner in which authority is delegated, and responsibilities assigned. Likewise, the manner in which policies, procedures, goals and objectives are conceived and communicated have substantial effect on the timeliness, relevancy and reliability of the product.

Now let us look at an example. Assume that a condition has arisen where the use of expensive and special equipment is not meeting management's criteria. According to these criteria, at least 75 percent of the equipment is supposed to be available for projects. Availability means to be in an excellent state of repair and safe to use. Safety is of prime importance to avoid litigation and to assure the welfare of employees and the public.

The condition is serious enough for management to arrange for an experienced auditor trained in forensics to look into the matter. A preliminary review indicates that only about 60 percent of the equipment meets the criteria of availablility and safety. The situation has great potential for trouble.

Here is the way the forensic auditor would likely proceed.

Talk to those in charge of maintenance and to the equipment users.

Much can be learned in this way as to the existence of problems, real and/or potential. The auditor will ascertain how those responsible assure themselves that criteria will be met.

Information gained through interviewing, provides leads but will need to be corroborated if used as direct evidence. Oral information may be incorrect, misleading and sometimes biased.

The auditor will likely talk with experts in the field and may even solicit them to testify. At this point, the auditor should also be looking for indications that the criteria set by management might be inappropriate. This could be a very important conclusion.

Observe the maintenance operation in action.

Depending on the circumstances, the auditor may not wish to be visible. Visibility might inhibit the workers and others. This type of evidence is termed “physical” and can be very effective.

To minimize the weight of the opposition, careful records will be made. Photographs might also be employed. If so, it is wise to have professionals do it. Photographs must be clearly explained and identified. The forensic auditor cannot afford to be discredited. Because most people are fully accustomed to high-tech visuals, the auditor will approach this type of evidence with much care and skill.

Look for and obtain pertinent documentation which should be in the original if possible.

Where data processing is used, hard copies will need to be obtained. In a maintenance operation such as this, there should be many documents. There should be policy statements, written criteria, published procedures, and reports together with evidence as to how communicated and how used. Since problems were suspected or known to exist at the beginning of the assignment, the auditor will determine how problems were treated.

The auditor will also look for any studies, special or routine, which may have been made as well as audit reports, external or internal. There may have been inquiries and these and similar documents will be of great assistance and will save time and original work on the part of the auditor.

All types of accumulated evidence will provide the basis for the auditors analyses.

The task will now be to pull the material together, summarize it and through a process of reasoning to reach conclusions. Reasoning is most effective when carried out within the framework of an audit finding. This framework which has been well established consists of (1) criteria, (2) condition, (3) effect and (4) cause.

In the process of analyzing the evidence, the auditor will test for sufficiency, reliability, relevancy and materiality. Critical tests are necessary to prepare for countering evidence which is almost certain to come.

Analytical evidence can be used to prepare charts, tables and other forms of graphics. This step is made easier through modern technology and equipment. Technology will also likely be used to refute or challenge the findings.

It must always be remembered that the ones to whom arguments are directed will have arguments, too. That is what forensics is all about.

Illegal Acts

If in the course of a forensic audit, the auditor becomes aware of the possibility of illegal acts, care must be taken. Likely, legal counsel will be consulted and the client or audit committee informed. Generally accepted auditing standards cover these situations and should be followed carefully. In forensic auditing, this is particulary true.

Conclusion

The concept of applied forensics in auditing is an ever increasing challenge. Those who choose to pursue the practice should find the effort and choice well worthwhile both personally and professionally.

FRAUDSTERS AND THE SEVENTH TECHNIQUE

Charles W. Raborn, Jr., CFE, CGFM*

While at the F.B.I. Academy in Quantico, the instructors in the Financial and Economic Crimes Training Unit made great efforts to open this writers eyes on many levels. One bit of insight came from a conversation that began with the phrase "Money is the root of all evil." Greed has always been a key factor in criminal behavior. Criminal minds (fraudsters) today are better educated, more sophisticated and more mobile than their predecessors—and they love money. The precept that "the pen is mightier than the sword" has been taken and adopted by many fraudsters as their rally cry. Fraudsters have learned that "pencil" crimes are difficult to prosecute, yield big bucks and are more "socially acceptable" than violent crimes. The last two decades have produced some tremendous financial frauds such as the $100 million dollar scam perpetrated by Barry Minkow, former head of ZZZZ BEST Carpet Cleaning.[1]

Fraudsters commonly hide or destroy records, which gives prosecutors and investigators a tough obstacle to jump. How, do you prove, to a judge and jury, a crime occurred? (without hard physical evidence showing the fraudster profited) The difficulties presented by "misplaced" or destroyed documents caused more than one agency to end a promising investigation. This is where an original thinker, Richard A. Nossen, entered the picture and led the way to something new.

Nossen began his career as a Special Agent for the U.S. Internal Revenue Service and retired twenty-four years later as the Deputy Assistant Commissioner of the Intelligence Division[2]. An internationally renowned lecturer and consultant, Nossen concluded that investigators and prosecutors relied too heavily on old techniques. The six

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1 "19*95 Catalog*," The Association of Certified Fraud Examiners.

2 In 1981 this was renamed "Cr*iminal Investigation Division.*"

basic investigative techniques: wiretapping, surveillance, interrogation, laboratory analysis of evidence, informants, and undercover agents, were no longer sufficient. Clearly a new approach was needed, a *seventh technique*[3] that would focus on money and offer enforcement a way to attack the fraudster via his wallet. Nossen proposed financial investigation as the missing technique.

Deceptively simple in concept, the focus of Nossen's technique is to show that the indiviudal has consistently, year after year, spent more money than was available from legitimate sources; thereby creating the inference that an illegitimate source of income must exist to support the excess expenditures. The *Net-Worth-Expenditure Principle* has become an important weapon in the enforcement community's war against fraudsters.

The *Net-Worth-Expenditure Principle* is a mathematical computation designed to determine the total accumulation of wealth and annual expenditures made by an individual. This particular method is effective in addressing instances where no books or records of income and expenses are available. Additionally, it offers two formats. The "*Net-Worth-Expenditure*" format is designed to be used in those instances where the individual was engaged in the acquisition and disposal of real estate. The "*Source and Application of Funds*" format is designed to show the source and use of funds where the individual expenses were consumable items such as automobiles and living expenses.

The use of the *Net-Worth-Expenditure Principle* by the I.R.S., in making a civil determination of taxpayers' income, has been upheld by the U.S. Supreme Court. Even more to the point, it has been upheld by the U.S. Supreme Court when used to establish one of the elements of proof of criminal tax fraud.[3]

These techniques pioneered a revolution in developing financial analysis tools for law enforcement's use. Over the last twenty years, our enforcement community has continued to react to the change in criminal behavior and has turned to merging multiple skills and disciplines. The creation of professionals, possessing the specialized skills needed to combat the fraudster, has become a growing field of endeavor. In fact, the *U.S. News and World Report* and *Working Woman* magazines have gone so far as to describe this arena as one of the fastest growing fields.[4]

While thinking about the enforcement community's efforts to develop innovative techniques, consider a quote from Cary H. Copeland, Director and Chief Counsel of the Executive Office of Asset Forfeiture for the U.S. Department of Justice:

> Law enforcement strategy has entered into a new era in the1990s. Destruction of the financial underpinnings of crime syndicates through asset forfeiture is essential to law enforcement success. All criminal prosecutors and investigators must master the basics of financial investigations if they are to be effective.[5]

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[3] Source: "The *Seventh Basic Investigative Technique - Analyzing Financial Transactions in the Investigation of Organized Crime and White Collar Crime Targets*".

[4] "19*95 Catalog*," The Association of Certified Fraud Examiners.

[5] Source: "The *Detection, Investigation and Prosecution of Financial Crimes*" Second Edition.

The effort to address white-collar and organized crime has become an area of major refocus for investigators and prosecutors alike. The skills in the various disciplines (investigator, auditor, and examiner) must overlap or merge if the enforcement community is to continue gaining on the fraudsters. Make no mistake, they are in the lead but, we ***are*** gaining ground.

GOVERNMENT ACCOUNTABILITY TO THE PUBLIC: THE DYNAMICS OF ACCOUNTABILITY IN THE U.S.*

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Government accountability to the public (GAP) has deep roots in representative democracies. That a government derives its just powers from the informed consent of the governed is the very heart of the democratic system of government. Fundamental to the concept of informed consent is citizen participation in government. As society has become more complex, the use of direct citizen participation in governance and personal contracts to monitor GAP have diminished. Governments are increasingly more aggressive in regulation of economic activities, protection of life and property, and provision of social services [GASB, 1994]. The less formalized methods of assuring informed consent and monitoring accountability have given way to formal balanced-budget laws, debt and tax restrictions, civil service systems, professional government managers, and improved independent auditing and external financial reporting practices. The importance of formal methods to monitor GAP increases as governments become larger, more complex and more distant from the citizens they serve. To a large extent, the information needed to assess and monitor accountability evolved as governments responded to the changing needs of their citizens. Yet, despite popular acceptance and the importance of GAP, there remains a discrepancy between what accountability information governments are willing (able?) to provide and what information the public expects.

This paper identifies major changes in the focus and monitoring of GAP and discusses how governments have responded to these changes. The first part of the paper discusses the cultural dynamics and political changes that have helped direct GAP's focus over the past 50 years. The second part of the paper addresses the changes in

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methods available to monitor accountability (i.e., budgets, performance audits, external financial reports and independent audits).

Cultural Dynamics and Political Pressures

Definitions of accountability in the public finance literature take on many different meanings. Often, these definitions utilize academic rhetoric in such a fashion that the reality of the meaning is obscured.[1] Yet, the essence of GAP is simple:

> *...accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used. Governmental accountability is based on the belief that the citizenry has a 'right to know,' a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives [GASB, Concepts Statement No.1, Objectives of Financial Reporting (1987), para. 56].*

In 1970 the American Accounting Association Committee on Concepts of Accounting Applicable to the Public Sector identified four levels of accountability:

(1) financial resources; (2) legal requirements and administrative policies; (3) efficiency and economy of operations; and (4) program results as reflected in accomplishments, benefits, and effectiveness. Subsequently, Stewart [1984] identified five levels of accountability, referred to as the "ladder of accountability:" (1) accountability for probity and legality; (2) accountability for processes, procedures, or measures of performance; (3) accountability for efficient and economical performance; (4) accountability for program outcomes and effectiveness; and (5) accountability for the selection/rejection of policies. These levels of accountability form a structured hierarchy. Accountability at the lower levels is a prerequisite to obtain accountability at the higher levels.

The basic definition of accountability has its roots in the U.S. Constitution and has remained relatively unchanged in recent history. Moreover, the basic accountability process also has changed little. GAP begins with the acknowledgement of the reciprocal links between governments and their resource providers, and includes the requirement to explain one's actions, and the analysis and assessment of the accountability information. Ultimately, the process comes full circle to provide feedback to the government in the form of praise or censure of its actions. [GASB, 1994] Although the definition and process have remained relatively unchanged, nonetheless, the focus of accountability and the monitoring methods have evolved. Stewart [1984] notes that the focus of accountability may be different depending on the service and government, and is different based on the right to information, the duty to report, the power to impose sanctions, and the relevant information to provide.

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[1] See, for example, Barnett, Brown and Smith [1991], Cigler [1990], and Craig and Gilmour [1992]

The change in focus emphasizes the need to consider the cultural basis for GAP and the processes used by governments to demonstrate GAP. To facilitate analysis, this paper divides the past 50 years into three eras, each representing shifts in the focus and monitoring of GAP.[2] These eras are defined by major shifts in federal policies towards state and local governments which reflect underlying cultural dynamics and political pressures.

To understand the changes in GAP over the last 50 years, it is important to describe the nature of accountability prior to the first era. In 1798, the Eleventh Amendment to the Constitution was ratified. This Amendment upheld the doctrine of sovereign immunity. It prohibited individuals from suing local, state or federal governments and prohibited state and local governments from suing the federal government or from suing each other. This Amendment was the direct consequence of the precarious financial condition of many state and local governments, and the result, at the time, was perplexing:

> *We thus see a society that rebelled against royal prerogatives and sovereign immunity, and a society based upon the view that the "people" and not the government are sovereign, reestablish the English doctrine of sovereign immunity.[Hurwitz, 1981]*

This Amendment created a situation of minimal accountability for elected officials. Since they were basically free from liability, the only method of enforcing GAP was the electorial process. Request for action against wrongful acts by the government were required to be petitioned before Congress.

In 1855, the Court of Claims Act was passed. This Act exposed governments to public claims in a few, selected areas. However, the Act did not allow for tort claims against the government. The 74th Congress alone heard over 2,300 petitions for private bills for compensation. These petitions exceeded over $100 million in value.

GAP: Probity and legality accountability - Part I (1935-1968)

The first era of probity and legality accountability is defined for the purpose of this paper as beginning sometime in the late 1930's and ending by 1968. It is characterized by the court's recognition of government's legal liability for the raising of revenues and the spending of resources. In 1946, the Federal Tort Claims Act (FTCA) was passed. This Act gave individuals a course of action for redress through the federal court system. The United States government was now legally liable for its actions. Eventually, through state law and court decisions, state and local governments became legally liable as well.

The threat, even though remote, of legal action forced governments to reconsider their perspective concerning accountability to the public. Prior to the passage of the

[2] Although presented herein as distinct eras, the shifts in GAP focus are more gradual than sudden, more evolutionary than revolutionary.

FTCA, governments and their elected officials were only accountable to the majority of the constituents and only at election time. Now, interest groups, secondary constituent groups, or individuals could force an issue or action to the forefront through the courts and compel the government to be accountable for its actions.

While this method of enforcing legal accountability was not widely used, it did create opportunities for causes (such as civil rights) to address, confront, and promote legislative issues. At the very least, the FTCA enforcement of legal accountability expedited policy changes and, more importantly, placed GAP issues squarely at the legislatures' (both state and federal) doorsteps, thereby, demanding attention.

GAP: The Era of Probity and Legality Accountability - Part II (1968-1980)

It is difficult to date exactly the beginning of the second part of this era. Again, for the purposes of this paper, we define the second part as the time period of the late 1960's to the early 1980's. This was a period of tremendous upheaval in the U.S. political scene. It began with a fairly naive citizenry just awakenening to the horrors of the war in southeast Asia and ended with the hostages in Iran. Although these political events, and the ones inbetween, no doubt changed the public's perception of government accountability, this section of our analysis focuses on the economic and financial changes in the flow-of-funds between the federal and state and local governments.

In 1972 Richard Nixon began to utilize revenue sharing as a primary means of managing state and local governments. The rational was to move spending closer to the consumers of the government service under the theory that those at the local levels could better decide where the money should be spent. The Nixon administration's philosophy was to use revenue sharing and block grants as a means of decentralizing government. The shifting of the spending of financial resources to the state and local governments served to shift the accountability focus as well.

In the early 1970's, the first wave of extensive revenue sharing reached local governments. Although many states and local governments exercised their responsibilities appropriately, the media delighted in reporting the spending of revenue sharing funds on golf courses, tennis courts, flower pots, and other seemingly frivolous projects. The federal government responded by restricting funds through a greater use of categorical and block grants. While grants had been used since the Roosevelt administration in the 1940's, and had been a primary tool of the Johnson administration's Great Society program of the early and mid-1960's, the Nixon administration during the 1970's that was responsible for the greatest proliferation of grant funding.

The growth in grant funding was based, in part, on a federal perception that state and local governments needed detailed regulations and guidelines to ensure accountability and uniformity in the administration of projects. Federal funds could only be received if the federal government took an active hand in implementing the program.[3]

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[3] This philosophy is especially interesting given that many programs (e.g. food stamps, education, welfare reform) were initially state programs which were adopted by the federal government.

In reality, the federal government succeeded in placing the image of accountability on itself and the burden of accountability on the state and local grant-fund recipients. This allowed the federal government's proclamation of their own success when programs met established objectives and their condemnation of state or local government implementation when programs failed to reach stated goals. State and local governments were now held accountable to the resource provider (i.e., the federal government) and GAP was dominated by the specific grant requirements of the federal government. This obligation to the federal government was noted by Governor Richard Snelling of Vermont who called state and local governments "sub-national units," indicating that they had lost their identity as independent units in a federal system.[4]

GAP: The Era of Probity and Legal Accountability - Part III (1980-present)

The beginning of the Reagan administration in the 1980's can be viewed as the point where federal funding for programs greatly diminished.[5] Federal funding to local governments accounted for 29.1% of local own-source revenue in 1978, but accounted for only 11.5% by 1987.[Yinger, 1990] Three issues are important when reviewing the focus of GAP during the Reagan and post-Reagan periods.

First, the trend in grant funding begun by Nixon in the 1970's increased dramatically during the 1980's. The funding that emanated from the federal government became almost exclusively grant funding. This grant funding had all of the problems and dual accountabilities that were evident in the seventies. The proliferation of grant spending, and the requisite audit of federal funds, was so pervasive that in 1984 the Congress passed the Single Audit Act in an attempt to provide more timely, relevant, and cost-effective audits of federal funds.

Second, an increasing number of programs were completely turned over to the state and local governments with either little or no federal funding provided. State and local governments became accountable for both the provision of the services and the funding of the services. Often, the inability of local governments to fund these federal mandates forced states to assist local governments by increasing their own intergovernmental transfers or by providing local governments the capacity to raise more revenues in its own jurisdiction. In a few cases, the state governments responded by taking over the financial responsibility for previously local operations. Thus, the focus of GAP had become increasingly complex.[6]

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[4] Speech at the Council of State Governments' Eastern Regional Conference, July 1980

[5] The reduction in spending actually started in the Carter administration. However, these cuts were small in comparison to the reduction in funding during the 1980's.

[6] The placement of program accountability at the state and local level resulted in several program reforms. Many states developed innovative education and welfare programs that would have been difficult to implement on a federal level. State and local self-reliance in the face of these new accountability challenges, while still maintaining balanced budgets, increased constituents confidence in these governments. This increase in citizen confidence in local governments occurred at a time when large budget deficits and program abuses diminished confidence in federal accountability.

Third, federal and state mandates have emerged as a primary method for establishing or modifying programs without funding. These mandates force the lower level government to locate revenue sources to finance the required service. In a sense, the higher level unit can establish goals, objectives and procedures, but not be accountable for the funding and implementation.

These mandates have lead to many conflicts between the state and federal government, and between local governments and the state. The accountability for these mandated programs is greatly diffused since the determination of service is established at one level of government, but the entire implementation, including funding, resides with the lower level government. In reality, the state officials (or local officials in regard to state mandates) are accountable for raising funds for programs over which they have no control. Since revenue raising issues are difficult at any level, mandates have successfully shifted the most difficult responsibility to other levels of government.[7]

In many cases, state and local governments have proven to be more resourceful, innovative, and fiscally responsible than the federal government. The fact that government at the local and state level has focused on needs, responded to demands, preferences, and revenue constraints and, therefore, has been more accountable through the eighties and early nineties, may prompt the federal government to further shift accountabilities to these units. Since the federal government can legislate and mandate to the lower level governments, no doubt state and local governments will continue to be tested.

Budgeting and GAP

The changing focus of GAP based on the political shifts in economic resource allocations has placed the burden on governments to use scarce resources more effectively. As federal transfers of funds have diminished and, simultaneously, federal transfers of programs have increased, state and local governments established policies and procedures for prioritizing resource allocation.

Resources are allocated in our society through a variety of mechanisms. For example, financial markets allocate resources by a strict economic distribution. Alan Schick [1990] differentiates budgeting as the allocation of resources according to rules and procedures established for claiming and rationing those resources. The budgetary process has primarily two groups of participants, claimants and conservers. From the early years of budgeting through the mid 1960's, sufficient resources were available to pro-

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[7] Unfunded mandates recently have resulted in lawsuits challenging policies ranging from U.S. immigration to the Brady bill. Lawton Chiles, Governor of Florida, recently has initiated a suit on behalf of his state requesting funding to support the U.S. immigration policy which has strained the state's resources. Also, several small town law enforcement agencies have filed suit to overturn the Brady bill based on a lack of resources for preforming the required background checks on gun applications. If such suits are successful, in the future it is possible that those government entities enacting laws and initiating policy may be accountable for identifying funding sources prior to implementation such laws and policies.

vide all essential goods and services. During this time, the established budgeting procedures heavily favored those individuals and agencies making claims on the available resources. The budgeting battles were largely over which discretionary projects would absorb the resources in excess of those needed to meet the basic government responsibility. Moreover, budgeting and budget accountability were not in the public domain. GAP did not include budget accountability either as a policy document or as an ex-post program evaluation.

In the late 1960's, the burden of the Vietnam War and Lyndon Johnson's Great Society programs increased the claims made on existing resources. For a short while, these claims could be satisfied by increasing the available resources and eliminating items previously regarded as discretionary and hidden from the publics' view. At the same time, federal spending and the anti-war movement induced citizens throughout the 1960's and 70's to become more distrustful of governments and begin to demand budgetary information. The budgetary responses to accountability demands were twofold. First, revenue sharing allowed the consolidation of programs under generic headings (e.g. education, transportation) and the transfer of these resources, and their accountability, to other government jurisdictions. This budgetary game allowed for spending reduction in many areas which were not noticeable to the public. In the early seventies, only limited budgetary accountability existed between governments. State and local officials knew that their governments were being asked to provide more government with less resources, but there was no systematic communication of this information to the citizenry.

The second response to the demand for budgetary accountability was the Nixon administration's attempt to gain control over microbudgeting by instituting planning program budgeting systems (PPBS), and management by objectives (MBO). These programs were the first major attempts to shift the budgeting power away from the claimants of the resources and toward the conservers of the resources. Included with these formal budgetary system changes was an implicit attempt to make the claimants more accountable for the funds requested and spent. The budget battle lines became entrenched as agencies attempted to justify, not only new programs and newly requested resources, but required spending for programs which had become ingrained in the very nature of the agency itself. Such defense inevitably required extensive documentation, often of a highly technical nature. Legislatures often found themselves inundated with information which could not be totally comprehended and could only be accepted as valid through faith.

It is not surprising to see an increased interest in performance auditing and program evaluation begin to emerge at this time. These budgeting systems, including the Carter administrations attempt at zero-based budgeting, met with mediocre success and are presently used only to some small degree, especially at the federal level. However, as discussed later in this manuscript, performance auditing and program evaluation have continued to grow as a major accountability tool.[8]

In the 1980's, the budgetary initiatives were attempts to shift the budgeting power

[8] See Brown, et.al., [1982] for a review of performance auditing in governments.

to favor the conservers of resources over the claimants of resources. One of the most notable of these initiatives is the Gramm-Rudman-Hollings law. The effort of Gramm-Rudman-Hollings was to macro-manage the federal budget by placing universal limits on deficits. Similar initiatives at the state level were seen through California's Proposition No. 13, Massachusetts' Proposition 2 1/2, and similar tax limitation proposals.

These attempts at conserving resources have met with limited success. Throughout the late 1970's and 1980's, several funding changes were subtlety inserted into many pieces of social legislation. These changes frequently have indexed spending in areas such as social security, government pensions, and medicare. Coupled with the increasing federal interest on debt (an indexation all its own), Congress has seen the discretionary portion of its budget shrink to approximately 25%.[9] State budgets have faced a similar situation due to an ever increasing needs for social services. More importantly, the claimants of these services have placed themselves in a most enviable position. Effectively, they have removed themselves from the budgetary system, while at the same time insuring themselves of continued growth in resources.

As the result of shifting budgeting procedures in preference of the conservers, and with a set of claimants with secured shares of the budget, it would appear that satisfying the remaining claimants is an impossible task. If the satisfaction of a significant portion of the claimants is futile, it would follow that government accountability, as perceived by these claimants/constituents, would be unacceptable.

While this entanglement of budget procedure and perception appears insurmountable, successful efforts have been made to arrive at effective, productive solutions. For example, Connecticut's Office of Policy and Management under Governor William O'Neill adopted a policy of negotiated investment strategy (NIS). NIS brought together local officials, federal administrators, and representatives of local groups to determine the most appropriate allocation of available resources for social services in the state. Through a process of setting consensus priorities, communication among the various groups was improved, leading to an allocation plan described by the participants as fair and beyond their expectations. [Kettl, 1988]

The inclusion of local representation and interest groups into the process is of particular interest, and represents a continuing trend in budgeting to satisfy constituents' demands for accountability. The inclusion of these citizen delegates enables budget committees to obtain a broad-base of perspectives and ideas, thereby, enabling the budget document to better reflect the preferences of the constituents. In addition, the inclusion of various groups in the budget process forges an alliance between the participants and the budget. It is instinctive for individuals and groups to embrace outcomes when they have been involved in the development of the results.

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[9] Based on 1989 figures, uncontrollable expenditures account for 77% of the federal budget [Derhardt (1991) p. 152].

Performance Auditing and GAP

In the 1970's, as federal revenues diminished, state and local governments were asked to provide more services with less funding. Governments responded to this problem by eliminating those projects deemed "discretionary" and by increasing state and local revenues whenever possible. As the decade progressed, the political, social and legal environments established a fundamental requirement for enhanced accountability. Politicians began to manage budgets in a "top-down positive government progressivism." [Hummel, 1989] At the same time, constituents contested proposed increases in revenue. Additionally, legal requirements for audits were included in many grants and revenue transfers, while special interest groups showed new concern regarding the legalities of government expenditures and revenues.

One response to these enhanced accountability demands was increased reliance on performance auditing. While various agencies had conducted performance audits since early in the 20th century, the demand for enhanced accountability of the 1970's acted as a catalyst to expand the use of performance audits.

The discipline and function of performance auditing has emerged during the past 20 to 30 years as part of an overall shift in the American political and administrative culture to a postpositivist, quality-oriented stance.[Wheat, 1991]

The inclusion of performance audits as an accountability monitoring method filled a need to associate the spending of public funds within appropriate government, political, and legal constraints. Audits are to ensure financial viability, legal compliance and program performance. The importance of performance audits to GAP was reinforced further in the 1980's through a series of highly publicized unacceptable expenditures of public funds.[10] The level of sophistication of performance auditing has struggled to keep pace with the demand for its use as a monitoring tool. However, the perception is that performance auditing is sufficiently developed that an additional demand has emerged. More governments are requesting performance audits to provide formal recommendations for policy changes and new policy developments. In many instances, this new demand conflicts with other auditing services. Several states have circumvented this problem by establishing the audit function as a component of the legislative branch. In 1938, only five states had an audit function attached to the legislative branch, in 1960 the number had grown to 15, and by 1982 there were forty such audit entities. [Brown, 1982] This trend will result in an increasing reliance on performance auditing as a policymaking tool to provide increased technical support for legislative action. Those audit functions which are directly responsible and responsive to legislative requirements for policy recommendations, which meet their accountability obligations, will persist. Moreover, this increased legislative support, when gathered by a neutral participant, may provide the monitoring mechanism to move GAP to the higher levels of the ladder of accountability (i.e., economy, efficiency and program outcomes).

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[10] During this time Congressional budget hearings were filled with stories of the $300 toilet seat, the U.S. Army's mule breeding farm (mules to pull caissons), the U.S. Navy's rum distillery (to pay sailors with fifths of rum), etc...

External Financial Reporting and GAP

Public financial management rests on an elaborate structure of interrelationships and fundings between levels of government. The external financial reports provide information to assist readers in determining accountability about the stewardship of public funds. The stewardship objective of external financial statements has changed little since the mid-1930's (generally considered to be the beginning of authoritative governmental accounting pronouncements). What has changed over the last 50 years is the scope of the activities reflected in the reports. This section traces the evolution of generally accepted governmental accounting principles for external financial reporting, parallelling the political underpinnings of the previous sections.

The motivation for the establishment of accounting principles came in response to the well-documented scandals of political patronage, graft and corruption in major cities; the same motives that eventually lead to the passage of the FTCA in 1946. Prior to that time, there were no systematic methods for enforcing GAP, financial reporting and auditing were at the discretion of the preparers. For example, a study of Illinois cities during 1931 and 1932 found that few had accounting systems capable of segregating transactions by activities and none had budgetary accounts that coordinated with their financial accounts. [Freeman, and Shoulders, 1993, p.25].

In 1934 the Municipal Finance Officers Association (MFOA, now the Government Finance Officers Association or GFOA) organized the National Committee on Municipal Accounting (NCMA). The NCMA was to effect improved methods in municipal accounting, auditing, budgeting and reporting and to enhance comparability of financial information among municipalities. Prior to its discharge in 1941, the NCMA issued 13 Bulletins.

From 1948 to 1953 the MFOA organized the National Committee on Governmental Accounting (NCGA) to review and update the NCMA efforts. The name change was to indicate that the accounting principles were applicable to all state and local governments not just municipalities. NCGA Bulletin No. 14, *Municipal Accounting and Auditing* (1951) became the basis for most governmental textbooks and many state laws relating to governmental accounting, auditing and financial reporting. Bulletin No. 15, *Municipal Audit Procedures*, provided audit guidance to public officials and independent public accountants.[11]

Almost 15 years later, in 1967, the NCGA was re-organized to review and update all the previous pronouncements. Its last, and without a doubt, most important publication was *Government Accounting Auditing and Financial Reporting* (1968), or the *Blue Book*. This book codified and revised the previous NCGA publications. Despite what appears to be a flurry of activity between 1934 and 1968, very little substantive changes

[11] During this time the number of audits increased. However, prior to 1974 the American Institute of Certified Public Accountant's, and its predecessor organization's, involvement in setting auditing standards for governments was limited to 2 Bulletins in the 1930's to support NCMA pronouncements.

had been effected, most pronouncements served to codify existing generally accepted accounting practices (GAAP).

In 1974 the American Institute of CPA's (AICPA) issued *Audits of State and Local Governmental Units* (ASLGU) prepared by the Committee on Governmental Accounting and Auditing and approved by the Accounting Principles Board (APB, since superseded by the Financial Accounting Standards Board, or FASB). The ASLGU recognized the authority of the 1968 *Blue Book* for governmental GAAP and the AICPA took over responsibility for setting government auditing standards.

During this same time period the National Council on Governmental Accounting (NCGA) was established by the MFOA with the stated objective to

> ...develop and issue standards for financial accounting, auditing and financial reporting for governmental units represented at the state and other levels of local government.[NCGA,1976].

The NCGA was a quasi-independent organization with 21 members and sponsored by the MFOA. Its charge during the early years was to reconcile the differences between the 1968 GAAFR and the 1974 ASLGU. However, the financial crisis of many major U.S. cities in the mid-1970's elevated the level of discontent with current GAAP for governments and precipitated the NCGA taking a more proactive position on financial reporting practices.

In 1979, NCGA issued Statement No.1, *Governmental Accounting and Financial Reporting Principles.* which remains today as the basis for much of governmental GAAP. The AICPA responded by issuing SOP 80-2, *Accounting and Reporting by Governmental Units*, which recognized NCGA Statement No. 1 as part of GAAP for governments. This SOP constituted acceptance by the NCGA as the rule-making body for government GAAP. Over the next 5 years the NCGA issued 7 Statements, 11 Interpretations, and a Concept Statement. Despite this prolific effort, the public's increased demand for accountability information had changed such that only a truly independent and unified standard setting body could address adequately all the user groups.

During this time, it's important to recall that all 50 states had different accounting procedures and that only 1 or 2 states were in compliance with existing GAAP for governments. There was no state equivalent to the MFOA. A coalition of members of state organizations (e.g., National Legislative Council, now the National Conference of State Legislatures, National Governor's Association, National Association of State Business Officers, National Association of State Auditors, Comptrollers and Treasurers, etc...) formed the State Government Accounting Project committee which ultimately became a task force of the NCGA. By 1983, *Preferred Accounting Practices for State Governments* was published.

These efforts by the NCGA, AICPA and the states did not deter the federal government from launching their own attack on government accountability. In part in response to the New York City default, between 1975 and 1978, Senator Harrison Williams of New Jersey and staff proposed legislation which would have created a governmental accounting standards board within the federal government itself. The federal government would have begun to regulate the accounting profession.

Thus, for the first time, preparers, attestors and even the FASB and the AICPA were on the same side. This threat of federal intervention virtually guaranteed the creation of a private sector Governmental Accounting Standards Board.[12]

In November 1980, Standard and Poor's sent a shock wave through the public sector with their article entitled, "Who's Watching the Books?" The article called attention to the budgetary gimmicks that brought New York City to the brink of bankruptcy, it highlighted the unregulated markets for municipal securities, and described the power-plays of special interest groups that were competing for governmental accounting rule-making authority (e.g., NCGA, NASACT, AICPA, FASB, etc...). Standard and Poor's reported that it had rejected many applications by state and local governments for credit ratings and had lowered or withdrew ratings on a large portion of its government securities. Its policy statement that governments must follow GAAP and be independently audited to be considered for a rating may sound trivial in the 1990's, but at the beginning of the decade of the eighties, this was a radical statement to make.

These happenings, built on the double-digit inflation, double digit prime interest rates, and high unemployment of the 1970's, caused the public to examine the enforcement of GAP. Closer examination of the financial statements of governments revealed that often many revenues and expenditures were omitted from the financial statements, payments were deferred past year-ends, cash due to others was held for excessive lengths of time, programs passed by elected officials were only partially funded, and significant liabilities (especially pension benefits) were omitted from the financial statements. The public wanted to know why the deteriorating conditions of governments were not clearly evident in the financial statements of government.

In 1984, the Governmental Accounting Standards Board (GASB) was created. For the first time, governmental accounting standard-setting was backed by a full-time staff and compensated board members. Accountability was directed squarely at the primary resource providers, the taxpayers. While audit requirements kept the legality accountability focus, the GASB broadened the traditional definition of users to include citizens, oversight agencies, creditors, and to a limited degree, internal management. Moreover, the GASB promulgated an accountability-based financial reporting concept. In Concept Statement No. 1, *Objectives of Financial Reporting* [1987], the GASB sets forth an accountability objective the duty of governments to be publicly accountable for the raising and spending of public resources, and the right of taxpayers and their elected representative to receive sufficient data about government so they can assess its performance.[Ives,1992,p.3]

According to *Concept Statement No. 1*, three broad objectives were identified as essential for accountability. The traditional objective of legal and budgetary compliance, and two new objectives, one on interperiod equity (whether current year revenues were sufficient to cover the full cost of current period services) and one on performance reporting (to assess the service efforts, costs, and accomplishments of the entity).

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[12] See Greathouse [1985] and Remis [1982] for a more detailed history of the NCGA.

The GASB established that the monitoring of accountability with current financial reports is limited to stewardship, at best. It acknowledged that in attempting to meet the general needs of all users in one set of general purpose financial statements, the specific information needs of none of the users may be meet. Therefore, different types of financial statements may be necessary to meet the needs of different user groups. For example, popular reporting, or reports to the citizens, are receiving serious attention for the first time, as is the development of analytic commentary in the form of financial condition assessments. The rise in the primacy of the taxpayer is acknowledged even by the Government Finance Officers Association (GFOA) which began an awards program for excellence in popular-type reporting in 1993.

GAP and The Independent Audit

Paralleling the development of financial reporting standards, a significant component of the monitoring of GAP rests with the quality of the independent audit. Some state and local governments have had rigorous audit requirements for a long time. However, since GAAP was incomplete, often the activities reported by these governments did not constitute the total economic activities of the entity. Other governments have no independent audit or external financial reporting requirements. Further, state and federal auditors frequently conducted repetitive and duplicate audits. By 1979 the Office of Management and Budget (and Congress, the General Accounting Office, the Joint Financial Improvement Program, and the AICPA) revised its Circular A-102, the uniform administrative guidelines for grants-in-aid to state and local governments and added requirements for a comprehensive audit of all units of government receiving federal funds. In 1984, Congress formalized the OMB policy in the *Single Audit Act*.

The purposes of the *Single Audit Act* of 1984 are to:

- improve the management by state and local governments of federally assisted programs;
- establish uniform audit requirements for these programs;
- promote more efficient and effective use of all audit resources; and
- insure that federal organizations, the extent possible, rely on the use the audit work performed pursuant to the Act.

OMB Circular A-128 contains the detailed audit criteria to be met when conducting a single audit. In 1990 the OMB followed with Circular A-133 which effectively extends the *Single Audit* requirements to institutions of higher education and other nonprofit organizations receiving federal assistance.

Other important changes in government auditing included the issuance by the GAO of *Government Auditing Standards*, commonly referred to as the *Yellow Book*. The *Yellow Book*, originally issued in 1972 and in its 4th edition, clearly establishes the accountability focus of government audits. The government audit is more comprehensive than the traditional private sector financial statement audit. The government audit report includes not only an opinion on the fairness of the financial statements, but also a report on the adequacy of the internal control structure and the extent of compliance with finance-related laws and regulations. Moreover, the *Yellow Book* acknowledges that the objectives of a government audit may be a combination of financial and performance audits.

> *The need for accountability has caused a demand for more information about government programs and services. Public officials, legislators, and citizens want and need to know whether government funds are handled properly and in compliance with laws and regulations. They also want to know whether government organizations, programs, and services are achieving their purposes and whether these organizations, programs, and services are operating economically and efficiently.[GAO, 1994, para. 1.11]*

GAP: The Future

Over the past two decades, there has been an increased interest in government accountability to the public. This interest can be observed by evaluating the dramatic increase in publications concerning accountability in the public sector since 1971 as presented in Table 1. The number of articles has increased from 1 in 1971 to 96 in 1993. This increase represents periodicals covering the public sector, accounting and finance, general business, and other strategic areas (e.g. computers, economics, etc.). Further, this increase has been universal in both United States and foreign journals. It is interesting to note the increase in the number of articles surrounding the presidential elections of 80, 84, 88, and 92. Each of these administrations attempted to modify the *status quo* of federalism, and in so doing altered, or attempted to alter, the focus of government accountability to the public.

Judging by the increased interest in GAP in recent years, it appears that the time has come to raise the level of accountability from probity or legality to performance. In 1990 Congress passed the Chief Financial Officers Act requiring the reporting of performance information. Also in 1990, NASBO created a task force to help states develop and report performance measures to the public. In 1991, the National Association of Public Administration adopted a resolution endorsing and encouraging the development and use of performance monitoring at all levels of government. In July 1993 Congress passed the *Government Performance and Results Act* that would require all agencies to develop strategic plans, set agreed-upon goals and objectives, and measure their progress towards theses goals. In September 1993, Vice-President Gore revealed the *National Performance Review* that relies heavily on performance accountability to re-invent government. Finally, in 1994, the GASB issued Concept Statement No. 2, *Service Efforts and Accomplishments Reporting* to provide a conceptual framework for future standards for service efforts and accomplishments reporting for state and local governments.[13]

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[13] See Bavon [1993] for a discussion of the federal government's performance measurement initiatives.

Table 1
Publications on Accountability in Government[a]

Year	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93
Total	1	3	3	10	13	11	18	40	36	49	50	31	25	37	44	47	62	64	53	52	43	95	96
U.S.	1	3	2	9	13	10	16	32	35	49	37	26	22	28	32	29	45	44	34	39	31	74	65
Foreign[b]	0	0	1	1	0	1	2	8	1	0	13	5	3	9	12	18	17	20	18	13	12	21	31
Public[c]	0	1	0	6	3	2	6	10	20	24	17	8	6	12	13	11	18	10	20	21	9	31	23
Acct./Fin.[d]	0	0	2	0	2	2	4	16	2	8	6	5	1	3	12	19	15	18	16	16	11	22	18
Gn.Bus.[e]	0	1	0	2	1	4	3	9	5	9	15	8	6	16	8	5	16	20	8	5	11	14	32
Other[f]	1	1	1	2	7	3	5	5	9	8	12	10	12	6	11	12	13	16	9	10	12	28	23

[a] Source is ABI/Inform. Search parameters were accounta.bility and government and not personnel.

[b] Articles appearing in journals published in other countries.

[c] Articles published in public sector journals. Public sector took priority on all journals. For example,Government Accountants Journal was considered a public-sector journal rather than an accounting/fi.nance journal.

[d] Accounting or financial journal, but not a government/public sector journal.

[e] General business journal.

Summary

In the political, budgetary and financial accounting sectors of government there has been an increase in information being disseminated to hold government officials accountable to the public. The public's awareness of major accountability disasters (e.g., the Iran-contra hearings or the Hoover Dam Visitor's Center) has been heightened by the intensity of the media focus. The response by governments in all sectors, and at all levels, has been to seek technical and political support for policy decisions. Governments have sought increased technical support though improved standards of financial reporting and auditing, expanded performance audits and program evaluations, and more sophisticated budgetary systems. Governments have sought to establish political support among its constituents by incorporating user groups in the due-process of standards setting and citizen committees in the audit and budget processes. The public, in turn, has increased its monitoring capability to ensure that the policies established are adhered to. Increased auditing, consideration of interest groups and their special information needs, media coverage of government proceedings (C-Span and local public-access channel broadcasts of elected officials meetings) and scrutiny of spending, combined with greater intragovernmental reporting have lead to an environment where few indiscretions go unnoticed.

The dynamics of government accountability to the public in the U.S. represents an ever-changing balance between socio-political, budgetary, and external financial reporting elements. It is difficult to select a single element (i.e. socio-political, budgetary or financial) and identify it as the leading indicator of accountability. Political factors appeared to lead in the sixties; financial factors in the seventies and; budgetary factors in the eighties. Current political issues of term limit constitutionality and intragovernmental lawsuits may point toward renewed emphasis on probity or legality accountability. However, the trend to incorporate performance audits and performance evaluations in statutes and as essential elements of the appropriation laws, the availability of the technical capability, and most critically, the public demand, will continue to move GAP to the higher levels of economy, efficiency, and performance. How fast and how far up the ladder of accountability will be dictated by the dynamics of the socio-political, budgetary, and financial reporting elements.

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