The Consortium’s international activities include:

(1) Encouraging collaboration and communication among professionals involved with government accounting, auditing, budgeting, information systems, cash management, debt administration, and financial management;

(2) Contributing to the advancement of government financial management principles and standards, and through educational events, promoting best practices in government financial to improve management control and accountability to the public;

(3) Disseminating, to its members and to the public, information concerning government financial management;

(4) Promoting the development and application of professional standards to support government financial management activities;

In addressing issues, the Consortium embraces many disciplines of governmental financial management including: accounting, auditing, budgeting, debt administration, information technology, 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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The editor invites submission of articles, research papers, letters and reviews of books and documents. Please submit articles to the editorial office indicated below. Also, requests for information on the Consortium should be addressed to:

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International Consortium on Governmental Financial Management

General Information

Working globally with governments, organizations, and individuals, the International Consortium on Governmental Financial Management is dedicated to improving financial management so governments may better serve their citizens.

Our mission includes three key elements. First, it highlights that, within the international community, the Consortium is unique - it serves as an “umbrella” bringing together diverse governmental entities, organizations (including universities, firms, and other professional associations), and individuals. At the same time, it welcomes a broad array of financial management practitioners (accountants, auditors, comptrollers, information technology specialists, treasurers, and others) working in all levels of government (local/municipal, state/provincial, and national). Additionally the mission statement emphasizes the organization’s commitment to improving government infrastructure so that needs of the people are better met.

Our programs provide activities and products to advance governmental financial management principles and standards and promote their implementation and application. Internationally, the Consortium (1) sponsors meetings, conferences, and training that bring together government financial managers from around the world to share information about and experiences in governmental financial management, and (2) promotes best practices and professional standards in governmental financial management and disseminates information about them to our members and the public.

The International Consortium on Governmental Financial Management provides three options for membership.

1. **Sustaining Members**: organizations promoting professional development, training, research or technical assistance in financial management; willing to assume responsibility for and to actively participate in the affairs of the Consortium. Each Sustaining Member has a seat on the ICGFM’s Board of Directors and receives 10 copies of all ICGFM publications to be distributed within their organization and, where applicable, discounted registration fees. (Dues: $1,000)

2. **Organization Members**: government entities with financial management responsibilities, educational institutions, firms, regional and governmental organizations, and other professional associations. Six organization members serve on the ICGFM’s Board of Directors and organization members receive 5 copies of publications to be distributed to their members, and where applicable, discounted registration fees. (Dues: $250/$150*)

3. **Individual Members**: persons interested in, dedicated to, or working with activities directly related to financial management and who wish to be members in their own right. Six members of the ICGFM Board of Directors will be selected from among all individual members. Each individual member will receive a copy of all ICGFM publications, and where applicable, discounted registration fees. (Dues: $100/$50*)

* A special discount is offered to developing countries, countries with economies in transition and regional groups and organizations in such countries to encourage their participation. This discount is not available to Australia, Canada, China, Egypt, European countries (except transition economies) India, Iran, Israel, Japan, Kuwait, Libya, Mexico, New Zealand, Nigeria, Oman, Russia, Saudi Arabia, United Arab Emirates, USA, and Venezuela. Full time students also receive the 50% discount.
The lead article in this issue of the Public Fund Digest deals with the development of associations of public sector professional accountants. This is an area that is often overlooked as countries attempt to improve their financial management skills. Hopefully, the article will give the readership some insight into the opportunities available for the development of such organizations.

Corruption is an item of intense interest for all countries and this issue includes three separate articles to address this area of concern. The first is a summary from a survey that was performed by Grant Thornton with assistance from ICGFM. The second is some suggestions from the former Auditor General from Guyana (Goolsarran) on the way forward. The last, but certainly not the least, is a case study by Mr. Dobrowolski from Poland on the actions taken to address corruption.

Financial audits are of prime concern to the auditors as they develop their documentation to support their audit opinions. A working group addressed this area and made pertinent recommendations to improve financial audits in all countries at a meeting in Malta.

The transition to accrual accounting continues to be an area of concern. A member of the International Public Sector Accounting Standards Board (Dr. Bergmann) provides a case study to reflect on the applicability of actions taken by a city in Switzerland. Professor Ouda has provided us with an article dealing with cash accounting and some of its shortcomings. Some suggested steps in a work plan to move from the cash to the accrual basis of accounting is found on pages 99 and 100 for those entities that desire further guidance.

In our attempt to give our readership some insight as to the laws that some countries have adopted pertaining to financial management, we included two laws in a prior issue: budgeting (Armenia) and accounting (Azerbaijan). In the last issue, we included another two laws: audit (Bosnia and Hergovina) and procurement (proposed in Zambia). In this issue, we include a draft law on internal audit and discuss the functions to be performed by the internal auditors. It is not intended that these examples serve as models laws to be adopted. Rather, it is hoped that each country will establish those laws that cover the basic aspects of financial management as reflected in these laws.

This issue concludes with a couple of articles (by Professors Simonsen/Armitage and Mr. Knight) on performance management and performance auditing. These areas are crucial to continued improvement in financial management practices.

As always, we invite your comments on these papers and any prior publications of the Public Fund Digest as we debate the issues. Contact me at j Hughes@odu.edu if you would like to contribute an article or discuss a government financial management issue. Or contact us by telephone, facsimile, and on the Internet at www.icgfm.org.

Jesse W. Hughes
Publications Editor

Peter Aliferis
President
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Use Exam-Based Assessment
to Develop Associations of Public Sector Professional Accountants

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Roles of professional accounting associations in supporting economic development and reform

Professional accounting associations perform vital economic roles. They are essential drivers of economic development and reform. Professional associations serve the following purposes, among many others.

- Identify qualified professionals. Professional associations adopt and enforce rigorous criteria for accountants to qualify for, and maintain, membership.
- Communicate technical developments. Professional associations promote the dissemination of knowledge through training, conferences, and publications.
- Advocate reform. The positions of associations, and the opinions of their leading members, can play an important role in forming public opinion and public policy.

In many countries outside those with economically advanced economies, professional accounting associations tend not to be financially or intellectually self-sustainable. It is no surprise that these associations do not entirely fulfill their public service purposes. An important reason is that the qualification of the associations’ members is performed in a way that is not consistent, rigorous, standardized, and otherwise compliant with international requirements.

This article focuses on the importance of the written examination in performing the assessment component of qualification. It argues that written examinations should assess capabilities in international, rather than national standards. It also argues that the written examinations should be administered in a local natural language in which business tends to be conducted. It proposes an assessment framework, and considers implications for associations of public sector professional accountants.

The importance of examination-based assessment

In the U.S. and many other advanced economies, one often takes for granted the ability to rely on recognized designations. They are evidence of at least some minimum level of education, experience, and capability. The most recognized accounting designation in the U.S. is the Certified Public Accountant (CPA). The CPA exam dates back to the 19th century. It has existed for so long, and so many hundreds of thousands of accountants have endured it, that CPA’s and non-CPA’s alike rarely imagine a world without it. Nor could they imagine a world without the supporting mini-industry of CPA review courses and materials.
It is through the qualification process performed by professional associations – which in turn relies on a tremendous examination infrastructure – that we are able to rely on professional designations. The qualification process requires some entity to determine whether candidates have met all the requirements to be designated as professional accountants. Qualification bodies must assess whether candidates demonstrate the capability to perform competently on the job. This assessment may take many forms, but most commonly is performed by means of a written examination. The development and administration of such an examination is a monumental task. From just a technical perspective, consider the scope of subject matter in which a professional accountant must be educated in order to comply with International Federation of Accountants (IFAC) criteria for professional qualification:

- Accounting, finance, and related knowledge;
- Organizational and business knowledge; and
- Information technology knowledge and competences.

These subjects, seemingly simple enough on the surface, are of course highly complex and cover a vast array of continually evolving topics. Fortunately, IFAC’s International Education Standard (IES) 2 establishes the minimum content that a professional accounting assessment must encompass. In the area of accounting, finance, and related knowledge, for example, the subjects to be covered include the following:

- Financial accounting and reporting;
- Management accounting and control;
- Taxation;
- Business and commercial law;
- Audit and assurance;
- Finance and financial management;
- Professional values and ethics.¹

The United Nations Conference on Trade and Development (UNCTAD) Model Accounting Curriculum, promulgated through UNCTAD’s International Standards of Accounting Reform (ISAR), breaks down this content into further sub-categories. The Model Accounting Curriculum, which itself is but an overview (though less summarized than the IES’s), requires 59 pages of text. Clearly, the subject matter in which professional accountants must demonstrate competence is both broad and deep.

It is important to note that IES’s allow for the assessment of competence to take any of various forms. “The critical consideration is whether the assessments are reliable and valid;” however, “there is no single preferred method for a final assessment of professional capabilities and competence.” The only IES requirement with respect to written examination is for “a significant proportion of candidates’ responses to be in a recorded form.”²

However, written examinations are extremely difficult to develop and administer reliably. Aside from the complexity of the technical subject matter of professional accountancy, there are many equally challenging aspects of professional qualification exams. These include administration, marketing, dissemination, grading, and maintenance. Therefore, it is not surprising that associations with limited resources are unable to conduct qualification programs in accordance with all international standards. Are qualification exams worth all the fuss?

**Ineffective or corrupt certification examinations: winners and losers**

Many individuals and groups suffer greatly from the lack of a proper accounting examination, and the economies of these countries suffer as well. However, this sad situation tends to provide great benefits to a few individuals and groups. The main link between these beneficiaries and this “examination vacuum” is the need to qualify accountants as a prerequisite to licensure: even in many of those countries lacking an objective professional accounting exam, accountants must be licensed in order for them to practice before the public.

The absence of an appropriate examination offers the opportunity for rent-seeking individuals to develop a proprietary, opaque examination that formally satisfies criteria promulgated by IFAC. In substance such an examination is often used to
generate revenue through corrupt practices. Corruption may take one or more of various forms, such as: direct payment to an examination or licensing official; informally requiring examination candidates to attend above-market-cost training at which an official is paid dearly to lecture; making qualification or licensure conditional on providing future favors, such as expressing an unqualified opinion on the financial statements of an enterprise with which an official has insider dealings.

Few associations are so brazen as to forgo altogether the assessment component of the qualification process. Instead, those that employ corrupt practices tend to assess candidates in an opaque and highly subjective manner. One accessible means of injecting subjectivity into the qualification process is to have an oral component to the examination.

It is not surprising that beneficiaries of such cozy arrangements fiercely oppose any attempts to disrupt them. Yet, unless they are disrupted, associations of such “qualified professional” accountants simply fail to serve the public interest. Therefore, the development of professional accounting associations is dependent on the presence of an objective and reliable qualification examination.

**Costs of non-standardized certification examinations**

One can imagine the various costs of non-standardized examinations by reference to the U.S. Even if all state societies were to have unlimited resources to qualify candidates, there would be strong reasons not to develop state- or association-specific examination systems. If CPA's in various states were qualified in accordance with examinations of varying depth and breadth of subject matter coverage, users of professional accounting services would have to take extra steps in order to distinguish between better- and lesser-qualified accountants. Worse, third party users of financial information would not have consistent levels of assurance that an entity’s financial statements were subjected to appropriate audit tests.

**A model for associations to consider**

**International standards for an international-minded market**

Neither IFAC nor UNCTAD has any formal authority over the licensure of CPA's. Nor can either of them mandate how state societies qualify CPA candidates. However, for accounting associations looking to achieve compliance with international norms, IFAC plays an invaluable role. If accounting is the language of business, then IES’s provide standardized requirements for assessing candidates’ fluency in that language. Of course, one’s fluency in accounting may be expressed in many “natural” languages other than English. Notwithstanding the growing dominance of the English language, it is clearly not the only natural language in which business is conducted. In several regions of the world, there is a common natural language in which business is conducted across geographic borders: for example, Spanish in much of Latin America. In a region where the natural language is other than English, associations should examine candidates in a language other than English. Otherwise, few truly professional accountants could receive a professional designation.

In many countries, professional certification faces even bigger problems internationally than the prevalence of many natural languages. Among them is the prevalence of country-specific accounting and auditing standards. The U.S., of course, also has its own accounting standards and auditing standards. But the country-specific nature of standards represents a relatively small problem in the U.S., due to the tremendous size and international dominance of the American economy. To glimpse the difficulties that country-specific standards impose on associations in other countries, imagine a situation in which each state in the U.S. had its own state-specific standards of accounting and auditing. NASBA could hardly afford to develop, administer, and maintain separate qualification examinations for each jurisdiction. Only a very large state society could even attempt to do so within a particular state.

For qualification bodies to serve their public purposes effectively, it helps to have standards that are, well, standardized. In an increasingly international economy, entities in different locations should produce financial statements expressed in a common technical language. There is decreasing justification for having to understand differences between various country-specific sets of accounting standards and auditing standards.
The standards covered by qualification examinations, therefore, should be internationally recognized. In most countries, that means the accounting standards should be International Accounting Standards (IAS's; now referred to as International Financial Reporting Standards, or IFRS’s); and the auditing standards should be International Standards of Auditing (ISA’s).

From the practical perspective of examination development, the use of international standards provides the benefit of allowing the examining body to capitalize on the broadest possible base of knowledge and literature. Otherwise, examination developers must make extensive use of subjective judgment in developing questions that address the country-specific aspects of standards, and also in determining the correct answers to those questions.

From the similarly practical perspective of examination marketing and dissemination, it makes sense to target an economically viable market of aspiring professionals. There is a global and relatively large market of accountants aspiring to be qualified in accordance with international standards; in contrast, there tends to be a relatively small market of accountants aspiring to be qualified in accordance with the standards of any particular country.

For associations in most countries to have a realistic hope of achieving a true professional qualification that provides adequate coverage of these topics and complies with other international criteria, they need to pool their political, intellectual, and monetary capital in order to implement a common qualification examination. Any such examination must assess capabilities and competencies in a uniform body of standards, auditing standards, etc. Aside from the question of international vs. National standards, this is essentially what CPA societies in the U.S. have done. All 54 licensing jurisdictions in the U.S. have established the CPA designation, administered by the National Association of State Boards of Accountancy (NASBA), as a requirement for licensure. And the CPA examination is required to be qualified as a CPA.

**How to address the prevalence of country-specific standards?**

Despite the strong movement toward international standards, the unfortunate fact remains that the majority of countries have not yet fully adopted international standards. As long as local GAAP or local GAAS does not fully comply with international standards, there will be a need to qualify accountants in accordance with local standards. Fortunately, countries where local standards differ from international standards can still apply this framework outlined above.

To the degree that associations must assess candidates’ knowledge of country-specific standards, an initial step for them to perform is to isolate differences between the country specific standards and the internationally recognized standards. This task can be a laborious and contentious one. Once the differences are isolated, however, associations have the information needed to assess candidates’ knowledge of applicable standards. They should do so by developing an additional examination module that tests only those specific topics where local standards differ from international ones. As difficult as it is to identify and test those areas where local standards differ from international ones, it is generally far less difficult to do so than to test all the required subject matter outright.

Exceptions to this rule occur where even the underlying principles of local standards deviate greatly from international ones. In those cases, however, I believe that professional accounting bodies should ignore local standards, as they are ultimately doomed to become obsolete. Better simply to defer the statutory examination process to state-sponsored licensing bodies or their closely controlled associations.

In countries with weak associations of professionals, the problems extend beyond the important but technical matters of national vs. international standards. An even bigger hurdle is to identify the potential population of professional accountants, and to foster the demand for their services. How to do so?
Important characteristics of professional accounting examinations

To adopt an examination program as a basis for assessing capability and competence, associations should require that it possess at least the following interrelated characteristics:

1. Appropriate technical and intellectual content: The examination program must assess appropriate capability in all the required technical subject matter. The assessment must be:
   - Broad: It must address all the subject matter of professional accounting.
   - Deep: It must address not just knowledge of technical subject matter, but also the higher intellectual skills of understanding, application, analysis, synthesis, and evaluation;
2. Local natural language: The natural language in which the examination is administered must one in which most candidates are fluent;
3. International technical language: The subject matter covered by the examination should include international accounting and auditing standards, and other subject matter covered should be in accordance with IFAC International Education Standards.
4. Effectively controlled administration: The examination must be developed, administered, and graded in a way that treats candidates equally and ensures the results will give a reliable indication of candidates’ capability.
5. Sound structure and infrastructure: The examination must be supported by adequate affordable and accessible learning materials, and programs of education and training;
6. Market recognition: Market participants should recognize the examination as giving a reliable indication of capability to perform competently. Market participants include employers, third-party users of financial information, and others who rely on the work of qualified professional accountants.

There are no great insights in the above list of characteristics. But it is very difficult and expensive to achieve these characteristics in even one subject, let alone all the various subjects in which a professional accountant must demonstrate competence. Given limited resources, associations must be judicious in identifying the subjects in which subjects they will assess by means of written examination.

**Which subjects should associations assess by examination?**

But should associations use examinations to assess competence in all subjects, or may some be assessed by other means? As a purely practical matter, the vast scope of subject matter required of accountants means that it would be too burdensome to assess capability in all subjects by means of examination.

Associations should focus their examination-based assessment on those subjects in which the market has the most concrete expectations of professional accountants. Employers and third-party users expect professional accountants to demonstrate competence, first and foremost, in the area of accounting, finance, and related knowledge. As discussed above, assessing even this one broad area is an exceedingly complex and demanding task. To the degree that associations must pick and choose the subjects on which to focus their examination efforts, that is the area on which to focus.

The areas of “Organizational and business knowledge” and “Information technology knowledge and competences” also encompass a broad range of complex subjects, as is shown below:
The subjects of “Organizational and business knowledge” bear a strong similarity to those in which business school graduates are expected to demonstrate competence. For reasons outside the scope of this article, business graduates are not expected to undergo a qualification process. The market for business skills relies mainly on the education and experience that businessmen and businesswomen possess. Business employers do not expect candidates to undergo a professional qualification process, which would require a formal assessment of capability and competence.

Similarly, associations lacking the resources to examine the full range of candidates’ capabilities, need not examine “Organizational and business knowledge” subject matter.

The market for information technology skills is somewhat different from the market for business skills. Employers of I.T. specialists often do rely on examination-based certifications. These certifications are essentially representations by entities that they have assessed the capability or actual competence of a person to perform certain I.T. functions. Regarding general I.T. knowledge, employers rely on education or experience or both. However, employers of I.T. personnel generally do not expect candidates to have gone through a full professional qualification process.

Professional accounting associations lacking the resources to examine I.T. capability should follow a similar approach, and use any of the following to assess a candidate’s I.T. capability or competence: I.T. education; I.T. experience; or, third-party I.T. certification.

Using these subjects as a foundation, an examination-focused qualification system might look like the following:

**Table 1**

<table>
<thead>
<tr>
<th>Organizational and business knowledge</th>
<th>Information technology knowledge and competences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economics</td>
<td>General knowledge of IT</td>
</tr>
<tr>
<td>Business environment</td>
<td>IT control knowledge</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>IT control competences</td>
</tr>
<tr>
<td>Business ethics</td>
<td>IT user competences</td>
</tr>
<tr>
<td>Financial markets</td>
<td>One of, or a mixture of, the competences of:</td>
</tr>
<tr>
<td>Quantitative methods</td>
<td>Manager of information systems</td>
</tr>
<tr>
<td>Organizational behavior</td>
<td>Evaluator of information systems</td>
</tr>
<tr>
<td>Management and strategic decision making</td>
<td>Designer of information systems</td>
</tr>
<tr>
<td>Marketing</td>
<td></td>
</tr>
<tr>
<td>International business and globalization</td>
<td></td>
</tr>
</tbody>
</table>

**Table 2**

<table>
<thead>
<tr>
<th>International Education Standard Subject Areas</th>
<th>Assessment method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting, finance, and related knowledge:</td>
<td>Examination</td>
</tr>
<tr>
<td>• Financial accounting and reporting</td>
<td>Examination</td>
</tr>
<tr>
<td>• Management accounting and control</td>
<td>Examination</td>
</tr>
<tr>
<td>• Taxation</td>
<td>Examination</td>
</tr>
<tr>
<td>• Legal and regulatory environment</td>
<td>Examination</td>
</tr>
<tr>
<td>• Audit and assurance</td>
<td>Examination</td>
</tr>
<tr>
<td>• Finance and financial management</td>
<td>Examination</td>
</tr>
<tr>
<td>• Professional values and ethics.</td>
<td>Incorporate to above exams</td>
</tr>
<tr>
<td>Organizational and business knowledge</td>
<td>Education requirements</td>
</tr>
<tr>
<td>Information technology knowledge and competences</td>
<td>Education, experience, or third-party certification</td>
</tr>
</tbody>
</table>
There are many potential variations on the this model, and there are few hard and fast international requirements regarding which competencies must be assessed by means of examination and which may be assessed by other means.

**Train, train, train**

In countries where there is no rigorous, comprehensive, examination-based qualification, there is unlikely to be a dependable and adequate supply of effective and affordable training programs to help candidates pass such exams. In these environments, it would be ideal for associations to dedicate extensive resources towards an intensive training-of-trainers program. Associations would then deploy these trainers to conduct a combination of: widespread and subsidized training of practitioners. The associations would, in parallel, coordinate closely with leading universities to improve accounting curricula as needed. In reality, few associations will have the resources to fulfill this ideal. Associations will need to utilize their limited resources to support members’ access to training. At a minimum, associations should identify a body of self-study textbooks, and other materials if available, that cover all the required subject matter.

**Implications for development of public sector accounting associations**

It is undoubtedly important to develop associations of private sector professional accountants. However, it is arguably much more important to develop associations of public sector professional accountants. In many countries, various forms of corruption and inefficiency in the private sector are but joint enterprises with the public sector, from which their pernicious effects spread and permeate the economy. The absence of a sound system of qualifying public sector professionals serves only to institutionalize corruption and inefficiency.

**Why hasn’t professional qualification of public sector professional accountants been more prevalent?**

There is a strong argument that associations of public sector accountants should implement rigorous examinations as part of their qualification process. Why hasn’t that happened?

Professional qualification has historically played a smaller role in the public sector than in the private sector, for several reasons. Relatively few sovereign governments have imposed on themselves the obligation to produce audited GAAP-compliant financial statements, so it is not surprising that the “good enough for government work” mentality often applied to governments’ financial statements. Also, the matter expertise required for government accountants to be effective is very broad. Licensure requirements generally do not encompass very much government-specific subject matter. As a result, the professional qualification required for licensure – e.g. the CPA in the U.S. – provides relatively low assurance of government-specific competence.

A specialized public sector qualification can provide greater assurance of public sector competence. The Association of Government Accountants (AGA), among others, has done so through the Certified Government Financial Manager program. Although the story of AGA’s implementation of the examination-based CGFM designation has been a highly successful one, there are several reasons why the CGFM model has a low chance of achieving similar success in most countries. AGA’s effective implementation of an entirely new examination represented an unusual confluence of favorable circumstances, such as: an already thriving association with a rich tradition of public service; extensive distribution channels, particularly in the form of strong local chapters; effective leadership and strategic management; a broad base of members with strong technical skills; adequate monetary resources; and considerable demand for accounting services, generated by the world’s largest public sector. Further, the CGFM’s success benefited greatly from the boost in demand for professional skills, driven by the CFO Act and other financial management legislation. Few associations are likely to encounter this fortuitous set of factors.

How can the model described above work for associations of public sector professional accountants? By building on the
foundation offered by qualification bodies that assess competence in the subject matter required of private sector professionals, there is a (relatively) very limited scope of subject matter in which public sector association needs to determine the qualification of candidates for specialization. In the realm of public sector specialization, the additional assessment can focus on those areas in which the additional subject matter required of public sector accountants is most extensive – for example, in the areas of financial accounting and reporting, and budgetary controls.

**Incremental capabilities that public sector professional accountants should demonstrate**

Associations of public sector accountants may use a foundational qualification to assess “general practice” capabilities. An essential issue to address is: in which subjects should associations assess public-sector-specific capabilities? Answering this question depends on identifying the topics in which public sector professional accountants are expected to demonstrate specific competence.

Within almost all subjects, there are specialized topics in which public sector accountants should demonstrate competence. In the area of financial accounting and reporting, for example, public sector accountants must demonstrate competence in a broad and complex range of topics. In the area of taxation, specialized requirements are rather few.

Which public sector-specific topics are extensive or different enough to warrant separate examination? It is important to determine:

- The topics in which public sector professional accountants should demonstrate competence, over and above those required of general practitioner professionals; and
- The scope of these topics – that is, the extent to which their breadth and depth exceeds corresponding private-sector topics.

Where the public-sector topics are pervasive in scope, it is appropriate to examine candidates’ capability in those topics.

Applying this approach, the following are the subjects and topics in which a qualifying body should use examinations to assess candidates’ capability:
Combining the analysis immediately above with the foundational analysis summarized on page “Which_subjects_should” yields the following approach to assessing the competence of public sector professional candidates:

### Table 3

<table>
<thead>
<tr>
<th>Subject</th>
<th>Illustrative Public-Sector Topics</th>
<th>Scope</th>
<th>Exam?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial accounting and reporting</td>
<td>Public sector GAAP, where different from private sector GAAP; budgetary accounting, budgetary-proprietory relationships, and related financial statements.</td>
<td>Extensive</td>
<td>Yes</td>
</tr>
<tr>
<td>Legal and regulatory environment</td>
<td>Laws and regulations specifically applicable to public sector accounting and finance.</td>
<td>Extensive</td>
<td>Yes</td>
</tr>
<tr>
<td>Management accounting and control</td>
<td>Behavior of costs in the public sector; performance measurement and reporting.</td>
<td>Extensive</td>
<td>Yes</td>
</tr>
<tr>
<td>Taxation</td>
<td>Public sector GAAS, where different from private sector GAAS (in ISA context, mainly the “Public Sector Perspectives” on ISA’s).</td>
<td>Limited</td>
<td>No</td>
</tr>
<tr>
<td>Audit and assurance</td>
<td>Public sector GAAS, where different from private sector GAAS (in ISA context, mainly the “Public Sector Perspectives” on ISA’s).</td>
<td>Limited</td>
<td>No</td>
</tr>
<tr>
<td>Finance and financial management</td>
<td>Categories of public expenditure and public revenue; public borrowing and debt; techniques and instruments of public treasury and financial risk management.</td>
<td>Extensive</td>
<td>Yes</td>
</tr>
<tr>
<td>Professional values &amp; ethics</td>
<td>Application of values and ethics to public-sector-specific topics.</td>
<td>Extensive</td>
<td>Yes*</td>
</tr>
</tbody>
</table>

* Incorporate professional values and ethics into above examinations.

### Table 4

<table>
<thead>
<tr>
<th>International Education Standard Subject Areas</th>
<th>Type of assessment</th>
<th>Foundational “General Practice” professional</th>
<th>Specialized (Incremental) Public sector professional</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting, finance, and related knowledge:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Financial accounting and reporting</td>
<td>Examination</td>
<td>Examination</td>
<td>Examination</td>
</tr>
<tr>
<td>• Management accounting and control</td>
<td>Examination</td>
<td>Examination</td>
<td>None</td>
</tr>
<tr>
<td>• Taxation</td>
<td>Examination</td>
<td>Examination</td>
<td>Examination</td>
</tr>
<tr>
<td>• Legal and regulatory environment</td>
<td>Examination</td>
<td>Examination</td>
<td>None</td>
</tr>
<tr>
<td>• Audit and assurance</td>
<td>Examination</td>
<td>Examination</td>
<td>Examination</td>
</tr>
<tr>
<td>• Finance and financial management</td>
<td>Examination</td>
<td>Examination</td>
<td>None</td>
</tr>
<tr>
<td>• Professional values and ethics</td>
<td>Incorporated into above exams</td>
<td></td>
<td>Incorporated into above exams</td>
</tr>
<tr>
<td>Organizational and business knowledge</td>
<td>Education requirements</td>
<td></td>
<td>None</td>
</tr>
<tr>
<td>Information technology knowledge and competences</td>
<td>Education, experience, or third-party certification</td>
<td></td>
<td>None</td>
</tr>
</tbody>
</table>

The subject matter covered by the foundational examinations is applicable to all professional accountants, regardless of specialization. The standards covered by the Financial Accounting and Reporting examination should be IFRS’s, and the standards covered by the Audit and Assurance examination should be ISA’s. In the areas of management accounting and control, and finance and financial management, essential principles and practices are, generally speaking, neither regulated nor country-specific; therefore, examinations covering these subjects may readily be standardized. Public sector accounting associations could therefore pool their resources with other professional associations, whether public sector or private sector,
regardless of country. These associations would need to share just two characteristics in order to integrate their efforts: intent
to deploy a rigorous, thorough examination; and, a common natural language.

Associations of specialized professionals, such as public sector accountants, would then need to develop and deploy an examination that covers the incremental subject matter that is additional to, or different from, what is required of the foundational professional qualification. (Also, if associations collaborate from different countries, they will likely have to develop separate examinations of taxation and law.)

Which examination system to use?

This paper has identified a hypothetical model for professional accounting associations to use in qualifying candidates, and one actual illustration of this model (the CIPA program). Actual associations should carefully decide what course they should follow. For an associations to conduct examination-based assessments, they must decide whether to rely on an existing examination or, alternatively, to develop a new one. Notwithstanding the model recommended by this paper, associations should carefully consider its costs as well as its benefits.

The following are illustrative qualifications that use examinations to assess some or all of the content required by associations of public sector professional accountants. Acronyms of the professional designations appear in bold text.

- Association of Chartered Certified Accountants (ACCA): Professional Scheme - International Stream
- Chartered Institute of Public Finance and Accounting (CIPFA): Certificate and Diploma in Public Sector Audit and Accounting (CDPSAA) [Initiative proposed by CIPFA]
- Association of Government Accountants (AGA): Certified Government Financial Manager (CGFM)
- Certified International Professional Accountant Examination Network (CIPAEN): Certified International Professional Accountant (CIPA)
- Chartered Institute of Public Finance and Accounting (CIPFA): Certified Public Finance Accountant (CPFA)
- Government Finance Officers Association (GFOA): Certified Public Finance Officer (CPFO)
- American Institute of Certified Public Accountants (AICPA) and National Association of State Boards of Accountancy (NASBA): Certified Public Accountant (CPA)

It is worthwhile to analyze these examinations to determine whether they meet the needs of public sector professional associations. To do so, one should first understand the ways in which examinations might not meet the needs of professional accounting associations.

Potential shortcomings of examinations, from perspective of professional accounting association

Given the importance of professional accounting certification examinations, one might expect that within any given country, several examinations meet these criteria. Unfortunately, most examinations do not. Some of the ways in which examinations fail to meet these criteria, and the main implications of these failures for association development, are as follows:
<table>
<thead>
<tr>
<th>Examination Characteristic</th>
<th>Examination Weakness (from perspective of prof’l accounting association)</th>
<th>Effect of weakness on exam usefulness for ass’n development</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Content</td>
<td>Narrow content: As described above, professional accountants are expected to possess knowledge that is broad and deep. A qualification exam could include all the right subject matter, but not in enough depth; or, include subject matter to the appropriate level of depth but fail to include all the required subject matter. Shallow content: Some examinations do not assess the required depth of capability.</td>
<td>Severe. If some subject matter content is not covered, exam cannot assess full range of required capability.</td>
</tr>
<tr>
<td>2. Natural language</td>
<td>Foreign natural language: There are a great number of natural languages throughout the world. Local associations tend to administer examinations in a natural language(s) in which most candidates are fluent. The sheer number of natural languages means few of them offer economies of scale sufficient to support an examination that reliably indicates whether a candidate has the knowledge to be a professional accountant. Therefore, local-language examinations generally are inadequate to use as a basis for qualifying professional accounting candidates.</td>
<td>Severe. If few candidates have native or fluent proficiency in the natural language of the exam, an association that uses the exam as the basis for qualification will attract very few members. These members will not be perceived as representative of qualified local professionals. The association will not have sufficient influence to serve effectively the accounting profession or the public interest.</td>
</tr>
<tr>
<td>3. Technical language</td>
<td>Local technical language: Most qualification examinations assess knowledge of local accounting and auditing standards rather than international ones.</td>
<td>Severe. If content is locality-specific, associations outside the locality cannot readily use the exam.</td>
</tr>
<tr>
<td>4. Administration</td>
<td>Weak internal controls over administration: The process of developing a database of reliable examination questions is extraordinarily difficult. It is similarly difficult to implement the grading system and internal controls needed to assess candidates consistently and objectively. These difficulties are multiplied several times over in countries where the examination is administered in a natural language other than English.</td>
<td>Severe. Internal control weaknesses reduce or eliminate exam integrity. Absolute integrity is a fundamental prerequisite for an exam to be used for association development.</td>
</tr>
<tr>
<td>5. Structure</td>
<td>• Condensed structure: Attempts to assess too much in too little time. Some examination bodies assess all professional accounting capability in just one sitting.</td>
<td>Severe. The depth and breadth of professional accounting knowledge requirements do not permit effective assessment in just one sitting. Moderate. A diffuse examination</td>
</tr>
</tbody>
</table>


Compliance of selected examination models with important characteristics for association development:

The following table applies the above characteristics to the examinations listed in Table 4. Where a characteristic having major effect is not met, the box is shaded red. Where a characteristic having moderate effect is not met, the box is shaded yellow.

Table 6

<table>
<thead>
<tr>
<th></th>
<th>ACCA</th>
<th>CGFM</th>
<th>CIPA</th>
<th>CPA</th>
<th>CPFO</th>
<th>CPFA</th>
<th>CDPSAA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Appropriate content:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Professional foundation</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>N*</td>
<td>Y</td>
<td>Y**</td>
</tr>
<tr>
<td>- Public-sector-specific content</td>
<td>N</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>Y**</td>
</tr>
<tr>
<td>2. Local natural language</td>
<td>N</td>
<td>N</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>Y</td>
</tr>
<tr>
<td>3. International technical language</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
<td>N</td>
<td>N</td>
<td>?</td>
</tr>
<tr>
<td>4. Effectively controlled administration</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>?</td>
</tr>
<tr>
<td>5. Sound structure</td>
<td>Y</td>
<td>Y</td>
<td>N***</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
</tr>
<tr>
<td>6. Market recognition</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>Y</td>
<td>N</td>
<td>N</td>
</tr>
</tbody>
</table>

* GFOA appears to have designed the CPFO examination to assess financial management qualifications, but not the full scope of professional accounting qualifications. This is not a criticism of GFOA or CPFO.

** The framework of CIPFA’s proposed CDPSAA qualification appears to encompass technical content that complies with IES 2. However, CIPFA has not yet specified the detailed technical content of the examinations on which the CDPSAA qualification will be based. Also, it is not

Conclusion and recommendation

Although all of the listed examination programs appear to be of high quality (or, in the case of CDPSAA, potentially high quality) all present advantages and disadvantages.

From the perspective of fledgling or struggling associations in countries where English is not a natural language of most candidates, the examinations supporting the ACCA, CGFM, CPA, CPFO, and CPFA designations all lack one or more essential characteristics needed to support association development. For such associations, the examinations supporting CIPA appear to possess the key characteristics that enable them to serve as a reasonable basis for development.

AGA, CIPFA, or GFOA may combine a program such as CIPA with an administration of the incremental specialized exams noted on page 11. This combination of foundational and incremental (specialized) examinations may serve as the basis for qualifying international associate professionals. These professionals, in turn, would constitute the membership of international affiliate associations. AGA, CIPFA, and GFOA should consider pursuing this possibility in coordination with ECCAA and CIPA-EN.
In particular, CIPFA’s proposed CDPSAA program could build on CIPA to offer an extraordinary opportunity to develop associations of public sector professional accountants:

- The CDPSAA program recognizes the need to use candidates’ local natural language to assess their public sector professional capabilities.
- The CIPA program uses local natural language to assess capability in the foundational professional accounting capabilities.
- The CIPA program has been implemented in the CDPSAA’s target markets of developing and transitional economies.

Therefore, CIPA appears to form a sound foundation on which CIPFA could build the CDPSAA designation. CIPFA should consider leveraging the CIPA program by refining the design of CDPSAA to assess only the specialized subjects in which public sector professionals must demonstrate competence.

1 IFAC IES 2, paragraph 23.
2 IES 2, paragraphs 12, 15, and 18.
3 The term “natural language” is often used in contrast with computer programming languages. This article makes an analogous contrast: between natural languages and the language of business, i.e. accounting.
4 IFAC Study 1, “An Advisory on Examination Administration, effectively summarizes these issues.
5 ACCA offers its Professional Scheme in two “streams”: U.K., which assesses capability in British standards; and International, which assesses capability in international standards.
6 CIPFA website, www.cipfa.org/international/download/training_details_jan2003.doc
Resisting Corruption In the Public Sector

The International Consortium on Governmental Financial Management (ICGFM)
And Grant Thornton

Executive Summary

On behalf of the International Consortium of Governmental Financial Managers, Grant Thornton’s Global Public Sector group carried out a worldwide survey of government executives on their opinions concerning public sector corruption. In addition, interviewees recommended ways for government institutions to reduce and resist corruption in government operations. Personnel from Grant Thornton International’s member firms interviewed 50 officials in ten countries for the survey.

Cultures of Corruption

Survey respondents distinguished between “retail” and high level corruption. Retail corruption is the small-scale, everyday graft, extortion, and bribery involving low-level public sector employees. High-level corruption, which is more harmful to a country, includes payoffs in public works contracts; questionable election laws; fixed election results; influence peddling; and nepotism. In some countries, retail and high level corruption combine to create cultures in which citizens and civil servants alike are indifferent to or accepting of dishonesty in government and politics. One of the chief causes of corruption, according to interviewees, is collusion among political groups, government executives, and the courts, aimed at protecting their members from criminal investigation and prosecution.

Reducing Corruption

Effective anti-corruption initiatives need to be multi-faceted, addressing cultural, political, and social causes of corruption. Interviewees recommend the following actions for governments to take to reduce corruption.

• Attack retail corruption by reducing opportunities for bribes, extortion and graft, such as by promoting the use of electronic payments and credit/debit cards for taxes, fees, or fines.
• Curtail corruption in revenue collection by centralizing collection, periodic staff rotation, taxing gross rather than net revenue, and using payroll withholding taxes.
• Cure corruption-prone procurement by centralizing purchases, broadly advertising bid solicitations, and using clear, well-understood procurement procedures.
• Protect people who report corruption, especially public servants. Ways to do this include passing “whistleblower” laws and introducing telephone hotlines for reporting corruption.
• Reform civil service laws to reduce nepotism or hiring of cronies. Pay civil servants reasonable wages so that they are not tempted to engage in corrupt activities in order to pay for the necessities of life.
• Institute independent anti-corruption boards or commissions and support them with adequate funds and a solid framework of anti-corruption laws.
• Introduce public education campaigns to help build citizen and civil servants’ resistance to corruption and support for anti-corruption activities.
• Strengthen internal controls and audit procedures to detect and help prevent fraud and abuse.

Finally, anti-corruption activities need to be transparent and their results publicized in the media. This helps build confidence among citizens that corruption is no longer a way of life in their country.
About the Survey

In spring 2004, ICGFM asked Grant Thornton’s Global Public Sector group to undertake an international survey of government executives on their opinions concerning public sector corruption. The survey explored the executives’ perceptions of the severity, causes, and consequences of public sector corruption. In addition, interviewees recommended ways for government institutions to resist corruption in government operations.

Anonymity

Our survey does not attribute thoughts and quotations to any of the people we interviewed, nor do we name them, their institutions, or their specific countries. These measures were essential to gain the confidence and full cooperation of the officials who participated in the survey.

Scope

Organizations such as Transparency International do a superior job in documenting the extent of corruption in different countries. International donor organizations including the U.S. Agency for International Development, the International Monetary Fund, and the World Bank have written many excellent reports, program manuals, and special studies on how to combat government corruption and fraud. Our survey’s scope is somewhat different: to learn what government officials in countries where corruption is an issue think about the causes and consequences of the problem. More important, we wanted their recommendations on how to reduce or eliminate corruption’s effect on the public sector and, by extension, on their societies, economies, and culture.

Methodology

With the guidance of ICGFM members, Grant Thornton developed a survey instrument with both closed and open-ended questions covering corruption, fraud, and related issues, and then asked experts in these topics to review the questionnaire. After orientation from Grant Thornton’s Global Public Sector, Grant Thornton International member firms based in Africa, Asia, Eastern Europe, Latin America, the Middle East, and the United States interviewed in person government officials and other executives of ten countries who had agreed to take part. Between December and April 2005, 50 interviews were conducted.

Most survey participants were senior officials in ministries of their countries. The mission areas of the interviewees’ offices include public health, education, finance, taxation, economic development, customs, international diplomacy, audit, and internal affairs. A few respondents from outside government included officials in a country’s institute of chartered accountants and executives from nongovernmental organizations involved in local development programs.

Grant Thornton member firms sent their survey notes to the Global Public Sector office in Alexandria, Virginia, U.S.A. for analysis by subject matter experts and survey specialists.

Defining Fraud and Corruption

Corruption is the misuse of public power, office or authority for private benefit—through bribery, extortion, influence peddling, nepotism, fraud, speed money or embezzlement.


What is corruption? Almost all participants in this survey agreed with the above definition by the United Nations Development Programme (UNDP). One interviewee suggested modifying the UNDP definition to recognize the factional nature of political power: “After the words ‘private benefit’ I would add ‘or for the benefit of certain groups or a political party.’”
When asked to list the types of corruption that caused the most problems in their countries, several respondents made a distinction between what some called “retail” and “high-level” corruption. Retail corruption is the small-scale, everyday graft, extortion, and bribery involving low-level public sector employees. Examples respondents gave of retail corruption include bribing police to overlook traffic violations, school officials to enroll students in public schools, or bureaucrats to speed the processing of a permit. High-level corruption includes bribes, payoffs, kickbacks, and graft related to public works contracts; questionable election laws; fixed election results; influence peddling; and nepotism. Of the two types, said respondents to the survey, high-level corruption causes much greater harm to a country than do retail bribery and graft. This is especially true in cases of massive fraud involving the levying and collecting of taxes and customs.

Specific types of corruption mentioned during the interviews include:

- Collusion among political groups, government executives, and the courts, aimed at protecting their members from criminal investigation and prosecution.
- Misuse of public power for personal benefit or for friends and relatives.
- Appointing cronies or family to public office.
- Frequent irregularities in government procurement.
- Bribery through contributions to political parties or candidates.
- Bribery of public officials. According to one respondent, “The bureaucrat does not sign until he or she receives money,” while another said that, “In my country, corruption is the process of buying goods and services from public entities.”
- Regular acceptance by government officials of forged papers, such as birth certificates, passports, and customs documents.
- Ignoring customs procedures and undervaluing imports in return for bribes.

Consequences of Corruption

Most of the interviewees for this survey said that corruption was a significant problem in their countries, and in some cases a major dilemma, leading to the following consequences:

- In developing countries, said one respondent, “the poor are being destroyed by corruption” because it inflicts disproportionate harm on low-income citizens by slowing economic development. In addition, said another, corruption tends to widen the income gap between the rich and the poor, resulting in further influence peddling and bribery.
- Governments do not collect enough revenues to sustain and improve public services. Causes include laxly enforced or inequitable collection of taxes, customs duties, and fees.
- Administrations are mediocre and ineffective because public officials and employees are appointed based on their agreement to carry out corrupt activities.
- Unfair competition and bribery create a business climate that prevents rather than promotes entrepreneurship and foreign investment.
- Public health is endangered because of poor protection of food, water, the environment, and pharmaceuticals.
- Seeing this corruption, citizens do not trust their governments, and outsiders form a bad image of a country and its people.

Ultimately, said one respondent, dishonesty and fraud in the public service are bad influences on human personality, creating a pernicious and persistent culture of indifference or acceptance of corruption. Indeed, many of the interviewees said that this negative culture was the greatest barrier to progress in combating corruption. Said one respondent, “The general public lives with the contradictions of corruption. The people are against it, but they accept it.” Said another, “In my country, we have to destroy corruption definitively, because it is destroying us.”

Procurement That Resists Corruption

In most governments the cost of procuring goods and services is second only to that of human resources (salaries and benefits for public employees). Survey participants recognized that procurement is an area prone to corruption, which may range from headline making scandals to smaller, less visible petty graft by frontline public employees. Many of the
interviewees said that migrating manual procurement processes to electronic processes has become an important activity in creating a corruption-resistant public sector. Electronic (or e-) procurement takes unneeded discretion out of the process by removing opportunities for face-to-face interaction. In addition, e-procurement creates an excellent audit trail of each transaction.

Officials interviewed for this report suggested the following ingredients of a smooth-functioning, corruption-resistant procurement operation:

- To the extent practicable, centralize procurement to facilitate bulk pricing, gain the benefits of specialized procurement employees, and reduce the opportunities for kickbacks and other corruption.
- Develop results-oriented specifications instead of spelling out the process of producing and delivering products and services.
- Broadly publish bid solicitations and awards, including on the Internet, to make the procurement process more transparent and trustworthy to vendors.
- Ensure that all vendors have full access to the information they need to prepare bids, including special conditions and requirements, the procurement process to be used, and the government’s estimated budget range for each procurement.
- For frequently purchased items, use preapproved vendors with negotiated catalog rates.
- Prepare and use clear, well-understood signoff procedures for bid evaluations and purchase transactions.
- For complex acquisitions, engage objective experts to determine specifications and expected pricing, and also to participate in approving deliverables. Use this information to draft pre-proposal specifications and invite comments from potential bidders.
- Provide for prompt and objective bid protests, perhaps by a government-wide procurement board, especially when losing bidders allege arbitrary decisions.
- Have a person or organization not directly associated with a specific purchase monitor its delivery for meeting timeliness, quality, and quantity requirements.
- Routinely evaluate vendors’ performance and establish and update a database of their performance “grades.”

Causes of Corruption

During the survey, we asked interviewees about the causes of corruption in their countries. Our review of the responses made it clear that any successful initiative to reduce or prevent corruption has to be multifaceted, addressing multiple problems at different levels of society and government. To facilitate analysis of the causes, we divided them into three categories: cultural/social, political, and institutional.

Cultural and Social Causes

“In my country, corruption is in all levels of politics, economics, and institutions. It is a cultural fact,” said one interviewee. Others reported an ingrained acceptance of public sector corruption in a society. Frequently, respondents said that a major cause of corruption was “indifference” or “acceptance” by public sector officials and employees, politicians, and the general public. Reasons for this indifference, said respondents, included that “people know the justice system will not punish people who do corrupt things.” Citizens become resigned to corruption because they see no way to stop it.

Social causes of corruption, according to the interviewees, include wide disparities in wealth, in the centralization of wealth and influence among a few families or groups, and in inadequate investigation or coverage of corruption scandals by the news media. In addition, in some countries there appears to be a societal acceptance that graft and demanding bribes is a right of government employees.
Political Causes

Political causes of corruption relate both to the electoral process and the behavior of elected officials once in office. Said one respondent, “Politicians and senior government officials say that they are against corruption, but in reality are either indifferent or accept it when the time comes to take action.” Another said, “The majority of political leaders live with corruption because they run the risk of losing power if they speak out against it.” Unfortunately, said an interviewee, in his country, “Complete politicization of authorities implementing anti-corruption measures, such as the public prosecutor and anticorruption commission officials, have rendered these organizations ineffective.” The impact of both political and institutional causes is made worse by collusion among the executive, legislative, and judicial branches of government aimed at engaging in corrupt activities or protecting their members from prosecution for such crimes.

Illegal campaign contributions and election fraud help bring corrupt parties into power, according to some interviewees, as do election laws that favor the rich and influential. A turnover in parties likely will lead to the replacement of many levels of public servants with party loyalists who have little or no experience but who are willing to join a network of accomplices to fraud and corruption. This inexperience contributes to the mediocrity of public service. Finally, several respondents said that politicians make weak laws concerning corruption, and may keep the consequences of being caught very low.

Institutional Causes

Institutional causes include the structure and operations of the public service. Most interviewees reported at least minor problems with corruption among lower-level public service employees. One respondent summed up the thoughts of many when saying, “Sometimes, the pay of civil servants is respondents noted that if low salary is a major cause of civil servant corruption, the problem should lessen as one goes up the career ladder—but then pointed out that this is not the case.

Many interviewees mentioned lax enforcement of anti-corruption laws as an institutional cause. They attributed such negligence to the entire justice system, including law enforcement, prosecutors, and judges. Another problem is lack of integration among groups in the justice system, which makes it more difficult to investigate and prosecute crimes of corruption.

Weak or nonexistent administrative laws, rules, and practices are major culprits in the inability to detect and prevent corruption problems. One example reported was that inadequate policies and procedures cause poor control over public procurement and capital contracts. Several others said that weaknesses in public sector audits and internal controls, especially in revenue collection, mean the loss of key tools for preventing fraud and abuse.

Institutions established to combat corruption have had varying success, said interviewees. For example, a country’s anti-corruption board or commission may educate the public about the problem, but be lax in investigating corruption and providing information to prosecutors. This may be because of ineffective laws or simple apathy in enforcing them.

Little Things Mean a Lot

Daily encounters between the general public and public employees are the most frequent opportunities for corruption—and for reducing a country’s “culture of corruption.” The actions listed below, suggested by survey participants, may seem small, but each makes a particular transaction between citizen and government less prone to bribery and abuse.

Fines, Fees, and Parking. Require that people pay fines by mail, electronically, or at a reliable collection agency. This includes fines for things like traffic violations, for operating a food store without a health permit, running a business without the proper license, or not having an up-to-date vehicle registration. Also, install parking meters in high-volume
parking areas, keep them in good repair, and enforce parking laws consistently. Do not allow private citizens to take over public areas and charge for parking in them.

**Electronic Payments.** Design financial transactions between citizens or companies and the government to be electronic, which reduces the opportunities for graft and bribery. In addition, electronic payment may encourage the use of credit and debit cards, which provide good transaction histories. Transactions such as driver’s license renewals, vehicle registration, and buying license plates are good examples of processes that benefit from electronic payment. For government owned or regulated utilities, use tamperproof electric/ water/gas meters at businesses and households to reduce pilferage and enable electronic reading of the meters with results compared to expected usage.

**Outsourcing.** Consider contracting out selected services—contractors tend to pay competitive wages. Services to consider include checking weights and measures (e.g., in gas stations), building inspections, traffic and parking fine collection, and utility meter installation and reading.

**Tax Payments.** Make it easy for people to determine the amount of income tax they must pay by using simple tax forms and making blank forms and instructions available in public places. Also, have the revenue collection agency provide assistance in filling out the forms.

**Queues.** Where lines typically form for public sector transactions, such as applying for licenses, use number-dispensing machines that indicate the order in which people will be served. Monitor the queues, for instance through video cameras, to prevent line jumping and selling of numbers.

**Courtesy.** Even the most honest civil servant gives a negative image of government if he or she is rude, unpleasant, or unable to handle difficulties. For this reason, provide public employees who work with the public training in interpersonal relationships and conflict management. Also, encourage citizens to use comment cards about the quality of services they receive; follow up on responses that report problems.

**Recommendations for Combating Corruption**

Survey respondents made dozens of recommendations about what governments can do to reduce corruption and its impact on citizens, society, and institutions. ICGFM’s experience is that most countries with severe, endemic corruption will need to develop a comprehensive anti-corruption initiative that takes into account nearly all of these recommendations. Once again, we divide this section into social/cultural, political, and institutional categories.

**Cultural and Social Solutions**

In the earlier section on cultural and social causes of corruptions, we reported that many interviewees believe that citizens in some countries accept corruption as part of their society and way of life. Overcoming this attitude requires removing its causes, which are largely political and institutional. Regarding actions a government takes, said one interviewee, “It is fundamental to the fight against corruption that it has to happen openly, and that the people need to be involved.”

To encourage public involvement, said several respondents, it is important to educate citizens on the value of a corruption-free society. Some recommended massive, multifaceted public campaigns to educate citizens and public officials on the negative effects of corruption. Another purpose of such campaigns would be to build awareness that the public should be getting services without corruption, said one respondent. Another believes that the campaign “…should be permanent, using all media to educate and encourage discussion among the people about the factors that cause corruption. This would include educational programs in the schools.” As indicated in the box on the cineminutos media campaign (see box below), the federal government of Mexico has instituted a campaign that includes television public service announcements showing vignettes of the causes and consequences of bribery and corruption (we conducted no interviews in Mexico). Simply publicizing the punishment of those guilty of corruption can be a deterrent.
Political Solutions

No matter what solutions a country adopts, political reform is absolutely essential. Several respondents said that fighting public service corruption starts with elected officials reviewing existing laws and regulations concerning corruption, strengthening those laws, and monitoring their enforcement. Laws protecting people who report corruption, especially public servants (e.g., “whistleblower” laws) are particularly important. Elected officials need to hold government executives accountable for corruption within their organizations, setting a “tone at the top” that permeates down to frontline employees. Finally, some interviewees said that countries should decentralize authority and functions to regional or local governments, where they can be more closely monitored by citizens.

Mexico’s Cineminutos Media Campaign: Showing the Consequences of Corruption

Mexico’s Ministry of Public Administration has helped produce several “movie moments” depicting the causes and consequences of corruption in daily life. These film vignettes, suitable for television public service announcements or group discussions, use professional actors to portray situations that citizens regularly encounter in real life. One cineminuto starts by showing a public school official demanding speed money from a mother to enroll her child. The mother tells her police officer husband that they need extra money for the bribe, so he extorts money from a garage owner, who in turn takes a bribe to get a car through inspection… The cycle continues, gradually moving to higher and higher levels of government and society.

“Specialized anticorruption agencies appear most effective for attacking specific areas of corruption within an overall environment of stability and effective governance.”

Anti-Corruption Boards or Commissions

Some of the countries included in this survey have set up independent boards and commissions responsible for dealing with corruption. Other countries in the survey have organizations with broader charters, but that include anti-corruption activity as a responsibility. Typical responsibilities of these bodies include preventing corruption; supporting government in detecting, investigating, and helping to prosecute incidents of corruption; and educating the public, such as through media campaigns. The interviewees’ opinions of the performance of such boards and commissions ranged from “ineffective” to “highly effective.” The interviewees consider some boards to be political window dressing, but think that others are producing greater success as these anticorruption bodies gain experience and demonstrate that their mission is serious business.

Characteristics of Effective Anti-Corruption Boards

Survey participants offered the following recommendations to countries contemplating forming or enhancing existing anti-corruption boards. First, an effective board must be truly independent; including it in the executive branch reduces potential effectiveness considerably. Some respondents think a board should be a virtual fourth branch of government (but caution against potential abuses, such as the chair of the board using it to persecute his or her enemies). In addition, the board should be managed by a single strong leader with assured lengthy tenure, who is not associated with a particular administration or majority party.

Such independence should include the freedom to follow any leads a board determines to be worthy of its use of resources. These resources need to include ample staff and budget, so that board employees can pursue leads without delay. The staff should be paid a fair wage and be well educated in the skills needed for the work. A good working
relationship with the public media can be a great resource for an effective anti-corruption board, but independence applies in this area as much as in any other.

Unfortunately, serving on an anti-corruption board or its staff can put people in harm’s way. The more effective the board, the greater the number of enemies it will gain, which may necessitate taking measures for the physical security and safety of board members, staff members, and their families.

Finally, anti-corruption boards or commissions tend to be no better than the laws and regulations a country establishes to combat corruption and the government’s willingness to enforce them. Governance reforms may be needed to create an appropriate framework for defining corruption and prosecuting those who practice it.

**Institutional Solutions**

Several respondents said that a first and important step in anti-corruption reform is to establish or strengthen an existing independent anti-corruption board or commission. We provide more information on these boards in the box on page nine.

Civil service laws that reduce the post-election wholesale turnover of public employees at all levels will help to prevent the formation of the “network of accomplices” that facilitates fraud and corruption. Likewise, ministers’ hiring, promoting, and transferring of employees may need to stop or be greatly curtailed, replaced by a career civil service. However, personnel in positions that are especially vulnerable to corruption should be periodically rotated to other assignments, said an interviewee, which will help prevent their concealing illegal transactions. Regular evaluations of anticorruption policies and procedures will help keep them effective, said another.

Salaries for civil servants and police should be set at reasonable levels. This helps reduce employees’ temptation to engage in corrupt activities in order to pay for the necessities of life. In return, public employees should receive training on avoiding corrupt activities and in reporting such actions, in addition to being monitored in the effectiveness of their work performance. Effective whistle blowing procedures for civil servants should accompany the related laws mentioned in the political solutions earlier in this report, both to improve reporting and to protect the whistleblowers. Several interviewees said their governments had introduced anti-corruption telephone hotlines because, in the words of one official, “We should be hearing about corruption that way, rather than at the dinner table.”

Of special interest to financial executives is the recommendation by several interviewees to strengthen internal controls at public entities, with particular emphasis on those that prevent fraud and abuse. Priority for internal controls improvement should go to processes involving revenue collections, procurement, and financial transactions. Introducing electronic procurement and payment should greatly enhance internal controls to those processes. Also, financial professionals working for or with the government should receive training to improve the quality of public sector audits. This includes auditors in chartered or independent public accounting firms who are engaged to perform government audits.

**Revenue Collection that Works**

Many countries with severe development problems have inadequate revenue collection functions, often rife with corruption. In such countries, citizens are rarely motivated to make honest tax payments, because they believe much of the money they pay will line the pockets of corrupt officials. This creates a vicious downward spiral of government resources that in turn generates even more corruption.

No system of revenue collection is entirely free of corruption risk; however, there are actions that can lead to corruption-resistant collection processes. The following page lists actions suggested by interviewees.
## Revenue Collection That Works

<table>
<thead>
<tr>
<th><strong>Anti-corruption action</strong></th>
<th><strong>Benefits of the action</strong></th>
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<tbody>
<tr>
<td>Combine all major revenue collection activities in one agency (e.g., income tax, customs fees, sales tax, and value-added tax or VAT).</td>
<td>Shows that government is serious about its collection activities. The action also enables the agency to rotate employee assignments, which helps prevent cover-up of corrupt activities.</td>
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<tr>
<td>Make the revenue agency autonomous, reporting directly to the chief of state.</td>
<td>Reduces the number of opportunities for senior officials to interfere with revenue collection and reporting.</td>
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<td>Have all departments in the revenue agency report directly to its head.</td>
<td>Minimizes opportunities for collusion between departments, such as between tax assessment and tax collection organizations.</td>
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<tr>
<td>Pay going commercial wages to revenue collectors.</td>
<td>This may create disparity with salaries in other government agencies, but it will reduce revenue collector staff turnover and the need to engage in corrupt activities in order to survive.</td>
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<tr>
<td>Periodically rotate the roles and relationships of revenue collectors.</td>
<td>Reduces the possibility of a revenue collector and an outside party becoming overly familiar over time.</td>
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<tr>
<td>Make sure no single revenue collector or agent is responsible for a single taxpayer. In this scenario, two agents are always assigned to a case or account and meet with taxpayers together.</td>
<td>Having two agents means that corrupt activities will require collusion by the two, which adds the difficulty of carrying out illegal acts.</td>
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<tr>
<td>Run a continuous education program for revenue collectors and agents.</td>
<td>Reduces guess work by agents, keeps them abreast of recent developments in detection and prevention, and adds to their sense of professionalism.</td>
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<tr>
<td>Where realistic, tax gross revenue rather than net income.</td>
<td>Eliminates judgment calls for both parties, because the numbers used for determining taxes are not derived in ways that enable fraud.</td>
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<td>Require employers to withhold taxes from employee salaries, with amounts that are determined by formula and reported and paid directly to the revenue agency.</td>
<td>Takes steps out of the tax reporting process and reduces the number of tax audits needed.</td>
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<tr>
<td>For small businesses, calculate tax based on agreed-upon gross revenue category; frequently check the appropriateness of the business’ inclusion in that category.</td>
<td>Makes overall process less prone to questionable numbers.</td>
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<td>Provide ample direct training to small businesses about how to keep books and how their tax category is selected.</td>
<td>Reduces the “I did not know” factor and demonstrates the fairness of the tax system.</td>
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<tr>
<td>Set priorities: focus effort on largest individual and corporate taxpayers.</td>
<td>The majority of uncollected tax revenues will be found among wealthy individuals and corporations.</td>
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<tr>
<td>Conduct frequent, sophisticated audits for the biggest taxpayers.</td>
<td>Reduces the possibility of accounting fraud going undetected.</td>
</tr>
<tr>
<td>Require installment payments of taxes throughout the year.</td>
<td>This “eases the pain” for the taxpayer and reduces the chances of defaulting on a large one-time payment.</td>
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<tr>
<td>Use electronic transactions whenever possible.</td>
<td>Reduces the opportunity for personal contacts that make corrupt activities easier.</td>
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<tr>
<td>Have the revenue agency monitor chartered or independent public accounting firms and impose heavy fines if they help enterprises to cheat on taxes.</td>
<td>Discourages accountants from helping their clients to reduce tax payments illegally.</td>
</tr>
<tr>
<td>Lobby for enforcement of laws and prosecution.</td>
<td>Shows that cheaters or those bribing tax collectors will not go free.</td>
</tr>
<tr>
<td>Maintain close coordination with justice system agencies (police, investigators, prosecutors).</td>
<td>Enables more effective data and evidence collection needed to successfully prosecute violators of tax and other revenue laws.</td>
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Additional Information

If you would like more copies of this survey or an opportunity to hear more about its content and about reducing public sector corruption, please contact ICGFM or Grant Thornton at the addresses below. We will be pleased to discuss providing your organization with a briefing or to present survey results at a conference or seminar.

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Introduction

Corruption results from a variety of economic, institutional, political, social and historical factors. It flourishes when democratic institutions are weak, laws are not enforced, political will is lacking, and when citizens and the media are not allowed to be partners in democracy. Corruption and unethical behaviour by public officials are serious threats to basic principles of democratic government, undermine public confidence in democracy and threaten the rule of law.

Secretary of State Colin Powell

Corruption is as old as mankind. No country is immune from it, be it a developed country or an underdeveloped one, a rich country or a poor one. Corruption is an immoral and unethical act which is committed by politicians and bureaucrats for their personal gain and at the expense of the broader interest.

This paper discusses the nature of corruption, its causes and its implications for society. It also examines, albeit not exhaustive, ways of preventing and combating corruption. The paper concludes that, notwithstanding international and regional efforts, national governments have the primary responsibility to display a serious commitment and to put in place mechanisms aimed at reducing corruption wherever it exists. One key institution, the Legislative Audit, should be regarded as the foremost institution in the fight against corruption and should be provided with the desired level of autonomy and flexibility as well adequate resources to do so.

Nature of Corruption

There are various definitions of corruption but the one that is generally used and accepted by Transparency International and most international financial institutions is that corruption is the misuse of public power for private gain. Arguably, this definition is too restrictive since it ignores the prevalence of corruption in the private sector. Andvig, Jens C. and Odd-Helge Fjeldstadt (2000), however, believe that public sector corruption is a more fundamental problem and that controlling public sector corruption is a prerequisite for controlling corruption in the private sector. For the purpose of this paper, corruption is viewed as that which prevails in the public sector.

Politicians and bureaucrats are the holders of public power. The former are usually elected to public office while the latter are appointed by the former to assist them in the discharge of their political responsibilities. A misuse of public power occurs where, in the exercise of their duties, politicians and bureaucrats deviate from formal rules or established procedures, for their personal gain and in doing so the public interest is sacrificed in favour of private interest.
In any society, corrupt behaviour manifests itself in four main forms. These are bribery, extortion, embezzlement and fraud. An act of bribery takes place when a person makes a payment to an agent of the State in exchange for an advantage or a benefit to which the person is not otherwise entitled, such as the provision of a service, the granting of a licence, a tax rebate or the award of a public contract. Extortion, on the other hand, involves the agent using his/her positional power to extract money or other benefits from another person although the latter is legally entitled to the service or benefit without such a payment. The agent often uses coercion, violence or threat of violence to enforce the corrupt act. Embezzlement is simply the theft of public resources by the agent while fraud occurs when the agent uses the knowledge at his disposal to deceive, conceal, distorts or manipulate information for his personal gain.

Tax evasion, money laundering, counterfeiting, black marketing, insider dealing and other criminal activities are not considered corrupt actions per se. However, when the responsible public officials refrain from prosecution, grant immunity, or provide inside information, then corruption is involved. Lambsdorff (2002) asserts that the self-seeking behaviour by politicians and bureaucrats is interpreted as corrupt behaviour when it is accompanied by the blunt neglect of the expectations and the interest of the public. Rose-Ackerman (1999) also echoes the same sentiment by acknowledging that that corruption forces scholars and policy makers to focus on the tensions between self-seeking behaviour and public values.

Corruption in the public sector appears to be more prevalent in areas where the State interacts with the members of the public such as the judiciary, public procurement, regulatory agencies, granting of permits, privatization, foreign exchange, police and taxation. It tends also to be biased in favour of capital projects where large amounts of resources are expended. The reason for this is that the risk of being caught increases with the number of transactions as well as the number of people involved and not with the value of the transaction. Therefore, persons with corrupt intent are likely to target large one off payments where the risk of exposure is less.

Judges and magistrates can be paid off for making rulings that are in favour of particular individuals or groups while the police can be influenced to drop charges against someone who has violated the law. The author recalls his own experience as the Head of the National Audit Office in Guyana where after thorough investigations of numerous irregularities committed by public officials, the Audit Office would provide the law enforcement and prosecuting agencies with full documentary evidence of wrong-doing. However, in most cases charges were not brought against the concerned individuals, purportedly for want of evidence. When charges were indeed instituted usually after a prolonged period, the majority of the cases were dismissed because key witnesses were no longer available, evidence could no longer be located or simply because the prosecutors lacked the competence and expertise when in the courtroom they are faced with a battery of eminent defence lawyers.

In the area of public procurement, specifications for goods and services can be framed in such a manner so as to place a favoured contractor in a position of advantage vis-à-vis other competitors. This, as well as other inside information, such as the details of other competitors’ bids and the “engineer’s estimate”, can also be leaked to the preferred contractor while the actual assessment of bids can be biased in favour of him or her. Sometimes, this corrupt behaviour is done with the tacit knowledge and encouragement of the government in an attempt to patronise its supporters and close associates.

When bribes are paid to win an award of, for example, a road contract, the contractor has to find some way of recouping his or her costs. Invariably, this is done by executing the works below the required specifications or by substituting inferior material, especially if the Engineer, who is overseeing the works on behalf of the government, is also a recipient of bribes. For example, instead of placing four inches of bitumen as the final top layer on a road, he or she may place two inches. The result is that within six months, the road may start to show signs of deterioration.

As an example, the Public Accounts of Guyana for 1997 highlighted the government’s importation of stone from an intermediate source at an inflated price for a road project financed from a loan by an international funding agency although adequate quantities of stone were produced in Guyana at a significantly lower price. The Stone Scam, as it was described in the media, amounted to about US$1.5M and also involved the supply of inferior quantity of stone, short-shipment, diversion of the stone to other projects not financed by the international institution, and the falsification of invoices. As a result of the Audit Office’s findings, the Government called in the investigators from the international funding agency who confirmed that
there was massive fraud in the execution of the project. The funding agency promptly terminated the project but it was the taxpayers who were saddled with a long-term debt for which they did not receive full value.

Goods of a capital nature are obviously more expensive than those relating to current operations. A corrupt agent would therefore prefer to acquire specialized products that are capital intensive, sophisticated and custom-built rather than off-the-shelf products where the prices are generally known. For example, military equipment may be favoured in preference to those that relate to education or health. The acquisition of such equipment in most cases would not be subject to a system of competitive bidding by virtue of their nature i.e. procurement is usually done through sole sourcing. In such cases, there are no competitive prices and invariably, the prices tend to be inflated and the differences kicked back as bribes.

Scleifer & Vishny (1993) cited the example of a bottle-labelling machine that was bought in Mozambique at several times the price of another machine that could have done an equally efficient job, allegedly due to kickbacks. Similarly, the Government of Guyana entered into a contract valued at approximately US$350,000 for the production of electronic copies of the Laws of Guyana without any form of competitive bidding. Faced with allegations in the media of corruption in the transaction, the Government rescinded the contract. The Permanent Secretary was surcharged G$500,000 and was transferred to another ministry.

Privatization also has significant scope for corrupt deals to take place. Developing countries with large public sectors are usually required by IMF/World Bank conditionalities to reduce such sectors through mainly privatization of state-owned institutions and assets. This requirement is usually made a condition for receipt of further loans, grants and other forms of assistance. In many cases, these privatisation programmes are undertaken with much haste in order to meet the conditionalities imposed. As a result, proper valuations of these institutions and assets are sometimes not carried out and adequate procedures are not followed to ensure an effective competitive bidding process is in place. There also tends to be a lack of transparency in the whole process.

In many of these countries, there is a general outcry that state institutions and assets are being sold off at give-away prices. For example, in the early 1990s, the Guyana Government sold 80% of the state-owned telephone company for US$17.5 million and granted the new owners 40 years of monopoly rights. Independent valuation based on the entity’s price/earning ratio, however, had placed the value of the company at a minimum of US$45M. There was no competitive bidding process but the Government argued that no other buyer could be found. Today, the new government is still trying to piece together information as to what happened in relation the privatisation programme of that period when several state-owned institutions were sold off.

The Russian privatization programme after the collapse of the Soviet Union is another case in point. Stiglitz (2003) argued that the stabilization/liberalization/privatization programme was “intended to set the preconditions for growth. Instead, it set preconditions for decline. Not only was investment halted, but capital was used up – savings vaporized by inflation, the proceeds of privatization or foreign loans largely misappropriated. Privatisation, accompanied by the opening of the capital markets, lead not to wealth creation but to asset stripping”.

Measuring Corruption

In view of the opaque nature of corruption, objective assessments of the levels of corruption in a country are not readily available. Perhaps the best substitute measure for actual levels of corruption is the Corruption Perceptions Index (CPI). The CPI is compiled annually since 1995 by Transparency International, an international watchdog organization with headquarters in Germany. The Index is calculated based on surveys carried out of the perceptions of knowledgeable people, such as senior businessmen and political country analysts, of perceived levels of corruption in a country. For example, for the CPI 2004, 146 countries were surveyed and data was gathered from 18 independent sources and 12 different institutions such as the World Markets Research Centre, the World Economic Forum, Economist Intelligence Unit and the International Institute for Management Development. The results, when computed using statistical methods, correlate well and provide some confidence about the actual levels of corruption.
Most of the countries surveyed consider the CPI as an authoritative pronouncement of what is perhaps the best substitute measure for the actual levels of corruption in their countries. It is fair to say that countries which share a deep concern for transparency, good governance and accountability, view the index as an important measure in their fight against corruption. An improvement of a country’s CPI score as well as its ranking, all things being equal, is considered an indicator of a reduction in the level of corruption. However, the first step in the fight against corruption must be the recognition of the existence of corruption and the extent to which it is perceived to exist in a particular society. It is in this regard that the importance of the CPI must be viewed.

Another important measure of corruption is the Bribe Payers Index (BPI). The BPI survey for 2002 was carried out by Gallup International on behalf of Transparency International. Business people from 15 emerging economies were asked to indicate which companies from particular exporting countries were very unlikely to pay bribes to obtain or retain business in their countries. The countries that came out on top are Australia, Sweden, Switzerland, Austria and Canada.

It is interesting to note that the United States came 13th with a BPI of 5.3 on a scale of 0 to 10. This is despite the existence of the Foreign Corrupt Practices Act of 1977 and the penalties involved for any violation. This act was passed in response to the SEC investigations in the mid-1970’s which revealed that over 400 U.S. companies admitted to making questionable or illegal payments in excess of US$300 million to foreign government officials, politicians and political parties. The Act prohibits American companies from making corrupt payments to foreign officials for the purpose of obtaining or keeping business. According to Peter Eigen, Chairman of Transparency International, the survey leaves no doubt that “large numbers of multinational corporations from the richest nations are pursuing a criminal course to win contracts in the leading emerging market economies of the world”.

**Implications of Corruption**

The economic consequences for countries with high levels of corruption are indeed very grave. First, goods and services become more costly thereby negatively impacting on the quality and standard of living of citizens. Trade is also distorted since preference is given to goods and services that offer the greatest bribes. In this regard, capital programmes are favoured in preference to those relating to basic health care, education delivery, agriculture and housing, among others. Because of this tendency, corrupt governments tend to contract high levels of long-term public debt since loans from international financial institutions are usually taken to finance capital projects.

Corruption results in the misallocation of scarce resources and areas that are in genuine need of developmental assistance are overlooked in preference to those that offer the greatest rewards for the corrupt politician or bureaucrat. Investor confidence is also shaken and countries that are in dire need of foreign investment are deprived of it. As a result, international flow of goods, services and capital is affected and investment ratios deteriorate. In fact, various studies have shown that high levels of corruption are associated with low ratio of investment to GDP, low foreign inflows of direct investment and low levels of capital inflows.

In addition, the loss of confidence is felt within the country and there is a tendency for professionals and other decent-minded citizens to migrate to the more developed countries to seek employment opportunities and a better way of life. There is therefore a brain-drain. In the case of Guyana, the cream of the Guyanese society lives and works in the United States and Canada, though admittedly this might be attributable more to the political and economic situation in the country rather than to corruption. Recently also, there has been a significant migration of Guyanese nurses and teachers, despite the construction of new schools and hospitals using loan funds. Foreign investment has also dried up mainly due to the political instability in the country.
Causes of Corruption

A review of the CPI over the years indicates that poor developing countries in dire need of public resources for the economic and social upliftment of their societies are the ones perceived to be most tainted with corruption. For example, in the CPI 2004, Bangladesh and Haiti were considered the most corrupt countries with a score of 1.5 while Finland with a rating of 9.7 was considered the least corrupt. The CPI is measured on a scale of 0 to 10. This type of ranking suggests that the main cause of corruption is poverty. A reduction in poverty is therefore likely to result in a reduction in corruption. With a significant portion of the world’s population living on less than $1 dollar a day, the task is indeed a daunting one.

It can be argued that democracy and accountability are the twin sides of the same coin. Without the former, the latter is unlikely to be attainable. Democracy leads to accountability which in turn leads to development. A lack of democracy leads to a lack of accountability which in turn leads to a lack of development, inefficiencies and indeed corrupt behaviour.

Accountability starts with the casting of the ballot in a free, open and transparent process and when the votes are accurately counted. Those elected to public office have to be accountable to the electorate since the failure to do so is likely to see a change in leadership in the next round of the democratic process. It follows that politicians who are not accountable to the electorate for their actions and who cannot be removed easily are likely to engage in corrupt behaviour. History is replete with such behaviour. Names that come to mind are Suharto, Idi Amin, and Mobutu. Corruption is therefore prevalent in countries where there are either non-existent or weak democratic institutions.

Corruption also flourishes where there are vague, archaic and cumbersome rules, for example, in the assessment and collection of state revenues. State intervention is also an area of concern as in the case of price controls and foreign exchange restrictions. A third area where corruption is prevalent is in relation to bureaucratic discretion. Examples include the State’s granting of duty-free concessions and in the allocation of house lots. In the most recent case in Guyana, known as the Duty Free Scam, 86 re-migrants obtained under questionable circumstances, the remission of customs duty on personal effects, including motor cars, purportedly brought into the country. The scam involved the falsification of documents and as a result, two officers have been placed before the courts while a senior official was interdicted from duty pending further investigations.

Combating Corruption

The Corruption Perceptions Index is an authoritative pronouncement of perceived levels of corruption in countries that are surveyed. An improvement of a country’s CPI score and its ranking, all things being equal, are indicators of a reduction in the levels of corruption. It seems reasonable therefore to suggest that the fight against corruption should commence with willingness of countries to recognise not only the existence of corruption in their societies but also the extent to which it is perceived to exist. The CPI 2004 listed 146 countries although there are 191 countries that are members of the United Nations. One possible recommendation can be that the remaining countries should be encouraged to be part of the CPI survey and should be given the necessary assistance by the international community. After all, corruption is a global problem that can easily migrate from country to country with cancerous effect. Some knowledgeable persons have likened the spread of corruption to that of AIDS.
Perhaps the most important way of preventing and combating corruption is the promotion of democratic systems of governance where none exists and the provision of assistance to strengthen democratic institutions where they are perceived to be weak. U.S. Ambassador Michel made a very valid argument when he stated that every system of public accountability should embrace the following:

- Every act or action is done openly according to law and prudent judgment;
- Every actor is responsible for his or act or action;
- Every act or action is documented and reported publicly;
- Every act or action is subject to independent, professional, non-partisan audit review and public reporting of the results; and
- Where the review shows that purposeful error has been made prompt corrective action, including punishment where appropriate, is taken.

Corruption is likely to be prevented if four basic principles are followed. The first is the arm’s length principle where decisions are made based on merit, thorough analyses of the facts and pertinent arguments, and on equality of treatment, rather than on the basis of personal and other relations. There should be no room for nepotism and favouritism. The second principle relates to citizens’ participation and involvement in public decision-making. When this happens, there is collective responsibility for actions taken and allegations of corrupt behaviour are likely to be minimized.

Decision-making also needs not only to be transparent but should be seen to be so. In this regard, a free and independent media coupled with reasonable access to information on government programmes and activities are indispensable tools for fighting corruption. For example, public procurement by the Canadian Government is maintained online 24 hours a day and contractors and the public at large can access information at any time on the status of a particular procurement activity. Recently, new rules require Ministers of the Canadian Government and other senior government officials to disclose every three months through departmental websites their expenditures on official travel, meals, entertainment and other expenses associated with their official duties. These initiatives will go a long way towards minimizing the extent to which corruption is viewed to exist in the Canadian public sector.

The fourth principle relates to limiting the use of discretion. Discretion tends to produce decision-making that is inconsistent and lacking in uniformity. This practice can result in allegations of corrupt behaviour regardless of how well-intentioned the system is meant to be. In addition, corrupt individuals will almost certainly seek to exploit the use of discretionary powers for their personal benefit.

Over the last ten years, a number of initiatives have been taken by the international and regional communities to combat corruption. These take the form of treaties or conventions, including the Inter-American Convention against Corruption, OECD Anti-Bribery Convention, African Union Convention on Preventing and Combating Corruption, and United Nations Convention against Corruption. These treaties and conventions set out general principles that member countries can follow in fighting corruption. For example, the African Union Convention provides for member states to institute legislative and other measures for strengthening internal accounting and auditing, hiring, procurement and management of public goods and services. An interesting component relates to education programmes to sensitise citizens about public good and public interest and to promote ethical behaviour.

The World Bank has also taken a number of initiatives to assist in the eradication of corruption not only with respect to projects that are funded by it but also within the Bank itself. In addition, IMF/World Bank conditionalities require several governments of developing countries to incorporate poverty-alleviation strategies as part of their budget measures. In fact, under the Highly Indebted Poor Countries (HIPC) Initiative, countries are required to provide audited statements of amounts expended on education and health in order to benefit from the various financial reliefs offered under the Programme.

While international and regional efforts to combat corruption need to be applauded, in the final analysis, corruption has to be tackled at the national level through a sincere commitment on the part of governments. In this regard, the Legislative Audit as the key watchdog agency, a vibrant media and reasonable access to information regarding government programmes and activities, are likely to promote a culture of accountability, thereby reducing corruption.
The Role of the Legislative Audit

The Legislative Audit, also known as the Supreme Audit Institution (SAI), is the watchdog of public accountability. It is the oversight body that evaluates government programmes and activities to determine to what extent they have been executed with due regard to economy, efficiency and effectiveness and in compliance with legislative approval to incur expenditure as well as with the relevant laws, regulations and circular instructions.

The SAI reports to the Legislative Branch on the work of the Executive Branch. In many jurisdictions, it enjoys a fair measure of independence from the Executive, and the head is usually the holder of a constitutional position. Many of the SAI’s reports are also circulated widely in the mass media and therefore the SAI is usually regarded as a high profile state institution. Staffing of the SAI comprises mainly employees with specialized training in economics, business, accounting, law and public management.

Given the SAI’s constitutional status, its relative independence from the Executive, its reporting relationship with the Legislature and its technical capability, the SAI is uniquely placed to fight corruption in the public sector thereby contributing significantly to the economic and social upliftment of its citizens. For example, in the early 1990s the SAI of Guyana played a crucial role in the restoration of public accountability after years of neglect and lack of financial reporting, and hence accountability for the use of public funds and other state resources. The SAI’s reports, which were highly publicized, were very critical of the Government’s accountability record, particularly in relation to financial reporting on its stewardship for the period 1982 to 1991 and the lack of transparency in its privatization programme.

Internal audit departments with the public sector complement the work of the SAI. Through their investigative, monitoring and evaluation activities and because of their focus on internal control, these departments contribute in no small measure to ensuring that sound and effective systems and procedures are in place. It should not be over-emphasized that good systems of internal control are a pre-requisite to minimizing the extent to which mismanagement, fraud and other irregularities can occur.

The Sarbanes-Oxley Act of 2002 emphasizes that it is the primary responsibility of management for “establishing and maintaining an adequate internal control structure and procedures for financial reporting”. However, both management and the oversight bodies can benefit from the work of Committee of Sponsoring Organisations of the Treadway Commission (COSO). COSO issued Internal Control – Integrated Framework in 1992 as a comprehensive framework for evaluating internal control, and published as a draft in October 2005 detailed guidance for smaller entities. In 2004 COSO also published Enterprise Risk Management – Integrated Framework which builds on the integrated framework on internal control and provides “a more robust and extensive focus on the broader subject of enterprise risk management”.

Conclusion

From the available evidence, the root cause of corruption appears to be poverty. Therefore, initiatives aimed at preventing and combating corruption should be linked to poverty reduction. However, this is easier said than done since a significant portion of the world’s population lives on less than $1 a day. Notwithstanding this, in keeping with IMF/World Bank conditionalities, several governments of developing countries are incorporating poverty-alleviation strategies as part of their budget measures.

There is also a strong positive correlation between democracy, good governance and accountability. Democracy facilitates accountability which in turn facilitates development. A lack of democracy almost inevitably leads to a lack of accountability which in turn impacts negatively on development. According to the United Nations Secretary-General, Kofi Annan, “where there is accountability we will progress; where there is none we will underperform”. Therefore, there should an encouragement in the promotion of democratic values and in the strengthening of weak democratic institutions. Vague, archaic and cumbersome rules and regulations also need to overhauled and modernized, and the use of discretion in decision-making should be severely restricted.
While international and regional efforts aimed at combating corruption need to be applauded, in the final analysis, the fight against corruption has to be dealt with at the national level. Decision-making needs to be open and transparent with a high degree of participation and involvement of civil society. A free and vibrant media should also be encouraged. As Secretary-General Kofi Annan points out “without good governance, strong institutions and a clear commitment to root out corruption and mismanagement wherever it is found, broad progress will prove elusive”. He further argues that investment strategies to achieve the Millennium Development Goals will not work in practice unless supported by States with transparent, accountable systems of governance, grounded in the rule of law, encompassing civil and political as well as economic and social rights, and underpinned by accountable and efficient public administration.

Above all, important watchdog agencies such as the Legislative Audit should be in the forefront in the fight against corruption and should be provided with adequate resources to do so.

References


Rose-Ackerman, Susan. (1999), *Corruption and Government: Its Causes, Consequences and Reforms*.
**Privatization** is one area strongly threatened with corruption. In recent years the NIK has not been extremely critical of the majority of audited undertakings, though cases of poorly carried out privatisations have been disclosed, where public interest has suffered vividly. NIK findings indicate that major irregularities tend to occur in the sphere privatised property valuation. Unfair valuation and underscoring state property value may have lead to undue financial gains at the expense of the State Treasury.

The argument that privatised property is worth as much as a potential buyer is prepared to pay is frequently abused. It is commonly recognised that honest stocktaking and valuation alone can provide the basis for good negotiations. What often lies at the bottom of failed valuation exercises is poor consulting companies’ performance in the course of privatisation processes.

The NIK would many times suggest establishing a system for independent reviewing property valuations; such system would permit correcting a number of erroneous valuations and motivate both consultants and public servants towards a greater diligence in executing their duties. The system permitting the verification of valuations has not been established yet, still the NIK recommendation remains valid.

Another important issue is failure to quote specific aims for particular privatisation exercises. General objectives may be clear, yet Government documentation will hardly ever list specific aims or targets for a given privatisation exercise. Quite frequently do targets remain unspecified, even in contracts with consulting companies which envisage payments of success bonuses without specifying success measures. As a result it is often hard to say if a given exercise has turned out to be a success, if expected results have been achieved and task performance by public officials proves honest. Lack of such specifications in particular privatisation cases opens way to all kinds of steps by officials in charge, representing the interest of the State Treasury.

**Managing public property**, and in particular the property of the State Treasury, is another vast area significantly threatened with corruption. Numerous NIK studies have indicated that lack of specific rules or supervision over the activity and people in charge, lead to cases of mismanagement of such property, which contradicts the principles of sane management and puts public interest at risk. State property would frequently be invested in an ineffective way in various liaisons with private entities, in order to limit corruption opportunities in this area it is necessary to amend the law, and strictly define basic managing rules in particular where the state property functions as a contribution into companies, where the State Treasury is a minority shareholder.

In effect it has no actual control over the property contributed. The system of monitoring companies needs to be definitely improved to focus on the state property and the representation of the State Treasury interest in there. It is as necessary to introduce legal regulations aimed at preventing abuse by way of improving efficiency of state-owned economic entities, which might be achieved in the course of works initiated at the Parliament aimed at protecting the industrial property.

**Corruption encouraging areas include also the activity of Local Government units**, which is exemplified in numerous NIK audit studies. Apart from public procurement contracts, which at the Local Government level are frequently concluded abusive
of the binding legal regulations, an area under threat is sales and hire of commune property. The NIK has pointed to the cases of transactions, where partners to Local Government units have obtained undue privileges to the detriment of commune interests. Local Government units (in particular organs of representation) have not fully developed control mechanisms. It happens that local Parliament deputies approach the NIK asking to take up an audit in suspicion that their local Boards have committed irregularities, and having difficulty in access to files or documents.

Even such situations were reported, where already after a NIK audit heads of villages or town mayors are unwilling to facilitate access to audit findings to deputies concerned, in particular if they are not favorable. NIK audits frequently disclose lack of transparency in the activities pursued by local Government authorities.

Another area threatened with corruption is the activity of State Special Purpose Funds, which manage public property of considerable value, enjoying at the same time a considerable degree of freedom in decision making - broader than that reserved for the disponents of state budget resources. In a broad system analysis concerning the functioning of the Special Purpose Funds, developed by the NIK in 1996, it was indicated that an excessive freedom in allocating public resources goes with lack of day-to-day control mechanisms.

Without questioning the need to continue with the special purpose funds (but also without questioning the need of major reforms in this area), the NIK called attention to the fact that creating “quasi-budgetary” modes of financing expenditures for the execution of state tasks with extra budgetary resources blurs the picture of the national economy and the actual financial balance of the public sector, making the book keeping more complicated, and at times more expensive, and audit work - more difficult. Holes and inconsistencies in the existing legal regulations heighten threats of occurring irregularities.

Excessive freedom enjoyed by state agencies in the sphere of investing public property frequent undertaking of tasks unrelated to the statutory alms of a given agency may also prove dangerous. Limiting corruption opportunities in this area may turn out possible if the activity of the Special Purpose Funds becomes subject to strict legal requirements, similar to those, which cover the state budget resources.

Public procurement by its nature constitutes an area threatened with corruption. Winning an advantageous contract for delivery of goods or services paid with public resources, at times of considerable height, may be - and frequently is - connected with a chance of making high profits by the delivering company. Still a few years ago, a considerable degree of freedom existed in delivering against public procurement, at times the deliverers themselves were arbitrarily selected, infringing on the principles of competition and procedures designed to select the most advantageous offer.

The situation changed in 1995, when the Public Procurement Act came into life, frequently recommended by the NIK in the past. The Act introduced order in the legal sense, but the regulations were frequently abused. In the practices adopted by the organs of the state the cases of complete ignorance of the requirements imposed by the Act were frequent, abusing the non-tendering procurement mode, and in cases when complete tendering procedures were followed - frequently order specifications were manipulated for a particular company to win the contract.

The issues related to public procurement should stay in the focus of NIK attention. Seemingly, minor abuses of tendering procedures might conceal very dangerous corrupt practices. Local Government units are also threatened with corruption in this sphere of social life, which is facilitated by a lower intensity of audit work, and at the same time greater opportunities for the abuse of the law unpunished. NIK audit findings collected in the course of a few public procurement studies carried out at the commune level, indicate a vast scale of irregularities. The leading instrument designed to limit the threat of corruption in this case should go in the direction of making internal controls more effective, in those units which are placing public procurement orders and are making servants really accountable for abusing the regulations of the Act.

Important strengthening is also required of the Public Procurement Office, which should establish closer co-operation with other head and central offices in state administration. While auditing the activity of the Public Procurement Office the NIK highlighted, among others, the fact that an important factor in preventing corruption, i.e. the necessity to obtain permission by the President of the Public Procurement Office to disregard tendering procedures or to offer preferential terms to local tenders, in fact turns out more
of a formal than technical security. The NIK presented the post-audit recommendation for each decision by the President of the PPO to be preceded with consultations seeking opinion by the proper Minister concerned with the technical field in question. The establishment of such tool could contribute to diminishing the threat of corruption in public procurement, especially where major financial consequences for the state budget are involved.

**Using administrative procedures for establishing quota and licensing also opens way for corruption.** Especially vivid examples of threats in this area have been yielded by the NIK audit of establishing and allowing customs quota. The audit disclosed the fact that over a number of years their number increased. Frequently they were established without any valid justification, without the necessary economic analyses, on the closing days of a given year, and in circumstances which inspire suspicions that one part of those hastily established quota was really inspired not by public interest but by the interest of particular groups of beneficiaries. There exists no system for quota monitoring. This nontransparent and blurred system, may have allowed irregularities which would revolt public opinion, just like the case of banning the imports of gelatin, which was directly aimed at protecting the interests of a single Polish gelatin manufacturer.

**An important area threatened with corruption is covered by the competence of the tax apparatus.** Tax regulations in Poland are very complicated and hard to grasp not only for an average taxpayer, but also for the civil servants employed with tax administration. Greatest difficulty ensues from the existence of the numerous tax relieves (tax exemptions, reductions, holidays and delayed payments) which are frequently granted without justification or due recognition of a given taxpayer’s situation. Thus, legally accepted discretion turns into anarchy in the hands of particular tax offices and chambers. In the NIK’s opinion actions aimed at diminishing the threat of corruption in the sphere covered by the functioning of the tax apparatus should focus on making the tax law simple and reducing the number of discretionary relieves available and should be combined with strict auditing of particular cases (carried out by tax inspectors’ teams from remote provinces). An important factor would be speeding up the process of automating work in all tax offices.

**Very serious is the corruption threat in customs administration,** which collects almost a quarter of all incomes into the state budget. The EU, too, highlights the need to pay a greater attention to the issue of corruption in custom services. In July 1998 the NIK presented to the Parliament a lengthy information material on post-audit findings in customs administration with a particular regard for supervision and procedures of customs check-ups. It contains a thorough analysis of the current state of the Polish customs services. It also contains tangible conclusions aimed at removing the irregularities and the systemic improvement of the functioning of the customs services.

Responses collected by the NIK from the Minister of Finance and the President of the Chief Customs Office indicated determination to follow NIK post-audit recommendations and announced important improvement in the effectiveness of the functioning of the services in question. The NIK will have an opportunity to study the implementation in their follow-up audits.

Hope for improving the functioning of the customs services and diminishing their vulnerability to corruption, is evoked by the activities initiated by the Chief Customs Inspectorate.

In order to diminish the corruption threat in customs services, it is necessary to implement far-reaching changes in the organisation of Customs Offices’ work and in the system of supervision and control. It is necessary to furnish the services with better equipment and introduce anticorruption organisational arrangements at their work, including the separation of particular customs activities to be performed by a number of customs officers, exchanging customs officers’ teams on an ad hoc basis, increasing the number of customs inspections performed outside the border check-points and reviewing customs applications. It is also necessary to establish a highly motivating pay system, rewarding customs officers for the results of their work. It is necessary to strengthen supervision over the functioning of customs warehouses.

**The Police** is also viewed as one of those public services, which is threatened with corruption. All irregularities in the Police’s functioning, even if they seem to be of marginal importance, undermine citizens’ trust in the state and in consequence contribute to the weakening of the authority of the state and the law. The NIK has for a few times now dealt with the functioning of the Police...
in its audits, disclosing on such occasions important system’s irregularities which might create opportunities for corrupt practices. A special phenomenon is the blurred system of financing the Police, which has come into life since 1 January 1999. It is marked by the absence of effective supervision over the legality, honesty and efficacy in the use made by the Police of public resources. Diminishing the corruption risk in Police activities requires introducing significant changes into the institution’s modes of functioning. Especially, is introducing changes to the ways of serving in road patrols is necessary, which provide the most frequent opportunity for the majority of citizens to have direct contact with the Police. In order to build trust in the Police and exclude the risk of all suspicion of potentially illegal money flows, it is necessary to free the Police from performing the role of “cash collectors” and withdraw from accepting cash payments while on duty.

**Corruption mechanisms disclosed and indicated in NIK audits**

- **Excessive competence in one servant’s hand**
  In the activity of many public institutions, occurs the phenomenon of leaving behind too much space for the activity of a single civil servant. One person performs a whole set of activities, practically without interference from other people. While one of leading instruments in counteracting corruption is the so-called “principle of many pairs of eyes” or separation of clerical responsibilities in spheres vulnerable to corruption.

- **Discretion in decision making**
  One of acceptable solutions in administrative procedures is leaving a margin of discretion in making decisions on cases, where the actual solution depends on a given servant’s approach recognition of the situation. The problem starts wherever discretion turns into excessive freedom with a servant handling a case not by according to verifiable criteria, but following his own discretion.

- **Ignoring documentation and reporting**
  Files of particular cases happen to be incomplete, while the respective decisions are based on incomplete and incorrect motions lodged by individuals concerned. The requirements related to documenting and reporting are taken lightly and approached as unnecessary bureaucracy, while frequently those very “formalisms” constitute the best guarantee of transparency in administrative procedures or in transactions where public property is involved. It is necessary to establish the principle that correct documenting and serious reporting of all activities are transparent and open factors in public administration.

- **Weakness of internal controls**
  Another important instrument in preventing corruption in public administration is an efficient internal control system. Public institutions should be scrutinised on a routine basis; strong internal controls are important components of democratic governance and management systems in administration, which is commonly recognised in EU countries. The NIK indicates the necessity to urgently strengthen internal control systems in state administration.

- **Unequal access to information**
  Offices capable of handling particular matters do not always provide proper information to everybody concerned about the existing possibilities. Profits from this, or another way of handling a given case, become available only to those who are aware of the existence of such possibilities and apply for them. In order to counteract corruption, it is necessary to establish such procedures in the activity of public bodies to guarantee to all parties concerned equal access to information on possible ways to handle cases in a given office.

- **Lack of accountability**
  Another factor which encourages corruption is insufficient execution of personal accountability vis a vis those servants who can be blamed for having committed irregularities in their offices. An important problem is practically no accountability for infringements on the discipline of public finances. Accountability before Committees for Budgetary Discipline has so far proven fictitious and quite often - detrimental actions and serious infringements on the Public Procurement Act have passed unpunished. The awareness of the fact that this or another action may go unpunished may very well encourage corruption.
NIK audit findings also indicate that in the practice of public administration activity there are no system’s solutions designed to counteract corruption. In Polish administration anticorruption solutions broadly adopted in the world are not implemented. Personal supervision is oriented versus eliminating situations, which encourage corruption, also in recruitment of employees for state services. The issue of counteracting corruption does not make subject of internal discussions or training courses. One might expect that each public institution where a corruption risk occurs should have developed a program of systemic activities designed to eliminate or at least seriously diminish the risk of corruption.

Source: Threat of corruption in the light of audit studies carried out by the Supreme Chamber of Control (the NIK) of the Republic of Poland, The Supreme Chamber of Control, Warsaw, Poland
Introduction

It is a basic right of the public and taxpayers to have accurate and reliable financial statements reflecting the complete operations and financial situation of government and other public sector bodies (including information on all revenues, assets and liabilities as well as expenditure). These are essential for the purposes of good governance, public accountability and transparency, as well as constituting a sound basis for economic decisions.

The opinion resulting from an SAI’s audit of the financial statements serves as an essential assurance to all stakeholders that the financial statements concerned are in fact reliable, that is that they are complete and accurate in all material respects. In the public sector there is also an expectation that the audit of such financial statements should also aim at giving assurance about the regularity of the revenue and expenditure operations underlying the financial statements.

Such assurances can only be given if the audit work which supports such opinions is of a sufficiently high standard and quality, and achieving this requires a professional approach. The purpose of the workshop was to identify the key issues of concern to SAIs in attaining and maintaining such high standards for the audit of their governments’ financial statements.

Representatives of the SAIs from the New Member States and Candidate Countries, along with Albania and FYROM participated at a workshop hosted by the Maltese NAO to discuss and exchange experiences on the subject of auditing public sector financial statements. Given that most of the countries concerned had some experience of auditing financial statements, even if the precise nature of their mandates could differ somewhat, the subject was going to be of wide interest for the participants. The presentations, from the ECA from old and new MS, were intended to facilitate an exchange of knowledge and practical experiences of current practices and standards for such audits. And, despite the differences in backgrounds, a large number of common points emerged during discussions.

At the end of each of the following headings, specific recommendations are indicated (in italics) which can help SAIs to ensure that the audits of financial statements, which they carry out, result in soundly based opinions which provide the assurance stakeholders require.

➢ **INTOSAI and IFAC standards on financial audit and compliance audit**

International auditing standards will help public sector auditors to achieve good practice in the audit work they carry out, although care should be taken to ensure that such standards are adapted to the particular circumstances of the audit body.
concerned. Such standards are not a straightjacket, and each SAI needs to derive specific methods, guidance and manuals which set out how it will meet the standards.

The INTOSAI auditing standards, specifically designed for the public sector, are useful but rather general in nature. The IFAC International Standards on Auditing (ISAs)\(^1\), more detailed and practical in nature and essentially designed for use in the private sector, are widely applicable to the public sector audit of financial statements, and the public sector perspectives incorporated in them are useful. However, there is a need for a full set of detailed guidelines specifically designed to help SAIs apply ISAs while implementing the INTOSAI standards. Workshop participants noted the usefulness of the EU Implementing Guidelines for INTOSAI Standards, but also noted that these had not been updated recently.

INTOSAI has recognised the need for further guidance and its Professional Standards Committee has set up a structure to issue a comprehensive set of public sector-oriented guidance covering all areas relevant for SAIs. There are six sub-committees, two of them dealing separately with financial (statements) audit and compliance (with laws and regulations) audit, chaired by Sweden and Norway respectively. These sub-committees have formed working groups to make proposals for INTOSAI “practice notes”. In the case of financial audit the content of the practice notes will be based on IFAC ISAs, co-ordination being done through an INTOSAI “reference panel”, consisting of SAI representatives, which also has an input into the IFAC standard-setting process (which is relatively slow). It is intended that INTOSAI guidelines on compliance audit, a subject which is not adequately covered by the ISAs, will be adopted in 2007.

The SAIs involved in INTOSAI standard-setting come from a relatively limited number of countries (mainly Anglo-American and Northern European). However, a few of the SAIs participating in the workshop are involved in the INTOSAI Professional Standards Committees’ working groups.

The SAIs of the New Member States and Candidate Countries show considerable awareness of the content of IFAC’s ISA standards and apply many of them. Some consider them directly applicable, and others have national standards based on the IFAC standards. Their importance is underlined by the fact that most of the countries participating in the workshop had access to translations of the ISA standards.

All the ISA standards were considered by the workshop participants to be relevant to their audit work to a greater or lesser extent, and those that were considered to be most applicable and useful by participants were those covering:

- Objectives and general principles governing an audit of financial statements (ISA 200), Consideration of laws and regulations in an audit of financial statements (ISA 250).
- Planning an audit of financial statements (ISA 300), Understanding the entity and its environment and assessing the risks of material misstatement (ISA 315), Audit materiality (ISA 320).
- Audit evidence (ISA 500), Audit sampling and other means of testing (ISA 530).
- Using the work of another auditor (ISA 600), Considering the work of internal audit (ISA 610).
- The auditor’s report on financial statements (ISAs 700 & 700R).

**Recommendations:**

- **SAIs should apply, or continue to apply, to their audit work the international standards which are appropriate for the public sector and to their specific national circumstances.** The application of such standards is particularly valuable in achieving a consistently high quality of audit in SAIs with a collegial structure.

- **SAIs should be more proactive in supporting the development of ISAs and INTOSAI guidance, and apply to be nominated to INTOSAI reference panels or working groups deliberating on audit standards, so that they can exert influence on the content of such standards.**

\(^1\) Issued by its International Auditing and Assurance Standards Board (IAASSB)  www.ifac.org
The importance of the SAI’s opinion resulting from its audit of financial statements

SAIs’ opinions provide the assurance needed by stakeholders that the financial statements concerned “give a true and fair view in accordance with the applicable financial reporting framework and, where appropriate, that they comply with statutory requirements” (to use the wording of the ISAs on the auditor’s reporting on financial statements). The expression “present fairly, in all material respects” is considered equivalent to “true and fair view” and other wording is sometimes used, such as in the case of the ECA which is required to give its opinion on the “reliability” of the EU accounts. Whatever the precise wording, the purpose of an opinion is to state whether the financial statements are free from material misstatement, that is to say complete and accurate in all material respects. Only then can the financial statements provide accountability and constitute a reliable basis for economic decisions.

Opinions providing such positive assurance constitute modern best practice. Opinions have very limited value if they provide only negative assurance, which means that conclusions relate only to the elements the auditor has actually examined, and not to the financial statements as a whole.

The importance and usefulness of this kind of audit is highlighted by the ECA’s experience for ten years of issuing a qualified opinion on the EU accounts and an adverse opinion on the legality and regularity of the underlying transactions.

SAIs also have a duty to underline the importance of their government producing good quality financial statements and adopting good accounting practice. This can be aided by the application of IFAC’s International Public Sector Accounting Standards (IPSAS) to government financial statements, which few of the governments of the countries attending the workshop yet do.

The SAI’s opinion, particularly as is often the case when it also covers compliance with applicable regulations, can also:

- Provide assurance that the national budget has been properly spent as intended.
- Help to prevent future irregularities.
- Help to improve financial management by identifying problem areas and system weaknesses.

Recommendations:

- **SAIs should produce opinions which aim at providing positive assurance concerning the truth and fairness of their government’s financial statements as a whole.**

- **SAIs should use their influence to promote the use of good accounting standards for public sector financial statements. They should ensure that they are consulted by bodies setting national standards for government/public sector accounting.**

- **SAIs should do their reporting on the results of their audit of financial statements in a way which can contribute to an improvement in public sector management and the avoidance of problems in future.**

The incorporation of the audit of compliance with laws and regulations into the audit of financial statements

It is generally considered that the audit of public sector financial statements should include an audit of the legality and regularity of the transactions underlying the financial statements concerned (compliance audit).

Integrating the audit of compliance with laws and regulations into the audit work aimed at verifying the financial statements is a good idea because it is efficient to examine the same transactions and documents for both purposes. This can be done to a large extent even when, because tolerance of error is usually lower, materiality levels for the audit of compliance with
laws and regulations tend to be lower than for financial statements audit. In such cases a single sample of transactions could be tested for both financial statement and compliance objectives, and audit testing may be extended for the specific purposes of the audit of compliance with laws and regulations.

Particular problems faced when carrying out an audit of compliance with laws and regulations, in addition to the materiality question mentioned above, are:

- The extensiveness of the regulations that have to be considered (which in some countries can include rules at a lower level than national legislation).
- The lack as yet of international standards and guidelines specifically dealing with the audit of compliance with laws and regulations.
- Occasional difficulties in obtaining sufficient relevant evidence.
- The need for risk assessments to specifically target the risks of irregularity occurring, and provide a basis for decisions on whether further testing is required specifically for the audit of compliance with laws and regulations.

IFAC’s Study 3 on “Auditing for compliance with authorities – a public sector perspective” is an interesting supplement to the rather concise public sector perspective included in ISA 250 on “Consideration of laws and regulations in an audit of financial statements”.

**Recommendations:**

- *It is perfectly feasible for SAIs to integrate their audit of compliance laws and regulations with their audit of financial statements, while taking into account the possible need for a different risk assessment and materiality limit.*

- *A specific audit assertion for legality/regularity should be developed by SAIs in the context of the audit of public sector financial statements to specifically cover the audit of compliance with laws and regulations.*

**Planning the audit of financial statements**

Proper planning of financial statements audits is essential if the audits are to avoid problems during the implementation and reporting phases. Some well-established SAIs devote as much as 20% of the total time spent on an audit on the planning phase, which includes considerable work on gaining knowledge of the corporate structure, systems and procedures of the entity being audited. This knowledge supports the risk assessment work which is the basis for the decisions on the nature and volume of the audit procedures planned to be carried out, in particular how much reliance can be placed on systems of internal control (which must be evaluated and tested).

This knowledge also provides the basis for decisions to rely on the work of other auditors, such as internal auditors, provided that the objectives and quality of their work are assessed to be in line with those of the SAI carrying out the external audit. If this is the case there should be considerable scope for such reliance. Public sector auditors may also consider sub-contracting part of their work to private sector auditors, in cases where the terms of reference are unambiguous and supervision by the SAI can be ensured.

The Audit Scotland practice of preparing a “Priorities and Risk Framework” for each entity being audited is an interesting idea for other SAIs. Its purpose is not only to document the main priorities and risks facing an entity to give auditors a focus for both financial and performance audits, but also to explain to auditees key issues about their control framework and the auditor’s objectives. This helps to promote a cooperative attitude on the part of the auditee and helps it develop its own effective risk management processes.
Recommendations:

• SAIs should devote time to planning financial statements audits sufficient for gaining all the knowledge of the entity required to assess the risks involved, and to decide on the combination of audit procedures and volume of work required to fully meet the objectives of such audits.

• SAIs need to devote considerable attention during the planning phase of their audits of financial statements to the identification of risks, so that their choice of audit procedures will enable them to detect significant problems.

• The materiality concept should be applied to the planning of audits of public sector financial statements.

• SAIs should take every opportunity to rely on the work of other auditors, particularly internal audit, wherever the requirements of the relevant ISA standards can be met.

The consequences of the transition from cash-based accounting to accruals accounting

Many SAIs (almost two thirds of the SAIs participating in the workshop and including the ECA) face a situation whereby the government financial statements subject to their audit are in the process of being changed from cash-based accounting to accruals accounting within the next few years. This poses problems not only for the government accounting services, which have to draw up appropriate new standards and procedures, but also for the SAIs which will face new and more complex accounting systems and procedures and financial statements. This implies a need for increased personnel resources.

Recommendations:

• SAIs could usefully exchange experiences on the problems they face in dealing with significant changes to the financial statements they have to audit, and to the accounting systems which produce them (cash-based to accruals).

• SAIs should use their influence to promote the use of good accounting standards, (firmly based on those developed internationally – IFAC IPSAS 2 ) for public sector financial statements. They should ensure that they are consulted by bodies setting national standards for government/public sector accounting.

• SAIs should plan for the extra resources they will need to both familiarise themselves with new accounting systems and procedures and financial statements and also to audit them. Special attention needs to be given to the running of the new system before it becomes the official accounting system, to the verification of opening balances which have to be developed for the first year of official operation, to reporting progress to Parliament and to carrying out special audits where significant problems arise.

Deciding on the content of an opinion on financial statements

This is a difficult and complex task, made easier if good planning ensures that major risks are identified in advance and that sufficient audit work is performed to provide a sound basis for a reliable opinion.

From this point of view some of the classic audit assertions can be difficult to verify. Making sure that some elements of the financial statements, such as revenue, are complete is particularly difficult. There can also be problems in verifying that liabilities are complete and that valuations are reasonable for both assets and liabilities.

An opinion on financial statements must always cover compliance with laws and regulations to the extent necessary to

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2 IFAC International Public Sector Accounting Standards
ensure discovery of a potentially material effect on the truth and fairness of the financial statements, or their compliance with statutory requirements. Where an opinion on compliance with laws and regularities is specifically required it is usually presented separately from the opinion on the financial statements, although often they are presented in the same document. The two opinions can show different results (for instance, one qualified and one unqualified), which does not mean that they are conflicting, given that each opinion is on a different subject.

Providing an unqualified opinion is risky unless the basis is sound, as material problems may come to light at a later time. Should this happen the auditor should have put himself in a position to prove that the problems concerned cannot have a material effect on the truth and fairness of the financial statements, and/or that he has applied all relevant standards to carrying out his audit work and evaluating the results.

Providing a qualified or adverse opinion or a disclaimer of opinion needs to be explained and justified, which means clearly describing the reasons in terms of nature and value. There can be problems in getting auditees to accept negative opinions, and in getting stakeholders, the press and the public to understand their true significance. Where expectations are unreasonable it is up to the auditor to make this clear.

Opinions on compliance with laws and regulations are usually particularly sensitive to public reaction, and it is therefore not unusual for auditors to report irregularities which may not be material in value terms, but are by context or nature.

In the end, when forming his opinion, the auditor has to rely on his own professional judgment, backed up by the knowledge that he has applied sound standards in the execution of his audit work, and that he and his staff have the required professional skill. While it may be hypothetically possible for two auditors to arrive at a different opinion in the same set of circumstances, professional standards and skills should ensure that this would be a very rare occurrence.

**Recommendations:**

- **SAIs need to devote particular attention to ensuring that the opinions they issue are based on high quality audit work and sound professional judgment.**

- **SAIs should use the ISA guidance (ISAs 700, 700R and 701 in particular) when drawing up their opinions on financial statements. Where national requirements differ from the international standards SAIs should use their influence to promote harmonisation.**
Conclusions

Carrying out effective audits which can support sound opinions on financial statements is not easy, and the public sector has its own particular complications, difficulties and exposure. From a practical point of view, many SAIs face problems in carrying out audits of financial statements, particularly where a specific audit of compliance with laws and regulations is required. A lack of resources within the SAI often further complicates the task, and this is exacerbated when new challenges are faced, such as changing the basis for government accounts from cash to accruals.

SAIs need to be confident in their skills and use their professional judgment, while benefiting from the comprehensive international standards which exist on the subject of the audit of financial statements. The more they can exploit opportunities for cooperation with their colleagues in other countries (as was done in this workshop) the easier that will be. Working together to harmonise and improve audit methods and practices is surely a very good thing.

The high professional level of staff in SAIs means that, whatever their status, they have the potential to promote and implement whatever changes may be needed to achieve the highest standards in audit quality.

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Abstract

A research project funded by the Swiss National Commission for Technology and Innovation (CTI) investigated the implication of accounting standards to government reporting. While the governments of many other countries still report on cash basis, the research project took place on the local level in Switzerland, where accrual accounting has been introduced as early as in the mid eighties of the last century. This environment is more challenging to accounting standards like IPSAS, because the improvement is less obvious than for the more frequent case where governments move from cash based to accrual accounting following IPSAS. However, the study has shown substantial differences between accrual accounting without standards and accrual accounting following IPSAS. The boldest differences are in the field of measurement, while the most important ones are in respect of the disclosures about potentially risky issues such as contingent liabilities. The financial reports under IPSAS reflect the concept of materiality. The focus is on aggregated items which are enough important to influence the financial position and performance, while the financial reports following traditional accrual accounting in Switzerland are focussing on accuracy by attempting to provide as many details as possible. This makes them rather unhandy in comparison to IPSAS based reports.

1. The rationale of accounting systems and standards

Accounting has been developed along different lines. The development of the anglo-saxon line of accounting standards has traditionally been driven by issues and cases being raised by the accounting practise, whereas the continental European line has created systems from scratch, following a systematic approach. Until the late 20th century the term used in continental Europe was rather “accounting system” or “accounting model” than “accounting standard”. I will therefore use the term accounting system for a systematic approach to accounting following the accrual principle, which does, however, not incorporate the typical elements of a nowadays accounting standard. Accounting systems can equally be found in the private sector, as well as in the public sector, which will be examined in this article.

Accounting systems are generally principle based, but the focus is usually less on the presentation, than on the bookkeeping. Most of them are accrual based, i.e. recognizing assets and liabilities when they are under a certain degree of control, rather than when cash is paid or received in exchange. They usually include accounts receivable and payable, as well as tangible and non-tangible assets and liabilities. The residual value of the assets minus the liabilities is generally called equity.
Especially in the German speaking countries, including Switzerland, the chart of accounts ("Kontenrahmen" or "Kontenplan") has therefore traditionally been extremely important\(^1\). The chart of accounts is the core of accounting systems, even though they usually include some principles for presentation, measurement, disclosure and consolidation. But the latter principles are much less prominent and certainly not designed for complex situations in large organizations. Accounting systems are – at least outside the core – more open for different solutions. Therefore different financial reports under the same accounting system generally look very similar at first glance, but may be very different at a closer look.

While the driving force of standards has been to enhance transparency and accountability to any outside reader, such as financial investors in the case of private companies or the electoral constituency for the public sector, the driving force for accounting systems was to ensure the right procedures inside the accounting units. Accounting systems have also played an important role when information systems were first implemented. They were designed to simplify and standardize the software being developed and implemented.

Accounting standards go further than accounting systems and include, beside structural guidelines which are provided both by systems and standards, the following issues:

**a) Presentation of Financial Reports**

Accounting standards focus on the relevancy of information to the reader. They all suggest a very common structure including the balance sheet, profit-and-loss-statement, cash-flow-statement, a statement showing changes in equity and disclosures. Standards include qualitative principles such as materiality, going-concern or consistency of presentation.

**b) Scope of Financial Reports**

Accounting standards require the entity presenting a financial report to consolidate financial statements of controlled entities. There are various techniques how to consolidate, however, all of them ensure that financial results of controlled entities cannot be hidden and transactions between controlled entities are to be excluded.

**c) Measurement of specific items**

Unlike accounting systems, standards require a principle based measurement of assets and liabilities. There are different measurement principles, but all of them try to enhance consistency and to avoid window dressing by the management or the government.

**d) Off-balance-sheet-reporting: Disclosures**

Accounting standards acknowledge that a balance sheet and profit-and-loss statement are not suitable to report any relevant aspects, such as options or other contingent transactions. These off-balance-sheet items need to be show in the disclosure section of financial reports, in addition to further information on specific line items and, probably most important, the accounting principles themselves.

Hence, accounting systems are not in contradiction to accounting standards, but do not go quite as fare with their requirements in respect of the information content. On the other side, accounting systems may give more guidance in respect of operational accounting procedures.

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\(^1\) In some countries, like Austria or Spain, the chart of accounts is even legally binding for private sector companies.
2. The Swiss accounting system

Being a continental European country, the tradition of Swiss accounting is in the line of accounting systems, rather than standards.

In Switzerland, private sector accounting was mainly influenced by the so-called Käfer chart of accounts (“Käfer Kontenrahmen”), named after Prof. Karl Käfer. This system of accounting, developed in the first half of the 20th century, is an accrual system, focusing on the chart of accounts, which leaves some but rather limited room for company specific adoptions. Unlike standards, this accounting system failed to give guidelines in respect of the scope or consolidation, of measurement and disclosures. For private sector companies such standards have only been developed in Switzerland towards the end of 20th century under the name of “Swiss GAAP FER”3. This standard, which loosely follows IFRS, has some importance for medium sized private sector companies, while larger, listed companies rather apply IFRS or US-GAAP.

The public sector in Switzerland has never been following private sector accounting systems or standards. It has traditionally been using a cash basis of accounting, distinguishing between ordinary and extraordinary funds of cash which were assigned to the various functions of government. In the seventies of the last century, the Conference of the Cantonal Ministers of Finance developed an accrual system of accounting, called Harmonized Accounting Model (HAM). Despite notable differences, the HAM is following the tradition of the private sector “Käfer-system”, by focusing on the chart of accounts. This system became a guideline for public sector accounting on state level in 1981. Because local governments are generally required to follow state legislation in the field of public finance, the HAM was gradually introduced on the two lower levels of the Swiss Federation. The federal level, however, continued to use a cash based system but also published a balance sheet and a profit-and-loss-statement, however only prepared on a statistical basis. The HAM is logical and well structured, but the structure or at least the terms used are different from any private sector accounting systems and also the one used by today’s accounting standards. This makes it difficult to understand for accounting professionals, even if, from a more theoretical point of view, there is nothing wrong with it. More importantly, there are hardly any guidelines in respect of the scope of financial reports or consolidation, of measurement and disclosures under HAM. The few guidelines in respect of measurement are non-binding and therefore generally not observed. To summarize: The HAM is a sound, accrual accounting system, but certainly not an accounting standard comparable to well known standards, such as IFRS, Swiss GAAP or the International Public Sector Accounting Standards (IPSAS)5.

The fact that the lower two levels of Swiss government are using an accrual accounting system, while the top level federal government is still on a cash basis of accounting is typical for Europe. As a large, international study by CIGAR, the Comparative International Governmental Accounting Research group, and PricewaterhouseCoopers revealed, there is clear tendency in many European countries that lower levels of government are implementing accrual accounting earlier than their national level counterparts6. Although the lower level governments in Switzerland were early movers, in many other European countries such reforms have taken place on the lower levels of government in the 80s and 90s of the last century. Unlike in Australia, New Zealand or Canada, many of them have, like Switzerland, not introduced accounting standards, but rather accounting systems, leaving important issues of financial reporting unanswered.

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2 First publication focussing on small and medium sized entreprises: Käfer, Karl: Kontenrahmen für Gewerbetriebe. Bern: Haupt, 1947. Later publication to include manufacturing and trading companies. Karl Käfer died at the age 101 years in 1999. The “Käfer-Kontenrahmen” has also influenced the chart of accounts in Germany and Austria.


4 The federal government will implement full accrual accounting following IPSAS in 2007.


Therefore, the case of Swiss state and local governments is of some interest not only for Switzerland itself, but for many other countries. What results can be expected, if full accrual accounting systems are further developed under the influence of accounting standards, such as the IPSAS?

3. **Hypothesis**

In the described setting one would expect certainly smaller improvements with the introduction of a full accounting standard, in comparison to a government moving from cash basis to a full accrual standard. Obviously there are different issues which might be improved, but do they really matter? Is cost and benefit of such reforms in a sensible ratio to each other? This leads to the following hypothesis:

H1: The application of an accrual accounting standard leads to different results from the application of accrual accounting system.

H11: The application of an accrual accounting standard leads to a different size of the financial report.

H12: The application of an accrual accounting standard leads to a different financial result (profit or loss).

H13: The application of an accrual accounting standard leads to a different balance sheet residual (net asset/equity).

H14: The application of an accrual accounting standard leads to a different structure of the financial reports.

Furthermore:

H2: The resulting differences between accounting standards and accounting systems lie primarily in the field of the scope of reporting, i.e. consolidation.

H3: The resulting differences between accounting standards and accounting systems lie primarily in the field of measurement.

H4: The resulting differences between accounting standards and accounting systems lie primarily in the field of notes/disclosures.

The setting of the research project, including only one reporting entity, the City of Kloten in Switzerland, obviously does not allow general conclusions, although the city might be representative for medium size local entities in Switzerland. It has been using the accrual HAM accounting system for more than 15 years. With its 17,000 inhabitants and a location in the vicinity of a large city, it is quite typical for Switzerland, a densely populated country in the centre of Europe. But for statistical reasons a single case must never be taken as a representative sample. On the other hand’s side, the first time application of accounting standards is simply too demanding and costly, to allow a larger sample for the time being. Funding for a larger scale of study would only be available, when accounting standards are implemented in a full scale reform project and not for research purposes only.

The hypothesis may thus only be tested in a single case setting, providing some indication for similar cases. If implementation of IPSAS or other accounting standard takes place, the hypothesis should be tested in a larger number of samples.

4. Results from the Kloten study

According to the design approved by the CTI, very diverse aspects had to be examined in the study. The underlying work, however, was to restate the financial reports for the year 2001 according to IPSAS\(^7\). This after the reports were presented according to HAM, as required by the Zurich State Local Governments Act (“Gemeindegesetz”)\(^8\). This restatement was examined in different ways and shall be examined also in respect of the four hypothesis presented in this paper. In order to establish a result on hypothesis one, the more detailed hypothesis’ are to be reviewed in first place:

H11: The application of an accrual accounting standard leads to a different size of the financial report.

Result: True. The financial report according to the accounting standard is much smaller in size than the report according to the accounting system. The report according to the standard includes only 24 pages, while the one according to the system includes more than 260 pages. This is due to a much smaller amount of details, such as single line items, which have to be aggregated when reporting under IPSAS because of their lack of materiality. Under the HAM accounting system the principle of materiality is not known at all. HAM is following the idea that a “true and fair view” is given, if as many details as possible are presented, including minor line items for each unit of the reporting entity. This might be because of the strong interest of the political constituency into operational details, such as travel expenses, which are easy to understand, rather than into the financial status or performance which are certainly more difficult to assess. However, it should be taken into account, that the principle of materiality is relatively new and unfamiliar to Switzerland. It is neither mentioned in the Käfer Kontenplan, nor in the Swiss Commercial Act\(^9\), which sets some minimum accounting standards for private sector companies. Only the privately set Swiss GAAP FER has introduced this principle in the late 20\(^{th}\) century in its standard number 3. The principle of materiality is still strange to the Swiss culture which is strongly emphasizing values like precision in the sense of being accurate in details.

H12: The application of an accrual accounting standard leads to a different financial result (surplus or deficit).

Result: True. In the financial (calendar) year examined, the surplus of the City of Kloten under HAM was CHF 5.704 millions, under IPSAS CHF 24.256 millions. However, the financial result is largely variable under HAM, because HAM and the Zurich State Local Governments Act allow the Local Governments to adjust the financial result by discretionary remeasurements. The City of Kloten has, for many years, depreciated any assets immediately after acquisition down to zero. In the year examined, depreciation accounted for CHF 10.807 millions under HAM, but only CHF 4.401 millions under IPSAS.

H13: The application of an accrual accounting standard leads to a different balance sheet residual (equity).

Result: True. Eight line items showed a difference of more than CHF 1 Mio. between the HAM-statement and the IPSAS-statement. The largest differences in absolute and relative terms were found under Property, Plant and Equipment and Provisions. Not surprisingly, the equity under HAM was CHF 96.5 millions, under IPSAS almost twice as much with CHF 192 millions, even though some revalidations of assets were offset by revalidations of liabilities. Unfortunately, this large amount of reserves hidden by the HAM statement cannot be taken for granted. The City of Kloten is an affluent municipality, close to Zurich, hosting many businesses as well as Zurich’s international airport\(^10\).

\(^7\) The restatement itself, not the analysis presented in this article, has been published: Bergmann, Andreas/Gamper, Andreas: Rechnungslegung für Kantone und Gemeinden im Rahmen von IPSAS. Zurich: KDMZ, 2004. 9-32.

\(^8\) The original report, according to HAM, was audited and approved by the Zurich State Office for Local Goverments. The restatement, according to IPSAS, was not officially audited and approved because there is, for the time being, no legal basis to do so. However, a CPA was closely involved in the preparation and measurement of the restatement.

\(^9\) Accounting standards section last revised in 1993.

\(^10\) First, provisional results from the reform on national level give a different picture. The increase in liabilities is much larger, than the increase in assets.
H14: The application of an accrual accounting standard leads to a different structure of the financial reports.

Result: True. The structure required by the HAM accounting system is very genuine. While the balance sheet and the profit-and-loss-statement find equivalents under both systems, the investment statement under the HAM accounting system and the cash-flow-statement under IPSAS are similar, but still different enough not to comply with the other system or standard. Disclosures are not required in the HAM accounting system and neither is a statement on net assets/equity. The HAM accounting system is neither conforming with IPSAS, nor with the Swiss GAAP for private sector entities. This makes it particularly difficult to understand HAM based financial reports even for accounting professionals.

H1: The application of an accrual accounting standard leads to different results from the application of accrual accounting system.

Altogether, H1 holds true in the case examined. The financial report according to an accrual accounting standard is substantially different from a report prepared according to an accrual accounting system. Obviously this result was established when comparing HAM- and IPSAS-based reports. However, one could expect similar results when comparing similar accounting systems to other full accrual standards, because the differences follow a systematic pattern.

H2: The resulting differences between accounting standards and accounting systems lie primarily in the field of scope of reporting, i.e. consolidation.

False. Although the scope of reporting leads to substantial differences, this is not the primary reason. Only 9% of the revalidations between HAM and IPSAS are to be accounted for differences in scope. The HAM accounting system allows the consolidation of different entities, although it gives no guidelines when and how to do so. Consolidation is very discretionary and certainly less transparent under the accounting system, while accounting standards provide guidelines in order to improve transparency. In the case examined there were no omissions, but even fully controlled entities, such as the electricity, gas and water supplier, were carried at historical values, without eliminating transactions with the city itself. Obviously the impact of consolidation may be greater under certain circumstances, especially if there are nationalized industries which are traditionally not consolidated. But on the local level the impact is probably limited by the scale of potentially consolidated entities.

However, the City of Kloten case also revealed difficulties in adopting IPSAS 6 and 7. Especially the concept of control, operationalized by the terms benefit and power, is very difficult to adopt. Benefit is often shared with others and power is strongly limited by veto rights, short and not renewable term periods for executives, unanimous votes required in boards and so forth. This leads to a scope of consolidation that is rather small, compared to what would be expected.

H3: The resulting differences between accounting standards and accounting systems lie primarily in the field of measurement.

True. 91% of the revalidations between HAM and IPSAS can be attributed to different measurement principles. HAM suggests depreciation on book values, in order to keep accounting procedures simple. This leads to a non-linear, declining slope of depreciation. In case examined, however, most assets were, following discretionary decisions of the City Council, immediately written off down to a value of zero. IPSAS on the other side, requires linear depreciation over the period of usage or fair values, where feasible. IPSAS also requires provisions to be made in clearly defined circumstances, while HAM fails to provide guidance in this respect.

\[\text{IPSAS 17 suggests for Property, Plant and Equipment to depreciate over the period of service. Other assets, such as Investment Property, should be reported at fair values according to IPSAS 16.} \]

\[\text{IPSAS 19} \]
H4: The resulting differences between accounting standards and accounting systems lie primarily in the field of notes/disclosures.

True. An accounting system like the HAM does not require specific disclosures, because of its more formal emphasize and focus on the “Kontenrahmen”. But such information may be important to make judgements about the financial status. Not surprisingly, for a local government it’s not so much due to sophisticated financial instruments, but rather due to contingent liabilities, which are very common, i.e. “Defizitgarantien”, which allow private providers of public services to get limited reimbursements for losses incurred when providing the public service.

5. Lessons learned

The main lesson to be learned from the City of Kloten case is that formal accounting systems are not providing as much transparency and accountability as full fledge accounting standards. In the presented case the main differences can be found in the following areas:

a) The application of accounting standards leads to different results being presented in the financial reports. Important items such as profit/loss or equity can be substantially different. The additional transparency does not necessarily lead to an increase in information load, as accounting standards follow the principle of materiality.

b) At least in the examined case on the local level of government, the differences are rather due to differences in measurement, than due to consolidation of controlled entities.

c) Notes and disclosures reveal important information otherwise hidden.

However, as these are not necessarily contradictions between accounting systems and accounting standards. The former may be developed into the latter. The main focus of such a development should be:

a) Adjust differences in presentation, especially adapt the principle of materiality.

b) Develop rules for the consolidation of related entities.

c) Set rules for the measurement of assets and liabilities.

d) Ensure disclosures explaining accounting decision and, even more importantly, allowing to assess off-balance-sheet risks.

Following this path, it would be very likely to observe a convergence between accounting systems and standards. Such a convergence could be an advantage not only for the accounting systems, but also for the standards, because accounting systems tend to give more guidance for the operation of accounting units. In private sector companies operational issues are usually resolved in the accounting manual. For the public sector, it might be sensible not to create accounting manuals for every single entity, but to provide an accounting system, as a go-between the standards and the accounting operation.
References/Literature


Cash Accounting And The Backwardness Of Government Accounting And Related Systems

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1 Introduction

Over the years, a considerable body of studies has dealt with moving from cash to accrual accounting. The main focus of these studies was on the superiority of accrual accounting. However, none of these studies has analytically studied cash accounting in the public sector. Moreover, none of these studies has shown the role of cash accounting in making the government accounting to be non-informative accounting system, and hence it has contributed to the backwardness of government accounting. In addition, none of these studies has researched the extent to which the use of cash accounting has precluded the development of related systems such as budgeting system, cost accounting system and management system.

Accordingly the primary aim of this article is to give an answer to the following questions:
- What are the problems that arise from the use of cash accounting in governmental sector?
- To what extent does cash accounting provide effective information that can lead to an effective management of government programs and activities and for result assessment?
- Can cash accounting be considered as an obstacle in developing the government accounting system and the related systems such as budgeting, cost accounting systems and management system?

2 Cash accounting in the public sector

2.1 Cash accounting: Nature and concept

The basis of accounting is a set of rules that determines when revenues and expenditures or expenses are recognized. The cash basis of accounting recognizes transactions and events only when cash has been received or paid. This takes place independently of the time when goods and services are ordered, delivered and consumed. Goods and services for which payments are made (labor, stores, transportation …etc.) are considered to be consumed when suppliers are paid. This means that the cash basis of accounting shows only the volume of disbursements. Such disbursements do not reveal the amount of resources used and the value of actual work done. According to the cash basis, the statement of receipts and expenditures is prepared to disclose information about cash flows during a period and cash balances at the end of that period (IFAC, 1993). Consequently, the financial statements include only three elements: cash receipts, cash disbursements and cash balances. Cash receipts and cash disbursements represent cash inflows and cash outflows respectively, and the cash balance is the difference between cash inflows and cash outflows. Inherent to cash accounting, it is not possible to prepare balance sheets because there are no assets and liabilities in the books: “sales are only recognized when cash is received (so there are no debtors); purchases are only recognized when cash is paid (so there are no creditors); there are no stock adjustments because the accounts are not concerned with recording usage, only with the fact that cash has been paid for purchases (so there is no closing stock figure); there are no fixed assets, for the same reasons (Jones and Pendlebury, 1984)” So cash accounting
measures financial results for a period as difference between cash received and cash disbursed and provides a comparison of actual against budgeted expenditures. Hence, the information, which can be provided to the different users, is about the sources of cash received during the period, the uses to which those funds were applied and the cash balances at the reporting date (IFAC, 1991). But: Why have most sovereign governments adopted the cash accounting? In other words, what are the advantages of the cash basis that made central governments adopt it?

2.2 Advantages of cash accounting

- Cash accounting is the easiest to maintain and serves the stewardship function of accounting well by furnishing information that can assist in assessing whether resources were used in accordance with the legally adopted budgets;
- The estimates on cash basis are meeting the requirements that are placed by the control function (Langendijk, 1990);
- As a result of its wide use, it facilitates the international comparison of the budgets and accounts;
- It provides useful data that permit analysis of the monetary impact of fiscal transaction and facilitates review and assessment of the cash position (United Nations, 1984);
- It produces the same data as accrual basis when expenditures are mainly for salaries, travel and for goods and services which are received, paid for and consumed within a fiscal year;
- It is simple, relatively cheap and easier to understand than accrual-based accounting and in many countries even preferred by national legislatures;
- The popularity of the cash basis in government accounting arose from the need for Parliament, or other representatives of the electorate, to monitor the collection of taxation receipts and the subsequent spending of those receipts by the government each year (IFAC, 1998);
- It describes over which management has full control, although it ignores resources over which full control has not been established, and it reflects legal reality associated with fiscal compliance as reflected in government budgets;
- It is more objective in comparison with the accrual basis. Cash accounting does not include the subjective adjustments that have to be made to produce balance sheets and income statements; and
- It provides necessary information on receipts and expenditures made during the fiscal year, expenditures that reflect that part of the acquisition of goods and services for which payments are made during the fiscal year.

Of course, the essential point is not whether the accounting system is simple, easy to understand, cheap or objective but the extent to which it provides the required and useful information that satisfies the users’ needs. This will lead us to answer the first two questions posed in the introduction. These two questions will be answered in section 2.3.

2.3 Shortcomings of cash accounting in the public sector

It has been noticed from inducing the practice that public sector entities around the world follow diverse accounting practices. However, IFAC (1998) has made some generalization by stating that most governments use cash-based information for budgeting, accounting and fiscal management. As a consequence, frequently, government activities are managed with poor quality financial information that is not reliable, not timely, or limited in its data on assets and liabilities (IFAC, 1998). So the main task of this section is to show the extent to which cash-based governmental accounting system provide poor quality financial information to the users. The fact that government accounts are maintained on cash basis has led to serious distortions and significant information is missed. In short, there are important shortcomings of the cash-based governmental accounting system, especially when the following facts are taken into account:

The Hidden Liabilities

One of the main shortcomings of the cash basis of accounting is the fact that it fails to provide governments with complete information on all the total liabilities which take place in a given year. Under a pure cash basis of accounting, no liabilities are recognized. Accordingly, neither liabilities due in the current period (short-term liabilities) nor liabilities which are owed beyond the current period (long-term liabilities) are recorded in the operating accounts of that period. As a result of not recognizing the long-term liabilities (for example, pensions and compensated absences) as well as their costs not being recognized and reported, the governments do not make plans to meet these liabilities when they come due. And this, in turn, will lead to increasing the deficit in a certain period more than in the other periods. For example, by the late 1980’s, Canada’s federal and provincial governments had accumulated more than $ 30 billion unrecorded employee pension liabilities. In some provinces, the size of unrecorded liability equaled or exceeded their accumulated deficits (Hillier-IFAC, 1997).
The accounting bases affect the volume of the deficit. Under the cash basis most of the liabilities are hidden, and this, gives the government the opportunity to manipulate the deficit amount. But the change from the cash basis to the accrual basis will show the hidden liabilities and will force the governmental entities to suddenly show a huge deficit in governmental funds. For example, the Government of Kate Carnell in the Australian Capital Territory has been at the forefront of accrual budgetary reform. When it came into government, it inherited a budget deficit of about $80 million. After implementing the new accounting system, it had an accrual-operated loss of $343 million in July 1996, despite considerable economic reforms that normally would have been expected to balance the budget (http://www.brw.com.au/newsadmin/stories/brw/19990329/1687.htm). This may explain why politicians do not warm to the new basis of accounting. It makes budgets look less impressive as it includes liabilities previously not accounted for. So as a result of using the cash basis, a huge amount of the government’s liabilities are not reported in financial statements and are not taken into account when assessing government’s financial position and results, or determining its future revenues requirements. Furthermore, the accrued expenses of the government are also not known at the end of the fiscal year. Consequently, all the previously mentioned demonstrate how misleading it is to use the cash-based accounting system in the government.

**No information on earned revenues is available**
Under the cash basis of accounting the revenues will only be recognized in the financial statements in the period in which cash is received. However, the cash receipts do not make distinction between current receipts and capital receipts. So an excess of receipts over payments cannot be called income because receipts might encompass capital receipts. This will result in revenues, which are earned in a given fiscal year, that are not known. As such, it is difficult to evaluate the efficiency of the collection staff, and to discover the losses during the collection process. In addition, under the cash basis, receipts and revenues are identical since no difference exists between the time when they are recognized and when they are collected.

**No information on the total cost of services is provided**
The use of a cash-based accounting system would result in reporting of only those costs that involved a cash flow during the period. However, the cash disbursements do not reflect what the organization costs to run during the year, because these disbursements may also include cash outflows resulting from, for example, acquisition of assets or redemption of debt related to the previous years. This means that the cash-based accounting system makes no difference between expenditures and disbursements, and generally no distinction between current and capital expenditure. Capital purchases are treated in the same manner as personnel expenses with no recognition that they are productive for years. This is due to the fact that cash accounting focuses only on the acquisition phase and not on utility phase. As a result, there is little incentive to use current capital assets efficiently. Accordingly, under the cash basis of accounting, it is difficult to know how much resources have been consumed in carrying out the operations during the accounting period (operating costs). Also as a result of not capitalizing the fixed assets and not recognizing of the long-term debts, the depreciation and interest costs are not accounted for. This, in turn, results in the cost of producing the services in the governmental entities, and the total cost of the programs and activities, which take place in a given period, are also not known. Consequently, it is difficult to get the right information about the total cost of services and goods produced during the year and those costs are important for performance evaluation, control, public contracts policy and price fixing policy, and to measure the efficiency and the effectiveness of the governmental entities.

**The total value of stocks is not disclosed**
The cash-based accounting system does not present information regarding the value of stocks that are consumed during the fiscal year or the stocks that still exist at the end of that year. This is due to the fact that the accounts are not concerned with recording the usage; rather, they are concerned with the cash outflow, which has been paid for purchases. As a consequence, there are no stock adjustments, stock valuation and stock measurement. This would result in the real value of the stocks to not be known and this in turn gives rise to the appearance of several problems such as: carrying cost problem; freezing the public money and opportunity cost of public capital. Furthermore, these stocks can be lost by a deliberate manipulation during the addition and deduction operations. It would be wrong, however, to assume that these problems are management problems rather than accounting problems. They are certainly both management and accounting problems. The output of the accounting system with respect to the stocks is considered as one of the main and important information sources that the management relies on in the decision making process. So the absence of useful accounting information regarding the stocks would result in management not able to take the right and deliberate decision in relation to the above stated problems.


**No information on the total assets is provided**

The elements, which are included in the financial statements under the cash-based accounting system, are cash receipts, cash disbursements and cash balances. Accordingly, there is no information provided on the total assets (financial and physical). For example, there is no information provided about the investment in materials, supplies, equipment and other assets, which are available for future use in carrying out the government unit’s work. No subsequent account is taken of whether the assets are still in use, have reached the end of their useful life or have been sold. Nevertheless, this information can be used in estimating how much is to be requested in each year’s budget. For proper understanding, we can give an example to illustrate the above-mentioned shortcomings: Assume that X government entity needs some raw materials costing $20,000 to use them in producing the goods and services. These raw materials are ordered in July, delivered and received in August, and paid for in September. In addition, this entity in October 2002 has sold goods in amount of $30,000 and it has agreed with the customer to pay 50% of that amount in November and the other 50% in January 2003. In addition, in November 2002 this entity has issued $1 million in long-term debt to cover its financial deficit.

**July (Commitment):**
The order is placed. The X governmental entity incurs commitment for $20,000

**August (Accrued Expenditure):**
The raw materials are received. At this point the X government entity becomes committed to pay for them. The accounts of the X governmental entity will show accounts payable (Liability) of $20,000 and an inventory of raw materials on hand of $20,000.

**September (Payments):**
Payment is due. A cheque is issued for $20,000 and accounts payable in X governmental entity are eliminated.

**October (Revenues earned):**
The revenues of goods sold are earned but not yet collected. The accounts will show accounts receivable of $30,000 and sales revenues account of $30,000.

**November (Receipts and issuing of long-term debt):**
The first half of the revenues is collected. Herein, the accounts receivable are reduced by amount of $15,000. Also the X governmental entity has issued $1,000,000 to cover its deficit, the accounts will show a long-term liability of $1,000,000. At this point, the accounts of X governmental entity show that the commitment incurred, the expenditure accrued, the asset acquired, the revenues earned and they also show the liability (short and long-term liabilities), disbursements and the receipts. If the above-mentioned transactions had been recorded under cash-based accounting system, the X governmental entity accounting information would provide only the payments of the bill of $20,000 (September) and the receipts of $1,015,000 (November), but would not have provided the following information:

- How much money others owe to the X governmental entity (accounts receivable)?
- What short and long-term liabilities have been incurred in a given year?
- How much resources have been consumed in carrying out the operations during the accounting period (operating costs)?
- How much revenues have been earned in a given period?
- What the value of inventory of the raw materials is at the end of a given period?
- What the value of the total assets is at the end of the fiscal year?

Clearly, the above stated example has shown that a cash-based accounting system provides information only on the payments and receipts and very important information is missed, and which in turn will lead to serious distortion in the decision-making process.

From all the previously mentioned, **True and fair view about financial position of government can not be provided.** As a result of using the cash basis of accounting, no information can be provided about the actuality of the financial position of the governmental entity at the end of the fiscal year. Besides, the changes in the financial position are not reported. Hence true and fair view of government financial positions can not be disclosed with the governmental cash-based accounting system.

**Over-spending appropriation**
The balances of appropriations (the estimated expenditures) available for expenditure may not be accurately stated when determined only on the basis of cash payments. Part of the balances so determined are needed to pay for the goods and services received or ordered but not paid for. Thus, there is a strong potential for over-spending appropriated amounts when the cash basis is used (United Nations, 1984).
No measurements of governmental performance are available
As illustrated in the above-stated example, important information is lacked on periodic revenues, expenses, long-term liabilities, amounts receivable, amounts payable, value of stocks and total cost of service produced. As a result, reliable information about the performance measurements of the government is not provided. For example, because there are no assets or liabilities, there is no measure for the net worth. Since the net worth is the difference between total assets and total liabilities, the changes in the total assets and the total liabilities will affect the net worth. So if the government increased the liabilities either by borrowing to fund the deficit or obligation to make payments in the future, such as pension; or increased the assets which would provide economic benefits to the reporting entity, these actions would affect the net worth. So, in the context of cash-based government accounting, it is not possible to measure whether the net worth is deteriorated or improved. Similarly, because there is no information available on the total cost of services and goods, the government can neither compare the total cost of the services and goods produced in a given year with the total cost of services and goods produced in the previous years nor with the private sector. Obviously, under the cash-based accounting system, the accounts tell us about the amounts of receipts and expenditures compared with the budgeted figures. So the only measure of performance which can be yielded is the comparison of budget with actual.

Cash-based accounting is inadequate for control purposes
Cash accounting is not a complete accounting system and its internal control is very weak. Inherent to this system is not possible to control the usage of the inventories during the year or to what extent the fixed assets have been used in a right way or how much is redeemed from the total government’s debt in the fiscal year. On the other hand, this system assists in fulfilling the budgetary control function. Budgetary control is concerned with ensuring that actual expenditures are in line with budgeted amounts and that the objectives and levels of activity envisaged in the budget are achieved. Therefore, it is required in the governmental entities (in order to achieve the control purposes) to prepare the budget as a control means on the activity of the governmental entity besides the financial regulations - restrictions, where the budget and the financial regulations are forming the cornerstone of the internal control system within the governmental entity. Hence, cash accounting system alone without the budget and financial regulation – restriction is inadequate for control purposes.

Cash-based accounting system is not cost effective
According to the nature of cash-based accounting, items such as fixed assets, creditors, commitments, debtors, payroll can not be integrated into one system as this system includes only cash receipts and cash disbursements. On the other hand in order to get information on items such as creditors, debtors, and commitments, etc. there should be other separate accounts used. These accounts are generally called regular accounts or extra accounting files (auxiliary accounts). These accounts are used to report on financial assets and liabilities that are not included in the cash accounting system. This is because a cash accounting system can not comprise all the elements of assets and liabilities, thereby increasing double processing and reconciliation problems associated with separated systems. Theoretically, an integrated system, able to produce information on all elements, would be more efficient than separated systems and therefore the accounting system would be clearly cost effective. So in total, we see that the cash-based accounting system is not cost effective as a result of using separate systems and the related reconciliation problems. Therefore we call upon integration in place of disparity and duplication.

It is not useful for comparison purposes
As it is clear from the nature of cash-based accounting system, it is interested in cash flows and recognizes the events and transactions only when cash has been received or paid. Therefore, what often happens is that one year can be charged by costs made in another. Accordingly, the use of cash basis results in interpenetrating the activity of different financial years. For example, if the government entity purchased spare parts in amount of $10,000 on account in 2002 and used them in the same year but the payments will be made in 2003, the accounts in 2002 will not show the accrued costs of the spare parts and the accounts in 2003 will show only the payments and these payments will be included in the total expenditures of that year although this year has not benefited from the spare parts. Consequently, the adoption of cash-based accounting system by governmental entities often makes the comparison between the results of different financial years less important and very difficult.

It gives rise to a deliberate manipulation
Finally, one of the greatest limitations of cash accounting relates to the potential for deliberate manipulation of the accounts to produce preferred results (Jones & Pendlebury, 1984). For example, the real spending of a department or services might be
the same under whatever system of accounting is adopted but in a given year, using cash accounting, the cash payments could be postponed by as little as twenty-four hours so that the accounts record a lower figure. Imagine a given department or service which can see that it is going to over-spend its budget. Rather than reduce its spending it maintains it, but postpones cash payments (Jones & Pendlebury, 1984). This is not to say that other accounting bases, in particular accrual accounting, are not impervious to manipulation, but they are not so open to the same abuses to which cash accounting is subjected.

In summary, this system is not able to provide information on the cost of services, earned revenues, accounts receivable, accounts payable, long-life assets, long-term liabilities, accrued interest on external debt, cost effectiveness and property inventories. In addition, cash-based information alone does not provide indication of long-term fiscal strength or of the relationship between revenues, expenses and changes in net worth, or the trade off between the burdens of current and future taxpayers. So cash-based accounting has failed to provide complete and effective financial information, which is essential for decision-making process and discharging of the accountability. In addition to the above stated shortcomings, the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) has identified in its study 1 (1991) seven objectives of governmental financial reporting. Of the seven objectives only the first three are met by a cash-based governmental accounting system. Those objectives are as follows:

1- indicating whether resources were obtained and used in accordance with the legally adopted budget.
2- indicating whether resources were obtained and utilized in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities.
3- providing information about how the government or unit financed its activities and met its cash requirements.
4- providing information about the sources, allocation and use of financial resources.
5- providing information that is useful in evaluating the government’s or unit’s ability to finance its activities and to meet its liabilities and commitments.
6- providing information about the financial condition of the government or unit and changes in it.
7- providing aggregate information useful in evaluating the government’s or unit’s performance in terms of costs, efficiency and accomplishments.

Based on the aforementioned shortcomings, it can be inferred that the cash basis does not meet the objectives of governmental accounting and financial reporting, and of course, it does not meet the users’ needs. In addition, these shortcomings can lead to another question; why are most central governments still adopting the cash basis in their governmental accounting systems?

As far as this question is concerned there are four reasons as follows:

1- Political reasons: by using the cash basis of accounting the politicians can easily cook the books, namely, they can easily show positive results or reduce the negative results and convince the public that they are doing something different than what they are actually doing. For example, a government may want to convince people: (Hillier –IFAC, 1997)

- that their budgetary deficit is less than what actually is;
- that they really haven’t exceeded spending authority granted by the legislature;
- that the growth in their total expenditures is less than what really is;
- that the liabilities to be met by the future generations are less than they really are;
- that this year’s performance compares favorably with their own or a previous government’s past performance; and
- that by comparison with other governments their performance is really quite good.

Another example, in 1993 two Dutch accountants J. Poot and C. Boer made an attempt to prepare the State balance sheet based on the accrual accounting system. They found out that the central government did a very defective financial reporting over its assets and liabilities. According to the data of the Dutch Ministry of Finance (based on commitment-cash basis) the net worth of the State (assets – liabilities) was $70 billion negative. But according to the balance sheet that was prepared by two accountants (based on accrual accounting) the net worth was $180 billion negative. So the use of cash basis by the Dutch central government accounting system has helped the Minister of Finance to reduce the negative results from $180 billion to $70 billion (de volkskrant, 1994). So it can be inferred that even though the cash-based government accounting does not provide the required information which can assist the politicians in evaluating the performance, discharging the accountability and decision-making, it is serving their interest by giving them the opportunity for a deliberate manipulation. This can explain why there are no political incentives, particularly in the governments that have an interest in limiting the amount of information that reveals about their performance, to use a more informative accounting system. Self-evident, the use of cash basis serves the interest of the government more than the public.
2- Traditional reasons: the cash accounting was used by the central government for a long time till it became one of the main traditions of the central government. The government accountants are accustomed to preparing the budget on cash basis and to disclosing the monetary position of the government, and hence, they are not required to prepare the balance sheet and income statement. In contrast to the informative accounting system, cash accounting can help them avoid the adjustments and evaluation problems that are faced with when preparing the balance sheet.

3- Resistance to change: usually, the civil servants are not active enough and they do not have the incentives that would make them bear the additional work that is involved in shifting to the new accounting system. Therefore, the fear of being burdened with the responsibility of carrying out new procedures that involve additional work, both in quantity and quality, may be the real reason for putting up such resistance

4- Scarcity: the scarcity of the qualified personnel with advanced knowledge in government accounting is one of the main reasons for maintaining the cash accounting.

2.4 Cash basis and the backwardness of governmental accounting and related systems

Until now, we have discussed the advantages and disadvantages of the cash-based governmental accounting system and it has been explicit that this system has more shortcomings and drawbacks than advantages and it does not satisfy the users’ needs. However, we would like to discuss another issue, which is: what was the impact of using the cash basis in the public sector during the last century on the development of governmental accounting system and the related systems, such as budgeting and management changes? In other words, to what extent has the use of cash basis in the public sector affected the governmental accounting system innovation, in addition to the related systems? First of all, by the backwardness we mean that governmental accounting is not an informative, innovated or developed accounting system. However, the fact that government accounting is kept on cash basis has given rise to the appearance of the following problems:

- not charging the non-cash items (such as depreciation) in governmental accounts;
- not improving the budget system;
- not adopting the cost accounting in the public sector; and
- not enhancing the management reform.

Those problems will further be clarified as follows:

A- not charging the depreciation in the governmental accounts

The most commonly accepted definition of depreciation in commercial accounting is that it is a systematic and rational method of allocating costs to periods in which benefits are received (Hendriksen, 1982). More precisely, it represents the value assigned to the usefulness lost during an accounting period by fixed assets that is by lasting or long-lived assets used in the production process (Mussari, 1995). However, the charging of the depreciation in the government accounts has been debated for many years. Many individuals and groups have argued that depreciation of general fixed assets should not be recognized while other groups have argued that it should be recognized. In fact, we do not intend to discuss whether the depreciation should be recognized or not. In connection with the current public sector accounting change, which is the transition to accrual accounting in the public sector, there are no constructive reasons to discuss this issue here because the depreciation is an essential feature of accrual accounting, namely, once accrual accounting is adopted the depreciation should be recognized. However, what we would like to discuss here is: How was the adoption of cash accounting by the public sector one of the main reasons of not charging the depreciation in the governmental accounts? Hence, it has assisted in the backwardness of governmental accounting system during the last century. In other words, it has assisted in making the governmental accounting a non-informative accounting system. In fact, the use of cash basis in the public sector is one of the main reasons of not charging the depreciation because of the following reasons:

Firstly, governmental budgets may be prepared on a cash, modified accrual, or accrual basis. When budget prepared on the cash basis, then the budget will only include the estimates in relation to cash payments and receipts. On the other hand, depreciation is an estimated expense that does not generate any payment or obligation in the accounting period to which it refers. Furthermore, depreciation is neither a source nor a use of governmental fund financial resources. Financial resource flows occur only when assets are acquired or sold (Fremgen, 1986). This means that depreciation is not expenditure. Since depreciation is not an expenditure, its presence in governmental budget, which is prepared on cash basis, generates a great
deal of confusion. The expenditures are budgeted and must be accounted for depreciation expense is not budgeted. In contrast, when the governmental budget prepared on accrual basis, namely, the budget is expense-based, then the recognition of depreciation would be possible. Accordingly, the preparation of the budget on cash basis of accounting has resulted in not recognizing the depreciation in the governmental accounts, similarly, the other non-cash items.

**Secondly**, one natural result of the adoption of cash accounting by the public sector is that fixed assets are not capitalized. This is because cash basis makes no distinction between expenditures that can be consumed in a given year and the expenditures that are productive for years beyond the given year. Consequently, it does not distinguish the capital expenditures from the current expenditures. As a consequence, capital purchases are deemed to be fully depreciated or to be fully consumed in the period in which they are paid cash without taking into consideration that they can be used for a period longer than one year. This can also show how the adoption of cash accounting has resulted in not capitalizing the fixed assets, and hence, not recognizing the depreciation in the governmental accounts.

**B- not improving the budget system**

The traditional (line item) budget has a long history in the public sector and is still used by most of governments. The traditional budget is designed to ensure legislative control over the expenditure of public money. However, it does not indicate the relationship between the expenditure and results, and this prohibits the formulation and execution of economically meaningful budgetary policy. Besides, it prevents proper political choice among objectives and rational allocation of resources and limits the public understanding of government activity (Wilenski, 1982). This budget is a short-term process that makes rational planning more difficult. It stresses inputs rather than outputs and controls only the inputs, which in turn, results in inhibiting the ability of the managers to flexibly manage resources to achieve program objectives. In short, this budget system does not satisfy the information needs of the efficient and effective government. On the other hand, the government can overcome the shortcomings of traditional budget by shifting to the program-performance budget. The latter aims to provide a systematic method of improving the allocation process; to incorporate in planning activity recognition of costs of alternative programs resources available; and to provide a basis for choosing between the feasible alternative programs (Mills, 1987). The program-performance budget indicates the relationship between the inputs and the outputs and whether the resources have been effectively used and the target objectives have been achieved. In short, it focuses on the purposes of expenditures and the outcome of the expenditures and provides data, which can be used to evaluate this outcome. Clearly, the program-performance budget has more advantages than the traditional budget. Then, the question is: why has the traditional budget lasted up till now?

Some have argued that it serves a valuable purpose in government. For example:
- it limits the expenditure to the amounts and to the items voted in the appropriations;
- it makes budgeting easier and more manageable; and
- it is adaptable to all-economic circumstances and conditions (Wilenski, 1982).

In addition, we see that accounting system, which is used to execute the budget, plays an essential role in choosing one method of budgeting in stead of another. In fact, each accounting basis has a special nature and characteristic that makes it appropriate for a specific use, hence, to be consistent with one of the budgeting methods (in practice there are three methods of budgeting: line-item budgeting, program budgeting, and performance budgeting). Similarly, the use of one budgeting method can also play a fundamental role in choosing one accounting basis in stead of another. Namely, in the public sector there is a strong relationship between the budget system and the accounting system, where they are complementing each other. For proper understanding we assume:

**Assumption 1**: that the budget system should be compatible with the accounting system that is used to execute the budget. Therefore, the basis on which the budget is prepared should be consistent with the basis of accounting used; and

**Assumption 2**: that the budget reform involves accounting reform to support it. So it can be inferred that there is an interrelationship between the budget system and the accounting system. This means that any change in one of them will result in changes in the other too.

On the first assumption, when the governmental accounting is based on cash basis, then it provides information on whether resources were obtained and used in accordance with the legally adopted budget; whether resources were obtained and utilized in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities; and about how the government or unit financed its activities and met its cash requirements. Typically, this is the information that satisfies the requirements of the line item (traditional) budget. This means that the nature and
requirements of the traditional budget are consistent with the concept and the implications of cash basis of accounting. Consequently, the continuity of using the cash-based governmental accounting would result in the lasting of the traditional budget in spite of its disadvantages.

Assumption 2 could make the fact more clear, when the government wants to overcome the problems of traditional budget, namely, to emphasize the output in place of input; to provide information relevant for performance measurement, decision-making, and discharge the accountability, it should develop its budget system, for example, shift from traditional budget system to program-performance budget system. However, each budgeting method needs a relevant accounting system that is consistent with its nature and requirements. Basically, cash-based accounting system is unable to satisfy the requirements of the program-performance budget. Therefore, the accounting system should be developed too in order to provide the required information, for example, to adopt accrual accounting in place of cash accounting. In reality, the nature and the requirements of the program-performance budget are consistent with the concept and the implications of the accrual accounting system. So the development of the budget system without taking into consideration the revamping of related accounting system will not achieve the target benefits from that development. Hence, the continuity of using the cash-based governmental accounting would not have resulted in improving and developing the budget system. This can explain why most of countries are still using the line-item (traditional) budget. Self-evident the use of cash basis in most of the governmental accounting systems was/is one of the main reasons behind the lasting of traditional budget, namely, it has assisted in the postposition of the budget reform by most countries.

Generally, we can say that if one government wants to develop its budgeting system it should firstly adopt the accounting system that would be able to execute this budget and be consistent with its nature. Should this not take place, the development of the budgeting system will not have major effects on the performance of the government.

C- not adopting cost accounting in the public sector
Cost accounting is also referred to as managerial accounting. Cost accounting is needed for the evaluation and decision-making of plans, programs and activities. The role that cost accounting can play in the public sector is similar to that role in the private sector. Essentially, cost accounting can play a vital role in the public sector organization by providing managers with the accounting information they need to carry out the planning and control functions. Thus, cost accounting can assist in such specific tasks as the allocation of costs to proper sectors and products; the selection of optimum products; setting price policy; determining the scale of production; determining and improving efficiency and productivity; plant utilization; and valuing and controlling inventories. In addition, Jones and Pendlebury (1984) have mentioned that an effective managerial planning and control system is an essential requirement of public sector organizations. Management accounting has a crucial part to play in providing the information needed to operate such a system. Information is needed at the planning stage to decide which activities to undertake and the resources that will be required. Information is needed at the control stage to measure how effective the organization was in achieving its objective and how efficient it was in the use of resources. Clearly, the adoption of cost accounting in the public sector has significant benefits; this in turn can lead to posing the following question:

Why has the adoption of cost accounting in the public sector been postponed up till now?

The nature of traditional governmental accounting system, which is based on cash basis and traditional budgeting method, does not assist in building and using of the cost accounting system in the public sector. For example, as a consequence of recognizing only cash flows and cash balances, no information is provided on how much resources have been consumed in carrying out the operations during the accounting period (operating costs). Also as a result of not capitalizing the fixed assets and not recognizing the long-term debts, the depreciation and interest costs are not accounted for. Thus this system does not intend to provide the information which is required for carrying out the planning and control functions. So the building of the cost accounting system in the public sector requires the adoption of accrual accounting and developing the budget system from traditional budget system to program-performance budget. One of the main ingredients to adopt the program-performance budget is the designing of cost accounting system and adopting of accrual basis in treating the expenses (United Nation, 1984). The need for cost accounting based on accrual accounting system becomes evident in a program-performance budget system as current and future costs of projects or activities have to be appraised. Consequently, cash-based governmental accounting system has assisted in postposition of building and using of cost accounting systems in the public sector. In reality, many developed and developing countries do not adopt cost accounting systems in the central government and this is a natural result of using cash-based governmental accounting systems in those countries.
D- not enhancing the management reforms
Similarly, we can infer from all the previously mentioned limitations and their role in not developing the budget system and postposition of adopting cost accounting system, which provide managers with the accounting information required to carry out the planning and control functions, that the use of traditional governmental accounting system has also not fostered the management reforms in the public sector. Management reforms focus on the performance in terms of efficiency and effectiveness, namely, the management reforms focus on output instead of input and the managers became completely responsible for the management of their departments. On the other hand, in order for the managers to manage their departments in an efficient and effective way, they need an accounting system that can provide them with meaningful information about the economic resources and the total costs of the output, where management changes are related to accounting changes. Self-evident, cash based accounting system is unable to provide this information. Accordingly, management reforms can not be reinforced or fostered in the context of cash-based accounting system.

2.5 Concluding remarks
This article has researched the extent to which the cash-based governmental accounting system provides the required accounting information that satisfies the user’s needs, in particular with respect to an efficient and effective government that is required for the new millennium. To summarize, we have seen that cash accounting provides essential information, is simple, easier to understand, cheap and much more objective than other alternatives. On the other hand, this system is not able to provide information on cost of services, earned revenues, accounts receivable, accounts payable, long-life assets, long-term liabilities, accrued interest on external debt, cost effectiveness and property inventories. In addition, cash-based information alone does not provide indication of long-term fiscal strength and the relationship between revenues, expenses and changes in net worth, and the trade off between the burdens of current and future taxpayers. Furthermore, cash-based government accounting does not provide the users with complete and comprehensive financial information that they need for decision-making purposes and does not assist to a great extent in discharging the accountability. Moreover, the use of cash accounting in the public sector has also resulted in the backwardness of the governmental accounting system as it has made it a non-informative accounting system. This emphasizes that cash accounting was/is one of the main obstacles in the development of the governmental accounting system in the last century. So in order for the governmental accounting system to be useful to an efficient and effective government, it should be an informative accounting system. Namely, it should provide the information that can demonstrate the accountability of government for the financial affairs and resources entrusted to it, and be useful for decision-making. In short, governmental accounting should disclose the total physical and financial assets, total liabilities, the net worth, expenses and revenues; and to what extent the economic resources were used in an efficient and effective way as well as to what extent the fiscal policies are in the interest of both current and future taxpayers. Therefore, there is an urgent need for additional information. One of the important accounting reforms, which merits serious consideration in providing additional information for policy formulation, management and control of resources and effective audit, is the use of accrual accounting.
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Laying the Foundation for the Internal Audit Function in Governments Throughout the World

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Introduction

There is a need to establish the internal audit function within governments throughout the world to effectively implement the concepts for risk management and internal control that have been adopted by many entities during the past ten years. Over a decade ago, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Internal Control – Integrated Framework* that has helped businesses and other entities assess and enhance their internal control systems. That framework has since been incorporated into policy, rule, and regulation, and used by thousands of enterprises to better control their activities in moving toward achievement of their established objectives.

As a result of many high-profile business scandals and increased awareness of the level of corruption in many countries noted by the Corruption Perception Index published by Transparency International, calls were made for enhanced corporate governance and risk management, with new law, regulation, and listing standards. The need for an overall risk management framework for the entity as a whole, providing key principles and concepts, a common language, and clear direction and guidance, became even more compelling. Thus, COSO published *Enterprise Risk Management – Integrated Framework* in 2001 that fills this need. This framework expands on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management. While it is not intended to and does not replace the internal control framework, but rather incorporates the internal control framework within it, entities may decide to look to this framework both to satisfy their internal control needs and to move toward a fuller risk management process.

Among the most critical challenges for managements is determining how much risk the entity is prepared to and does accept as it strives to create value. Using these integrated frameworks, legislation has been enacted or is being considered by many countries to extend the long-standing requirement for governments to maintain systems of internal control as well as require management to certify and the independent auditor to attest to the effectiveness of those systems. Governments throughout the world are encouraged to adopt similar legislation based on these frameworks to provide a fuller risk management and internal control process.

To assist in achieving the goal of improving their risk management processes, many countries are establishing or enhancing an internal audit function within their governmental units. The professional practice of internal audit is supported by a framework published by the Institute of Internal Auditors. This framework provides for a code of ethics, internal auditing standards, development and practice aids, and practice advisories. Government throughout the world are further encouraged to adopt this Professional Practices Framework for Internal Auditors.
Concept of Risk Management

**Introduction.** The underlying premise of risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to erode or enhance value. Risk management enables management to effectively deal with uncertainty as well as associated risk and opportunity while enhancing the capacity to build value.

Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity’s objectives. Risk management encompasses:

1. **Aligning risk appetite and strategy** – Management considers the entity’s risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
2. **Enhancing risk response decisions** – Risk management provides the rigor to identify and select among alternative risk responses—risk avoidance, reduction, sharing, and acceptance.
3. **Reducing operational surprises and losses** – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.
4. **Identifying and managing multiple and cross-entity risks** – Every entity faces a myriad of risks affecting different parts of the organization, and risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.
5. **Seizing opportunities** – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.
6. **Improving deployment of capital** – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

These capabilities inherent in risk management help management achieve the entity’s performance and prevent loss of resources. Risk management helps ensure effective reporting and compliance with laws and regulations, and helps avoid damage to the entity’s reputation and associated consequences. In sum, risk management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way.

**Risk Management Defined.** Risk management deals with risks and opportunities affecting value creation or preservation and is defined as follows:

> Risk management is a process, effected by an entity’s legislative body, management and other personnel, applied in strategy setting and across the entity, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

This definition is purposefully broad. It captures key concepts fundamental to how organizations manage risk, providing a basis for application across all sectors. It focuses directly on achievement of objectives established by a particular entity and provides a basis for defining risk management effectiveness.

**Achievement of Objectives.** Within the context of an entity’s established mission or vision, management establishes strategic objectives, selects strategy, and sets aligned objectives cascading through the entity. The risk management framework is geared to achieving an entity’s objectives, set forth in the following categories:

1. **Strategic** – high-level goals, aligned with and supporting its mission
2. **Operations** – effective and efficient use of its resources
3. **Reporting** – reliability of reporting
4. **Compliance** – compliance with applicable laws and regulations

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1 Adapted from the Executive Summary of Enterprise Risk Management – Integrated Framework (September 2004) published by the Committee of Sponsoring Organizations of the Treadway Commission.
This categorization of entity objectives allows a focus on separate aspects of risk management. These distinct but overlapping categories – a particular objective can fall into more than one category – address different entity needs and may be the direct responsibility of different executives. This categorization also allows distinctions between what can be expected from each category of objectives. Another category, safeguarding of resources, used by some entities, also is described.

Because objectives relating to reliability of reporting and compliance with laws and regulations are within the entity’s control, risk management can be expected to provide reasonable assurance of achieving those objectives. Achievement of strategic objectives and operations objectives, however, is subject to external events not always with the entity’s control; accordingly, for these objectives, risk management can provide reasonable assurance that management, and the legislative body in its oversight role, are made aware, in a timely manner, of the extent to which the entity is moving toward achievement of the objectives.

**Components of Risk Management.** Risk management consists of eight interrelated components. These are derived from the way management runs an enterprise and are integrated with the management process. These components are:

1. **Internal Environment** – The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity’s people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
2. **Objective Setting** – Objectives must exist before management can identify potential events affecting their achievement. Risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity’s mission and are consistent with its risk appetite.
3. **Event Identification** – Internal and external events affecting achievement of an entity’s objectives must be identified, distinguishing between risks and opportunities. Opportunities are channeled back to management’s strategy or objective-setting processes.
4. **Risk Assessment** – Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.
5. **Risk Response** – Management selects risk responses—avoiding, accepting, reducing, or sharing risk—developing a set of actions to align risks with the entity’s risk tolerances and risk appetite.
6. **Control Activities** – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
7. **Information and Communication** – Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
8. **Monitoring** – The entirety of risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations or both.

Risk management is not strictly a serial process, where one component affects only the next. It is a multidirectional, iterative process in which almost any component can and does influence another.

**Relationship of Objectives and Components.** There is a direct relationship between objectives, which are what an entity strives to achieve, and risk management components, which represent what is needed to achieve them. The relationship is depicted in a three-dimensional matrix as follows:
This depiction portrays the ability to focus on the entirety of an entity’s risk management, or by objectives category, component, entity unit, or any subset thereof.

Effectiveness. Determining whether an entity’s enterprise risk management is “effective” is a judgment resulting from an assessment of whether the eight components are present and functioning effectively. Thus, the components are also criteria for effective risk management. For the components to be present and functioning properly there can be no material weaknesses, and risk needs to have been brought within the entity’s risk appetite.

When risk management is determined to be effective in each of the four categories of objectives, respectively, the legislative body and management have reasonable assurance that they understand the extent to which the entity’s strategic and operations objectives are being achieved. Further, they are assured that the entity’s reporting is reliable and that applicable laws and regulations are being followed.

The eight components will not function identically in every entity. Application in small and mid-size entities, for example, may be less formal and less structured. Nonetheless, small entities still can have effective risk management, as long as each of the components is present and functional properly.

Limitations. While risk management provides important benefits, limitations exist. In addition to factors discussed above, limitations result from the realities that human judgment in decision making can be faulty, decisions on responding to risk and establishing controls need to consider the relative costs and benefits, breakdowns can occur because of human failures such as simple errors or mistakes, controls can be circumvented by collusion of two or more people, and management has the ability to override risk management decisions. These limitations preclude a legislative body and management from having absolute assurance as to achievement of the entity’s objectives.

Encompasses Internal Control. Internal control is an integral part of risk management. The risk management framework encompasses internal control, forming a more robust conceptualization and tool for management. Internal control is defined and described in Internal Control – Integrated Framework. Because that framework has stood the test of time and is the basis for existing rules, regulations and laws; that document remains in place as the definition of and framework for internal control. Consequently, the entirety of that framework is incorporated by reference into this one.

Roles and Responsibilities. Everyone in an entity has some responsibility for risk management. The chief executive officer is ultimately responsible and should assume ownership. Other managers support the entity’s risk management philosophy, promote compliance with its risk appetite, and manage risks within their spheres of responsibility consistent with risk tolerances. A risk officer, financial officer, internal auditor, and others usually have key support responsibilities. Other entity personnel are responsible for executing risk management in accordance with established directive and protocols. The legislative body provides important oversight to risk management, and is aware of and concurs with the entity’s risk appetite. A number of external parties often provide information useful in effecting risk management, but they are not responsible for the effectiveness of, nor are they a part of, the entity’s risk management.

**Concept of Internal Control**

Introduction. Senior executives have long sought ways to better control the entities they run. Internal controls are put in place to keep the entity on course toward their goals and achievement of its mission, and to minimize surprises along the way. They enable management to deal with rapidly changing economic and competitive environments, shifting demands and priorities, and restructuring for future growth. Internal controls promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.

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2 Adapted from Executive Summary of Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission on their website (www.coso.org).
Because internal control serves many important purposes, there are increasing calls for better internal control systems and report cards on them. Internal control is looked upon more and more as a solution to a variety of potential problems.

**What Internal Control Means.** Internal control means different things to different people. This causes confusion among legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an entity. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.

This concept deals with the needs and expectations of legislators, management and others. While internal control can help an entity achieve its objectives, it is not a panacea. It defines and describes internal control to:
1. Establish a common definition serving the needs of different parties.
2. Provide a standard against which governmental bodies, business, and other entities—large or small, in the public or private sector—can assess their control systems and determine how to improve them.

Internal control is broadly defined as a process, affected by an entity’s legislative body, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations

The first category addresses an entity’s basic objectives, including performance goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as budgetary control releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

While internal control is a process, the effectiveness is a state or condition of the process at one or more points in time. Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the legislative body and management have reasonable assurance that:
1. They understand the extent to which the entity’s operational objectives are being achieved.
2. Published financial statements are being prepared reliably.
3. Applicable laws and regulations are being followed.

**What Internal Control Can Do.** Internal control can help an entity achieve its performance goals and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the entity complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.

**What Internal Control Cannot Do.** Unfortunately, some people have greater, and unrealistic, expectations. They look for absolutes, believing that internal control can ensure an entity’s success—that is, it will ensure achievement of basic objectives or will, at the least, ensure survival. Even effective internal control can only help an entity achieve these objectives. It can provide management information about the entity’s progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, through shifts in government policy or programs, economic conditions can be beyond management’s control. Internal control cannot ensure success or even survival.

An internal control system, no matter how well conceived and operated, can provide only reasonable—not absolute—assurance to management and the legislative body regarding achievement of an entity’s objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.
Components of Internal Control. Internal control consists of five interrelated components. These are derived from the way management runs its activities, and are integrated with the management process. Although the components apply to all entities, small and mid-size entities may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

1. **Control Environment** – The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity’s people, management’s philosophy and operating style, the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the legislative body.

2. **Risk Assessment** – Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with the change.

3. **Control Activities** – Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity’s objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

4. **Information and Communication** – Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as suppliers and shareholders.

5. **Monitoring** – Internal control systems need to be monitored—a process that assesses the quality of the system’s performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the legislative body. An internal auditing function is often established within an entity to assist in monitoring the effectiveness and efficiency of internal control systems.

Integrated Framework. There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity’s operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity’s infrastructure and are a part of the essence of the enterprise. “Built in” controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.

There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category—the effectiveness and efficiency of operations, for instance—all five components must be present and functioning effectively to conclude that internal control over operations is effective. The internal control definition—with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance—together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.
Roles and Responsibilities. Everyone in an organization has responsibility for internal control.

1. **Management** – The chief executive officer is ultimately responsible and should assume “ownership” of the system. More than any other individual, the chief executive sets the “tone at the top” that affects integrity and ethics and other factors of a positive control environment. In a large entity, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they are controlling the operation. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit’s functions. In a small entity, the influence of the chief executive is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are finance officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of the entity.

2. **Legislative Body** – Management is accountable to the legislative body, which provides governance, guidance and oversight. Effective members of the legislative body are objective, capable and inquisitive. They also have knowledge of the entity’s activities and environment, and commit the time necessary to fulfill their responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active legislative body, particularly when coupled with effective upward communications channels and capable financial, legal, and internal audit functions, is often best able to identify and correct such a problem.

3. **Internal Auditors** – Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

4. **Other Personnel** – Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone’s job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

5. **External Parties** – A number of external parties often contribute to achievement of an entity’s objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the legislative body in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are those transacting business with the entity, financial analysts, bond raters, and the news media. External parties, however, are not responsible for, nor are they a part of, the entity’s internal control system.

**The Monitoring of Risk Management and Internal Control Systems by the Internal Audit Profession**

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

Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization under a prescribed Code of Ethics. While differences may affect the practice of internal auditing in each environment, compliance with the International Standards for the Professional Practice of Internal Auditing is essential if the responsibilities of internal auditors are to be met. If internal auditors are prohibited by laws or regulations from complying with certain parts of the Standards, they should comply with all other parts of the Standards and make appropriate disclosures.
Services provided by internal auditors are comprised of the following:

1. **Assurance Services** – These services involve the internal auditor’s objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved in assurance services: (1) the person or group directly involved with the process, system or other subject matter—the process owner, (2) the person or group making the assessment—the internal auditor, and (3) the person or group using the assessment—the user.

2. **Consulting Services** – These services are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice—the internal auditor, and (2) the person or group seeking and receiving the advice—the engagement client. When performing consulting services the internal auditor should maintain objectivity and not assume management responsibility.

To assist the internal auditor in maintaining a high level of professionalism, practice advisories are issued and development and practice aids are provided by the Institute of Internal Auditors. The framework for the professional practice of internal auditing at each level of government is represented in the following model:

![Internal Auditing Model](image)

International Standards for the Professional Practice of Internal Auditing. The Standards consist of Attribute Standards, Performance Standards, and Implementation Standards. The Attribute Standards address the characteristics of organizations and parties performing internal audit activities. The Performance Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated. While the Attribute and Performance Standards apply to all internal audit services, the Implementation Standards apply to specific types of engagements. There is one set of Attribute and Performance Standards, however, there are multiple sets of Implementation Standards: a set for each of the major types (assurance and consulting) of internal audit activity. The purpose of the Standards is to:

1. Delineate basic principles that represent the practice of internal auditing as it should be.
2. Provide a framework for performing and promoting a broad range of value-added internal audit activities.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational process and operations.

The set of attribute and performance standards is listed in Appendix 1 and specific explanations, including the implementation standards for each attribute and performance standard, are available on the Institute of Internal Auditors website (www.theiia.org).

**Conclusion.** To effectively monitor the implementation of risk management and internal control systems, it is essential that an internal audit function be established within all governmental units. A draft law on internal audit is included in Appendix 2 to assist in establishing this function.
1. Attribute Standards
   a. Purpose, Authority, and Responsibility
   b. Independence and Objectivity
      i. Organizational Independence
      ii. Individual Objectivity
      iii. Impairments to Independence or Objectivity
   c. Proficiency and Due Professional Care
      i. Proficiency
      ii. Due Professional Care
      iii. Continuing Professional Development
   d. Quality Assurance and Improvement Program
      i. Quality Program Assessments
      ii. Internal Assessments
      iii. External Assessments
      iv. Reporting on the Quality Program
      v. Use of “Conducted in Accordance with the Standards”
      vi. Disclosure of Noncompliance

2. Performance Standards
   a. Managing the Internal Audit Activity
      i. Planning
      ii. Communication and Approval
      iii. Resource Management
      iv. Policies and Procedures
      v. Coordination
      vi. Reporting to the Legislative Body and Senior Management
   b. Nature of Work
      i. Risk Management
      ii. Control
      iii. Governance
   c. Engagement Planning
      i. Planning Considerations
      ii. Engagement Objectives
      iii. Engagement Scope
   d. Engagement Resource Allocation
   e. Engagement Work Program
   f. Performing the Engagement
      i. Identifying Information
      ii. Analysis and Evaluation
      iii. Recording Information
   g. Engagement Supervision
   h. Communicating Results
      i. Criteria for Communicating
      ii. Quality of Communications
      iii. Errors and Omissions
      iv. Engagement Disclosure of Noncompliance with the Standards
      v. Disseminating Results
   i. Monitoring Progress
   j. Management’s Acceptance of Risks
Appendix 2. Sample Law on Internal Auditing

LAW ON INTERNAL AUDIT OF PUBLIC SECTOR

Chapter 1

GENERAL PROVISIONS

Article 1

(1) This Law regulates the system, way of working, objectives, principles, organization, functioning and responsibilities of the internal audit in the public sector.

(2) The provisions of the Law shall apply to the following public sector entities (hereinafter: organizations): budget users, Pension and Disability Insurance Fund, Health Insurance Fund, Road Fund, Employment Bureau, local government units, agencies and other institutions established by law, public enterprises and legal entities in which the state is dominant shareholder.

Chapter II

DEFINITIONS AND TERMS

Article 2

In the present Law, the following terms shall mean:

a) Internal audit: is an independent and objective assurance activity designed to add value and improve an organisation’s operations. It helps an organization to accomplish its objectives by bringing a systematic, discipline approach to evaluate and improve the effectiveness of risk management, control and governance processes.

b) Compliance/regularity audit: the auditor assesses whether the operations and activities of the particular organisation are in compliance with the legal provisions, rules and governing regulations in effect.

c) System-based audit: is an in-depth evaluation of the internal control systems, aiming to assess whether such systems are functioning properly.

d) Performance/value for money audit: the auditor assesses the economy, efficiency, and effectiveness of the operations and the use of resources at a well-defined area of the activities or programmes in a given organization.

e) Financial audit: covers the examination of accuracy and completeness of the accounting records and financial statements.

Chapter III

STANDARDS, OBJECTIVES, FUNCTIONS, PRINCIPLES AND TYPES OF INTERNAL AUDIT

Internal Audit Standards

Article 3

(1) Internal Auditors work in accordance with the accepted internal audit standards based on internationally accepted internal audit standards.

(2) In line with the international standards on internal audit the Minister of Finance shall regulate the accepted standards for professional performing internal audit by secondary legislation.

(3) The Minister of Finance shall publish the accepted Standards for professional performing of internal audit in the Official Gazette.
Objectives, Functions and Principles of Internal Audit

**Article 4**

(1) The objective of the internal audit is to provide to the head of organization an independent, objective assurance to improve the operations of the organisation and the effectiveness of internal control systems.

(2) The main functions of the internal audit activity shall include:
   a) evaluating significant exposures to risk factors and advising the head of the organization on the reduction of risk;
   b) assessing and evaluating the economy, efficiency and effectiveness of the operations of financial management and control (hereinafter referred to as FMC) systems, and giving recommendations to the head of the organization to improve systems’ operations;
   c) examination of assurance and completeness of accounting records and financial statements;
   d) assessing and evaluating the compliance with internal and external regulations for the establishment and operations of FMC systems;
   e) monitoring the implementation of measures taken by the head of organization on the basis of the audit reports.

**Article 6**

Internal audit shall be exercised in line with the principles of lawfulness, independence, impartiality, confidentiality and professionalism.

*Types of Internal Audit*

**Article 7**

Types of internal audit shall be:
   a) system audit;
   b) compliance/regularity audit;
   c) performance audit;
   d) financial audit.

**CHAPTER IV**

**ORGANIZATION, HARMONIZATION AND FUNCTIONAL INDEPENDENCE OF INTERNAL AUDIT**

**Organization and Harmonization of Internal Audit System**

**Article 8**

(1) The Minister of Finance shall be responsible for regulation, development, coordination and harmonization of the internal audit system in the public sector and collaborates with the relevant international institutions in the field of internal audit.
Central Internal Audit

Article 9

(1) Central Internal Audit shall be established as a department in the Ministry of Finance.
(2) Central Internal Audit in the Ministry of Finance shall perform the following activities:
   - regulation, development and harmonization of the internal audit in the public sector;
   - Internal audit activity in the Ministry of Finance
   - Internal audit activity in the organizations where internal audit units have not been established or where the Minister of Finance shall deemed necessary.

Harmonization of Internal Audit in Public Sector

Article 10

In order to regulate, develop and harmonize the internal audit system Central Internal Audit in the Ministry of Finance shall perform the following:
   a) to prepare draft laws and secondary legislation on internal audit;
   b) to give proposals for development and harmonization of internal audit system;
   c) to prepare guidelines for establishing and functioning of internal audit and to publish sample internal audit manual;
   d) to monitor the implementation of the legal regulations, the accepted standards and the Code of Ethics, the internal audit guidelines and methods;
   e) to develop training system for internal auditors;
   f) to prepare summary quarterly and annual reports on internal audit;
   g) to collaborate with the State Audit Office and other professional organizations.

Establishment and Operations of Internal Audit Units

Article 11

(1) The head of the organization shall be responsible for the establishment of the internal audit unit in the organization and shall ensures the necessary resources for its functioning.

(2) The operations, the status and the tasks of the internal audit units shall be stipulated in the organisational and operational rules of the organization.

(3) The internal audit units in the entities referred to in Article 1 of this Law shall be responsible for performing internal audit tasks at the second line budget users.

(4) The number of internal auditors employed by the organisation shall be determined on the basis of a needs assessment in proportion with the tasks of the organisation, the size of funds managed.

Functional Independence

Article 12

(1) The head of the organization shall be responsible for ensuring the functional independence of the internal audit activity and this responsibility cannot be delegated.

(2) The internal audit unit shall report directly to the head of the organization.

(3) The head of Internal Audit Unit and the internal auditors shall not carry out other tasks in the organization not related to the internal audit function.
Article 13

(1) The internal audit unit shall perform its activity in compliance with the laws, regulations, professional standards and internal audit manual.

(2) The Minister of Finance regulates the content of the internal audit manual by secondary regulation.

CHAPTER V

PROFESSIONAL REQUIREMENTS OF THE INTERNAL AUDITOR

Article 14

The internal auditor, besides general employment requirements in the public sector determined by law, shall fulfil the following requirements as well:

- university or college degree in the fields of economics, law or equivalent, if it is in line with the systematisation act;
- minimum two years of working experience in internal audit, external audit or finance.

CHAPTER VI

COMPETENCIES OF HEAD OF INTERNAL AUDIT UNIT

Article 15

The head of Internal Audit Unit shall be responsible for the following:

a) having the internal audit manual, the Internal Audit Charter and the Code of Ethics;
b) preparing strategic and annual audit plans on the basis of risk assessment, and after the approval by the head of the organization, ensure the implementation and monitoring of their execution;
c) organise and co-ordinate the internal audit activities and supervise their implementation;
d) inform the head of the organization about existing conflict of interests referring to his/her task;
e) inform the head of the organization should suspicion arise about irregularities and/or frauds that may result in criminal, infringement or disciplinary procedure;
f) send the audit report to the head of the audited organisation, and if the audited organisation is a second line budget user, to its head as well;
g) prepare quarterly and annual audit report;
h) ensure that during the internal audit activity, quality assurance processes are implemented and methodological guidelines, issued by the Minister of Finance, are observed;
i) register the audit activities and keep audit-related documents;
j) ensure training of internal auditors, prepare and submit annual training plans to the head of the organization for approval and ensure their implementation,
k) assess annually the capacities and resources of the internal audit unit and submit recommendations to the head of the organization;
l) report to the head of the organization on the implementation of the annual audit plan and explain any changes in the audit plan;
m) monitor the implementation of the action plans, prepared on the basis of the internal audit recommendations.
CHAPTER VII

RIGHTS AND RESPONSIBILITIES OF THE INTERNAL AUDITOR

Article 16

The internal auditor shall have the following rights:

a) to enter into the premises of the audited organisation, taking into account the security rules and the rules of good conduct;
b) to have access to the appropriate audit-related documents in the audited organization, containing state, profession or business secrets and to other documents and data stored electronically by adhering to the provisions on data and secrets protection defined in the relevant laws and secondary legislation, to ask for copies, extracts or certificates of the aforesaid documents, and in certain cases, to take the original documents, leaving a copy behind, with a note of receipt;
c) to request oral or written information from any employee or head of the audited organisation;
d) to request information from other institutions in connection with the operations and management of the audited organisation;
e) to initiate engagement of external experts;

Article 17

The internal auditor shall have the following obligations:

a) to implement the audit programme during the audit activity;
b) to inform the head of the audited organisation about the start of the audit and to present his/her letter of appointment;
c) to study the documents and conditions indispensable for formulating an objective opinion;
d) to elaborate his/her findings objectively and truthfully in a written form and support them with evidence;
e) to inform the head of Internal Audit Unit immediately if during the audit suspicion of irregularity and/or fraud arises that may result in criminal, infringement or disciplinary procedure;
f) to draft an audit report and consider and harmonize it with the relevant persons at the audited organisation;
g) to send the final audit report to the head of Internal Audit Unit;
h) to inform the chief internal auditor immediately in case of conflict of interests regarding the audit or regarding the person where the audit is carried out;
i) hand back the original documents in full at the closure of the audit or if in the course of the audit activity the suspicion of an act, negligence or deficiency arises which may result in a criminal, infringement, liability or disciplinary procedure give back the documents to the head of budget user against a acknowledgement of receipt, as it is his/her task to take the necessary measure;
j) to keep any state, professional or business secret he/she has disclosed in the course of the audit,
k) to keep all working papers in an internal audit file.

Conflict of Interests

Article 18

(1) The head of Internal Audit Unit or the internal auditor shall not participate in the audit if any of the following types of conflict of interests exists:

a) During the last three years the auditor has been employed in the audited organisation;
b) Over the last three years, the auditor, the spouse, relatives of up to the second degree have been employed in a senior position in the audited organization;
c) The auditor, the spouse, relatives of up to the second degree have stock or shares in the audited organization;
d) Other circumstances exist that may bring potential conflict of interests, when deemed as such and reasoned in writing by the head of Internal Audit Unit.

(2) The provisions referred to in paragraph 1 of this Article shall be applied after the expiry of three years from the day this Law comes into force, i.e. from the date of the first appointment of head of internal audit unit or internal auditor.

CHAPTER VIII

RIGHTS AND RESPONSIBILITIES OF THE AUDITED ORGANISATION

Article 19

The head of the audited organisation shall have the right to:

a) request a personal identification document and a letter of authorization of the auditor, otherwise, they can refuse to cooperate;
b) be invited to make comments and discuss the draft audit report.

Article 20

The head and the employees of the audited organisation shall have the following obligation:

a) assist and cooperate during the audit;
b) provide oral or written information, declaration requested by the auditor, provide access to documents and submit the requested original documents by the set deadline, with a note of receipt thereof;
c) upon the request by the auditor, provide a declaration on the completeness of the documents and data;
d) on the basis of the audit findings and recommendations, prepare an action plan determining the responsible persons and the deadlines for undertaking the necessary measures within their competences and inform the head of the organisation and the head of Internal Audit Unit on the implementation of the action plan;
e) provide adequate working conditions for the auditors.

CHAPTER IX

IMPLEMENTATION OF THE INTERNAL AUDIT ACTIVITY

Planning of the Internal Audit Activity

Article 21

(1) In order to plan the audit work, the head of Internal Audit Unit shall prepare a strategic and an annual audit plan, which shall be approved by the head of the organization.

(2) The Minister of Finance shall regulate the content of the strategic and annual audit plan by secondary legislation.

Article 22

The head of Internal Audit Unit of the organization shall send the annual audit plan for the next year to the head of the organization and to the Minister of Finance no later than December 15th of the current year.
Audit Programme

Article 23

(1) The head of Internal Audit Unit or an auditor appointed by him/her shall develop an audit programme for each audit activity and shall appoint the internal auditors for the respective audit activity.

(2) The Minister of Finance shall regulate the contents of audit programme by issuing secondary legislation.

Letter of Authorization

Article 24

(1) The internal auditor shall be provided with a letter of authorization (appointment), signed by the head of Internal Audit Unit.

(2) The letter of authorization of the head Internal Audit Unit shall be signed by the head of the organization.

(3) The letter of authorization of the external expert engaged by the head of the organization shall be signed by the head of Internal Audit Unit.

Audit Report

Article 25

The auditor shall prepare an audit report containing the subject, findings, conclusions and recommendations of the audit.

Quarterly and Annual Audit Report

Article 26

(1) The head of Internal Audit Unit and the head of the organization shall be responsible for preparation of quarterly and annual audit report.

(2) The quarterly and annual report shall contain:
   a) summary report on the internal audit activity performed in the respective period;
   b) report on the realization of the audit findings and recommendations.

(3) The head of the organization shall send the quarterly audit reports to the head of Central Internal Audit Department in the Ministry of Finance upon his request.

(4) The head of the organization shall send the annual audit report to the Minister of Finance no later than April 15th of the next year.

CHAPTER X

TRANSITIONAL AND FINAL PROVISIONS

Article 28

The Minister of Finance, within six months from the date of effectiveness of this Law, shall issue the secondary legislation in line with Articles 3, 13, 21 and 23 of this Law.
Article 29

(1) The provisions referred to in Articles (as applicable in other laws) shall cease to be valid when this Law comes into force.

(2) The regulation on the manner of performing internal audit defined on the basis of Article (as applicable in other laws) will be substituted by publishing accepted professional standards of internal audit based on Article 3 of this Law.

Article 30

This Law shall come into force on the eighth day from the day it is published in the “Official Gazette”. 
Evaluating Performance in Government Organizations

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Introduction

Evaluating performance is a goal all organizations must accomplish in order to continually improve efficiency and effectiveness. Governments face unique challenges in implementing performance measurement systems due to their vast amount of information and their large number of interested and diverse parties. Performance measurement is the process of determining how effectively and efficiently taxpayer resources are being used for the delivery of services and the administration of programs. Prudent budgeting, collection and analysis of data, and comparisons to benchmarks are all necessary elements in performance measurement. An important element in evaluating performance of a governmental entity is the measurement of overall financial condition. Financial condition is the ability of a government to meet its financial and service obligations, currently and in the future. Although many financial ratios exist to evaluate financial condition, nonfinancial measures help immensely in the evaluation of performance.

The purpose of this paper is to provide a guide and evaluation of performance in governmental organizations. This paper will discuss the history of performance measurement in governmental entities, the development of a basic performance measurement system, a description of financial ratios in current use, and the utilization of the “balanced scorecard” model for governments.

History of Performance Measures

Measuring the performance of governmental entities has been the subject of various publications and research studies for many years. (See: Chaney, Mead, and Schermann, 2002; Ittner and Larcher, 1998; Kline, 1997; Poister and Streib, 1999; Steinberg, 1998). In the 1960’s, an interest in program budgeting, and in the 1970’s, program evaluation, created the need for performance measures. The financial crises of many cities, particularly New York City, in the 1970’s, led to improvements in the financial reporting standards and their compliance. Financial performance problems were much easier to detect because of these improvements. Extensive research on measuring financial condition was conducted in the early 1980’s, however, it was generally accepted that the potential of performance measures exceeded their actual usefulness in practice (Poister and Streib, 1999). This attitude was shaped by the fact that many governments did not have the
capabilities to obtain the information needed, did not know what measures were needed to evaluate their programs, and often
did not have the resources available to implement a performance measurement system. In 1980, the International City
Management Association (ICMA), now the International City and County Management Association, published handbooks
dealing with evaluating financial condition, implementing a financial trend monitoring system (FTMS), as well as other
items. The ICMA identified environmental factors, and their effects and interactions with organizational factors, and how
they could be translated into financial factors. Since 1987, the Governmental Accounting Standards Board (GASB) promoted
developing more complete information on an entity’s performance than the traditional financial statements. Their research
project on “Service Efforts and Accomplishments” (SEA) focuses on measuring outputs, outcomes, and efficiency.

In the 1990’s, taxpayer interest, legislation, pressure for privatization of public services, and media coverage of
corruption and mismanagement, increased interest in performance measurement systems. The ideals for these systems
changed during the 1990’s into those used today. The Government Performance and Results Act of 1993 required strategic
planning as well as performance measurement, monitoring, and reporting by all agencies of the federal government. As of
the late 1990s, 47 of 50 states used some form of performance measurement for their agencies (Poister and Streib, 1999).
Many city, county, and local governments also followed the trend in developing and reporting measures of performance.
However, few governments have completely dedicated themselves to creating, implementing, and monitoring successful
performance evaluation systems. Resistance is found at all levels in governmental entities. Like any organization
implementing new programs, change must be embraced by top management and communicated to all other levels. In 1997, a
grant to further SEA research allowed the GASB to address developmental needs for performance measurement and reporting
standards (www.seagov.org). The purpose of the six-phased project was to encourage external reporting and communication
of performance information.

The 1999 issuance of GASB Statement No. 34, Basic Financial Statements – and Management’s Discussion and
Analysis – for State and Local Governments, should bring uniformity in financial indicators. With the government-wide
statements, it will no longer be necessary to adjust for the basis of accounting and measurement focus differences inherent in
fund accounting. Financial ratios that can be constructed using the new statements will provide for consistency, and allow for
better benchmarking data to be established. Therefore, financial condition and performance should be much easier to
evaluate.

The Performance Evaluation System

The budget plays a very important role in identifying the performance of governments. Traditionally, the
importance of the budget related to the allocation of money to each department or program. Now, there is a trend to integrate
performance measures into the budget, going so far as to allocate money based on performance (Foltin, 1999). The budget
process should not only concentrate on controlling spending, it should also serve as the link between planning, management,
communications, and benchmarking in performance measurement. The budget determines operational accountability, which
provides citizens with better value for their tax dollars.

A government should begin the development of a performance evaluation system with a strategic plan of short-term
and long-term goals. Then, relevant measures need to be determined to evaluate performance. Most performance measures
can be classified into four categories: inputs, outputs, efficiency, and effectiveness. Input measures determine volume or
amount of resources used to provide a service to citizens. Output measures gauge the amount of services provided to
citizens. Efficiency measures determine the correlation between inputs and outputs. These three measures are typically
financial, including amount of expenditures, labor hours, and unit cost. Effectiveness measures estimate the quality and
productivity in providing services to citizens. These types of measures are typically nonfinancial, often utilizing data from
citizen evaluation surveys.

Once data is gathered, it is critical to compare to established benchmarks. Without benchmarking, indicators have
little value. Benchmarking to outside standards has been difficult for governments to accomplish because of a lack of
identified benchmark results. Operational differences, unique services and programs, and special revenue sources and
restrictions often complicate the situation of finding a good benchmark for many governments. It is getting easier for
governments to make comparisons, though, as the Government Finance Officers Association (GFOA) created a database of
financial indicators from about 1,800 Comprehensive Annual Financial Reports (CAFRs) and organized the information by
population and government type. Ken Brown’s Comparative Ratios for Cities, published annually, provides benchmark ratios
by municipal size, region, and state.
Financial Ratios

There is general agreement that financial condition, or long-term financial health, includes financial position, financial performance, liquidity, and solvency. However, the ratios that best determine financial condition have not been agreed upon. The ICMA provides twenty-seven financial indicators to assess financial condition. Although they are not subdivided into the categories described above, they provide useful information on them. It is beyond the scope of this paper to identify and discuss all available financial ratios. However, current research has identified certain indicators consequent to the issuance of GASB Statement No. 34 that warrant discussion. More research and practical use will be needed to determine if these ratios, or other ratios, will become the standards for governmental entities.

A good ratio to determine financial position of a government is Unrestricted Net Assets as a percentage of Expenses. The results of this ratio quantify the government’s ability to provide basic services. A high ratio indicates the government has a history of accumulating surpluses. Although obtaining a certain level of surplus is positive, too high a ratio may be cause for taxpayer discontent. A high ratio may cause taxpayers to question their tax levies or the quantity of programs available. A low ratio does not necessarily indicate a weak financial position, as initiating new programs would result in a low percentage for that year.

Financial performance can be quantified by the resultant percentage of Change in Net Assets to Total Net Assets. This ratio allows those interested to identify the effect of current year surplus or deficit on total net assets. Although it is important to follow trends in all ratios over time, that is especially true for the Percentage Change in Net Assets because one year may not be indicative of the government’s overall performance. Another indicator of financial performance is the general support rate, which is the percentage of General Revenues and Transfers to Expenses. The result of this ratio shows the extent the cost of services is supported by general revenues and transfers. Again, a change in this ratio over time is the important factor to monitor to determine the success or lack of success of a government’s operations. One would expect this ratio to be quite high for governmental activities which utilize general revenue sources, and low for business-type activities, which are generally self-sufficient. Financial performance can also be evaluated by the change in short-term debt ratio, which is the ratio of Short-term Debt outstanding at year-end to General Revenue. Short-term debt is commonly used by governments for interim financing due to the timing fluctuations in revenue sources, such as property taxes. However, most governments budget and strive to pay off their short-term debt before year-end; therefore, the goal for the short-term debt ratio is zero. Not obtaining a ratio of zero does not necessarily signify a problem or deficit in cash flow, but it certainly raises a red flag that the government may not have adequate policies over cash receipts.

Liquidity is a measure of the ability to meet current liabilities from available cash, cash equivalents and short-term investments. Liquidity can be evaluated by the quick ratio, which is the sum of Cash, Current Investments, and Receivables divided by Current Liabilities. A high ratio is good, as the government has more liquid assets available. A low ratio can signify liquidity problems.

Solvency refers to the government’s ability to meet its obligations, and provide its services on a continuing basis. The solvency of a government can be evaluated with the debt to assets ratio, which is Long-term Debt to Total Assets. The result indicates the percentage of assets that are financed by liabilities. Therefore, a higher percentage indicates a higher degree of leverage. Net debt per capita is disclosed in the statistical section of the CAFR and simplistically states the debt burden on a per capita basis.

In 2001, Crawford and Associates developed, copyrighted, and trademarked The Performeter™ (www.crawfordcpas.com). This is a financial analysis tool used to measure a government’s financial condition. The performance measures analyzed include the following: overall financial condition, intergenerational equity, level of reserves or deficit, revenue dispersion, self-sufficiency, debt load, financing margin, debt-to-asset leverage solvency, debt service coverage solvency, and liquidity. All of these measures are defined by financial ratios. Their analysis provides insight into the overall financial condition, financial position, solvency, and liquidity of government.

Balanced Scorecard Model

Traditionally, governmental organizations have almost exclusively relied on financial measures; such as, comparison of actual to budget. In fact, the comparison of actual and budgeted expenditures is the most common and recognized performance measure used by governments. To maximize usefulness and aid in decision-making, performance evaluation systems should include both financial and nonfinancial measures. Due to the broad audience of interested users of
governmental accounting information, detailed financial ratios are not enough to present as indicators of performance or financial condition. Nonfinancial indicators are needed to bridge the gap between accountants and managers and the public and other users regarding the performance of programs and entities over time. One way of doing this is to implement a balanced scorecard. (Ellingson and Wambsganss, 2001)

Many legislatures, citizens, and researchers believe the future success of governments will require them to become more customer-focused and results-oriented, like is done in a for-profit business. The balanced scorecard, developed by Kaplan and Norton, is a set of performance measures developed on the basis of four categories: financial, customer, internal business processes, and learning and growth (Kaplan and Norton, 1992). Although their intended users of this model were for-profit entities, the ideas can be applied to governments. By modifying the balanced scorecard for governments, new areas of performance evaluation can be identified and utilized for great improvements. The balanced scorecard approach provides for a balance between financial and nonfinancial measures, current and future performance, and a short-term and long-term focus.

Performance measures used in the balanced scorecard model are linked to the organization’s mission and strategy. The first step in the development of the balanced scorecard is identifying the organization’s mission. The mission should be clear, concise, and most importantly, achievable. It should also allow for innovation, because a flexible mission is easier to work with than a concrete one. Once the mission is established it must be communicated to all levels of the organization. By developing objectives and measures for the four perspectives of the model, the organization completes the third process of business planning. The final step in the balanced scorecard is feedback and learning, which aids in modifying strategies and maximizing performance.

The goal of most governmental entities is to minimize taxes and maximize services. Therefore, the financial perspective of the profit-oriented business approach must be modified to the service objective of the government. Instead of using profitability measures; such as, return on assets or earnings per share, the government can use cost per unit of service, or per capita cost per unit of service. However, determining the success of the government from the financial perspective is much more difficult. Success of government services depends on measuring their quantity and quality, which are not easily obtained or quantified. The most commonly used measures are effectiveness and efficiency. Effectiveness measures compare actual outcomes to those desired at the beginning of the period, the prior year’s results, or benchmarking to other governments. Efficiency is measured by the outcome to input ratio. In businesses, efficiency measures include profit margin and return on investment. The government can use amount of services to per capita expenditures.

Traditionally, the effort of governments has been to satisfy elected officials and interest groups, rather than the people who utilize their services. The government needs to reevaluate who they are actually servicing, or who their customers are. Once the customer is identified, their needs and expectations can be determined. Kaplan and Norton identified two measures for the customer perspective: level of current customer satisfaction and performance drivers that identify and measure factors that affect future customer satisfaction. Customer measures depend on the mission of the governmental entity or service. For example, a city garbage service may monitor customer acquisition and retention, whereas the welfare agency may monitor customers no longer requiring their services. Customer satisfaction is a measure that remains the same when extrapolating the balanced scorecard model to governments. Assessing the quality of services, response times, and the entity’s reputation are all measures used in businesses that are applicable to governments. The information needed for these measures can come from customer surveys, focus groups, suggestion boxes, and other sources.

The internal business processes category involves the processes, personnel, technology and procedures necessary to operate a successful customer-oriented organization. There are three areas in for-profit entities that Kaplan and Norton identified for the internal business processes perspective: innovation, which includes research and development of new products and services to meet future customer needs, operations, which encompass timely, efficient and consistent delivery of products and services, and service after the sale, which includes warranty and repair work. Although governments rarely would have any sort of research and development, they still need to project future needs of their customers. Shifting from problem solving to problem prevention should be the focus of government agencies and programs. Future planning does present unique challenges for governments because the budget and political systems are short-term. Politicians are reluctant to implement prevention programs, which incur costs in the current period, but do not show benefits until their term is over. In the area of operations, governments can use similar measures as for-profit entities. Identifying and measuring the timeliness, consistency and efficiency of the delivery of services are examples of measures governments can implement. Although government entities do not typically provide warranty or repair work, there are still measures subsequent to providing the service that governments can identify and evaluate. For example, they could use response time to customer complaints. This is an important factor for customer satisfaction and retention, as well as the government’s reputation.
The learning and growth perspective measures the entity’s ability to develop and utilize now and into the future, employees, information systems, and organizational capabilities of the entity. Employee measures can include employee satisfaction, retention, and productivity. In order to empower employees, governments should follow the approach of businesses that have successfully implemented the balanced scorecard, and shift from a top-down approach to a team-work approach. Employees need to be empowered to be innovative and make suggestions to improve not only their satisfaction, but also customer satisfaction. The most critical driver in all employee measures is employee training. Although there are not current statistics available on how much governments spend on training, it is likely to be much less than what businesses spend. Trained, knowledgeable employees not only improve measures in the employee section of the learning and growth perspective, they also improve the measures in the customer perspective, because customer needs are met effectively and efficiently. Like for-profit organizations, governments need to invest in information systems and other technologies that will meet future needs of employees in order to fulfill the customer’s demands for services. Organization capabilities are policies and procedures that provide motivation, empowerment and employee support. Measures for employee suggestions and team performance are examples in this area.

**Conclusion**

Performance measurement systems are increasingly being implemented in governments. They add an additional level of accountability for the taxpayers above the standard financial statements. Many state and local governments have successfully implemented systems that have proven to increase their efficiency and effectiveness. As other governments implement performance measurement systems, more consistent ratios will be developed to evaluate financial condition, as will comprehensive benchmarking data. Other systems will continue to be used, such as the balanced scorecard, which focus on nonfinancial data to evaluate performance and improve efficiency and effectiveness. These systems will aid politicians, managers and employees in identifying strengths and weaknesses in order to achieve maximum services at minimum costs. However, the ultimate value will be for the average citizen and taxpayer, who will be better able to determine the performance of their government.

**References**


As a result of involvement in five different organizations as they were at the early stages of introducing performance audit, or in upgrading audit skills, the author has attempted, based on these experiences and anecdotal stories and situations, to provide some generalized guidelines / principles that can be useful in achieving success. Although perhaps self-evident, these have often been ignored in practice.

This paper consists of three parts:

1. Strategy for Successful Introduction
2. Major Steps/Skills for Performance Audit
3. Acceptance in a Difficult Environment

These are highlighting some issues/areas that the author considers particularly important for success in introducing performance audit and in achieving sound results in what can at first prove to be a difficult environment. It is not intended as a “manual” and the auditor should become familiar, if not already so, with relevant literature, manuals and guidelines.

This paper aims to provide some lessons learned regarding what works well and what can go wrong with development projects.

1. Strategy for Successful Introduction

Role of External Assistance
There is so much information available world-wide through access to data on the internet that it can be questioned what outside intervention if any is required. Institutions can access all the information needed to introduce change from within. Consultants who provide only methodology (in the form of manuals and training) are not, in my view, providing what the institutions want or require.

The key to success is to have a team approach integrating the experience of the consultants with the in-house knowledge of the particular environment. In this way the new methodology and approach fits the needs of the institution; and hopefully the transfer of skills occurs with a minimum of errors and waste in developing this knowledge and capability. The value of consultants, if properly utilized, is that the development occurs with a much shorter learning curve.

Relevance, Context and Timing
Manuals are needed as a basis for the work and as a means to ensure consistency throughout the audit organization. These manuals should be tailored to the needs of the organization although most of the methodology is likely to be common, particularly where the organization complies with, or intends to comply with, INTOSAI or the IIA standards. Where consultants are involved, there is little value in just regurgitating standard material; the manuals should be tailored to the particular needs of the organization. These manuals should be specific to the local needs but do not need to be so specific
that the auditor just follows a set of detailed audit programs, especially tailored to every individual organization to be audited.¹

Consultants cannot tailor the audit methodology without substantial assistance from those experienced working within their own context. A team approach, with members from within the audit organization working closely with the consultants, has the dual advantage of ensuring the most relevant methodology and at the same time transmitting the knowledge of the consultants to members of the organization.

Training, both formal and “on-the-job”, is crucial to ensuring that the auditors have familiarity with the new methodology being introduced and are able to put into practice the audit material developed. The formal training should be tied in closely with the manuals being developed. Otherwise, the manuals are less likely to be used and in fact, the training material may become a substitute for the manuals – thus wasting to some extent the work and cost of producing the manuals.

Thus the manuals and training should be tailored to what is encountered within their own environment. The “on-the-job” training component ensures that this will be the case.

On-the-job training provides the hands-on experience, and with it the confidence, to apply the new approaches to audit. I have a particular philosophy in training, somewhat like the Zen approach of answering a question with a question. The experienced auditors should not tell the inexperienced what to do. Rather, the form of training should be through questions that the new auditors have to work out how to answer themselves (of course, with the experienced auditor there to provide assistance whenever required). In this way, the training is provided in an environment of challenge and discovery. The new auditors have the satisfaction of doing the work themselves. The next time, the new auditors will require much less guidance than the first time and by the third audit, they can most likely do the work on their own entirely.

Finally, the training should be “just in time training”. A formal training course should be tied in closely with the implementation of the new approach. Otherwise, if too soon, the material can be forgotten before the auditor has the opportunity to put it into practice. If too late, the auditors are struggling without the benefit of training. In particular, IT training should not be provided without a sufficient number of computers available for all course participants to practice and adopt the new material and the new technology.

Commitment

Success is dependent on commitment and participation at all levels of the audit organization. The new initiatives should not be set up with consultants working in a vacuum. The best auditors, although difficult to spare from on-going work, are the people most needed in introducing the changes. Most audit organizations have serious resource limitations and demanding on-going commitments and hence, senior management are often loath to assign resources, especially their best auditors, to the project. Nevertheless, some sacrifice of time and effort in meeting the current year’s responsibilities is required to advance the organization’s long-term goals. Success at the beginning is dependent on having auditors who have energy and commitment and senior managers who are supportive, and are seen to be supportive, of the changes being introduced.

The effort in introducing change across the organization can be underestimated. The time invested in training is substantial. Performance audits take considerable time and effort, especially in the beginning. Performance audit reports require considerable writing skills and generally consume much editing and re-writing time. The commitment of the organization can be tested during the early stages of change.

¹ The audit team needs to develop a set of audit programs (for attest or compliance audits) and each year update, or modify as required. The first time an organization is subject to a new audit, there is much work in developing audit procedures, including flow-charting the systems and processes. Subsequent audit work is usually much less time-consuming since the previous audit program often requires only minor modifications. In much of performance audit work, the audit procedures are more function-related than organization-related. Audit programs (including audit criteria) for say materiel management are applicable across organizations with usually little variation. Much effort, however, up front, needs to be invested in understanding the business.
There should be participation throughout the organization. The project team should include both senior representatives and working level involvement. This can be achieved, for example, by having a working group and a steering committee. Where only the head of the organization is involved, the changes can be perceived as remote by the rest of the staff. Where only lower level members are involved, there can be insufficient buy-in by the senior members. Clear direction and commitment must come from the top manager of the audit organization (the Auditor General, and ideally members of the Public Accounts, in the case of a SAI; or the Head of Internal Audit with the backing of the Chief Executive Officer, and/or the Audit Committee, in the case of IA).

**Continuity**

As discussed above, retention / absorption / adoption is best gained by developing teams of auditors with the accumulative experience in doing the new audit work. These people are a valuable resource of the audit office. Unfortunately, they are also those most likely to have job opportunities elsewhere outside of the audit office. Retention of these people has to be a prime concern of the organization. The organization can expect to face a problem of turnover of the most experienced staff.

A strategy, or set of strategies, is needed to respond to the threat of loss of institutional knowledge and experience. One or more of the following might be considered:

a) if possible within the staffing structure and rules, provide a bonus based on a minimum length of service using the new audit skills, and/or have the employee sign a contract guaranteeing a minimum length of service after receiving the training;
b) establish on-going training (particularly focused on the transfer of knowledge from the experts to the others – on-the-job training and train-the-trainer are key in developing the new audit skills); and
c) ensure more than one person with the necessary skills to maintain continuity – an especially serious problem where IT is concerned².

### 2. Major Steps/Skills for Performance Audit

#### What to Audit

The audit organization should strive to achieve early success in the introduction of performance auditing or in introducing new audit methodology such as, for example, the use of CAATs. The selection of the most appropriate audit subjects is key in realizing this success. Unsuccessful audits tarnish the image of the auditor within the organizations audited and reduce confidence, and support, within the audit institution.

First, the audit institution should consider the strategic selection of audits. This may be on the basis of the senior official’s personal strategy, knowledge and priorities. This person can be supported by the efforts of the auditors in his/her organization in identifying a list of potential audits. These can be identified based on some of the following: issues identified in earlier audits; introduction of new programs / systems (which are likely to encounter start-up problems); areas of high materiality and/or judged to be of high risk; concerns raised in the media; reports of other audit institutions (that may have identified issues that exist within the organizations covered in one’s own audit work).

Then out of these, the highest priority audits should be identified, based on the key considerations listed below.

Selection of initial audits should consider:

- Ease of successfully completing the audit (relatively limited scope; existing methodology; within the technical capability of the auditors; strong likelihood of meaningful findings);
- Relevance (important program; known area of significant weaknesses; public concern); and
- Impact (within the powers of management to improve; meaningful recommendations possible; potential for significant savings and/or improvements in the effectiveness of the organization)

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2 Ensure at least two IT audit positions in organization (either two senior positions or ensure that the person in the junior position is provided the necessary experience and training to take over the senior position as soon as the senior person leaves); or have contractual arrangements with consultants to ensure continuity.
Selection of audit area and defining the scope of the audit work should be based on a risk assessment. Under a risk assessment, the auditor focuses on areas which are of high materiality and potentially high risk, caused for example by the existence of inadequate controls.

The auditor should also consider the risk, regarding the returns from the audit resources expended. The auditor should avoid for example an audit which requires extensive audit effort with only a low likelihood of discovering anything significant (positive or negative) to report. An example here is useful: we examined the utilization of school facilities (in terms of number of students per square foot of classroom space) and found considerable variation between schools. This appeared to be a significant finding. The problem, however, was how to improve the situation. If the schools had been recently constructed, we might have been able to point to poor planning of the school expansion program. Given that these were existing facilities, then the other option was to recommend how to improve the utilization of the facilities. This had us considering such concepts as busing children to more distant schools and closing down schools: quite obviously well beyond the scope of the original audit, focused on utilization of the facilities. The lesson is that we should consider what possible findings are likely to arise from the audit and what possible actions can be recommended that lie within the scope of the audit. Where the underlying problems, or their solution, lie far from the area to be examined in the audit, the auditor should reconsider whether the audit is appropriate.

This type of analysis should be carried out in a “survey stage” and the decision whether to proceed to a full audit can be made on the basis of the anticipated findings and what recommendations can likely be usefully put forward. The auditor should not be frightened of not proceeding if, at this stage, there are good reasons for not proceeding. For example, it may become evident that technical expertise is needed to fully understand the operations or issues to be addressed in the audit. If this expertise is not currently available, the audit can be postponed until such expertise is available or outside consulting expertise can be afforded.

**Key Components of a Performance Audit**

Within the main framework, or audit steps, in carrying out a performance audit (planning, conducting and reporting), the following aspects deserve particular consideration and attention.

*Understanding of the Business.* The auditor should have a clear knowledge and understanding of the business. The development of a program structure and logic model can be helpful in gaining this knowledge. The model lays out in a logical relationship: the activities, resources, outputs, outcomes (both intended and unintended) and objectives (both latent and manifest) of the organization. There are different ways of modeling the structure of the organization. The exercise helps in identifying what should be measured, what can be measured and what are being measured by the organization. It can also be used in clarifying accountability of the components of the organization and whether the objectives are being pursued or indeed whether the stated objectives can be expected to be realized through the activities and resources provided by the organization.

*Developing Audit Criteria.* Although performance audits often include some degree of compliance audit, normally they do not necessarily take the existing standards and procedures as beyond challenge and question. Even, on occasion, legislative requirements may be a source of audit comment if problems are occurring that the existing legislation did not anticipate or allow for. Audit criteria can provide a set of “guides” which can be used as a method for determining audit findings by comparing “what is” against “what should be”. Further, a set of criteria helps to define the scope of audit coverage and what needs to be examined by the auditor. Audit criteria provide structure for the conduct of the audit; contribute to the development of the audit program; and form a basis for generating findings. A hierarchy of criteria can help to form and structure observations.

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3 The manifest objectives are those stated by the organization (and in official statements of government policies). The latent objectives may exist but are not formally stated (for example, a government program to provide country wide training could be a means of reducing the unemployment rate where an individual undergoing training is not included in the unemployment figures).

4 Some performance auditors prefer to establish “hypotheses” at the start of the audit. This concept is very similar to the use of criteria.
It can be useful to discuss the audit criteria with management and obtain as far as possible agreement. Sometimes audit criteria have to be tailored to the situation because there are often good reasons for managers conducting their work differently from general practice. In this case, the criteria should reflect the different practice. Discussing these criteria with management at the beginning of the audit can reduce conflict at the reporting stage.

**Ensuring Sufficient Evidence.** A challenge to the auditor is deciding what constitutes sufficient evidence. The extent of evidence affects what the audit report can state. If the auditor wants to conclude with regard to the whole area covered by the audit, the evidence has to be representative of that area and of sufficient quantity and quality to provide assurance of the conclusions.

The safest way of reporting findings is to state what was looked at and what was found. The audit coverage may not always be sufficient to generalize from those facts. The auditor should take care that the evidence is strong enough to support statements in the report even if management at the time of reviewing the report do not challenge the evidence, or the extent of the evidence. There is always the possibility that management officials may wish to revisit the supporting evidence, such as when they are putting together a corrective action plan. When the officials are developing their plan, they may want to discuss with the auditor all the examples that were found in need of correction. If in reviewing these details, management concludes that the evidence is insufficient to support the conclusions, the auditor is in an embarrassing position.

If the audit report simply lists a series of negative findings, the evidence required applies only to those particular projects/activities/transactions examined. If however, the auditor wishes to generalize about all projects/activities/transactions, the audit evidence has to be sufficient to demonstrate that, usually on the basis of a statistically valid sample, the majority of such projects/activities/transactions have the same characteristics of satisfactory performance (assurance) or suffer from the same negative findings.\(^5\)

**Conducting Cause-and-Effect Analysis.** Wherever possible, the auditor should endeavour to determine the underlying cause(s) of a weaknesses or error observed. Normally, there is at least one major underlying cause for the weakness or error, such as:

- Inexperienced individual carrying out the transaction;
- Insufficient training of that individual;
- Lack of proper systems and procedures;
- Insufficient management involvement / scrutiny; or
- Unclear accountability.

Sometimes, the original scope of audit work excludes collecting evidence relating to one or more of the underlying problems. For example, HR staffing and training may be weak and as a result staff makes errors. Ideally, evidence collected allows the auditor to make observations about both the “cause” and the “effect” of any weaknesses observed. This by no means is always the situation. Where the problem area is not included in the scope of the audit, the auditor has to make a decision as to whether additional work should be undertaken (which may lie in another part of the organization) or whether to recommend that the problem area is covered in future audit work. The original scoping of the audit can help to anticipate possible impact of other areas on the originally selected audit area and as a result, the auditor may decide to combine different areas within the audit to ensure that the causes and impacts are included in the audit work. Some performance auditors draw up a “problem tree” at the start of the audit.\(^6\) This has the advantage of helping to anticipate what aspects of the operations the auditor should include within the audit scope.

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\(^5\) When management complains that there is insufficient positive findings, I sometimes make the following comment: “One lie makes a person a liar but one true statement does not guarantee that the person is honest.” It is unfortunate but true that to conclude positively requires much more assurance than to determine that errors exist (although of course to determine the extent of the errors likewise requires much more audit evidence).

\(^6\) This approach is described in the “Handbook in Performance Auditing: Theory and Practice” published by the Swedish National Audit Office (Riksrevisionsverket – abbreviated RRV).
It is usually a matter of judgment as to which factor, or combination of factors, is generally accepted as the underlying cause(s). It is these underlying causes, however, that need to be addressed to obtain long-term improvement of the operations. It is also these causes that the recommendations for improvement need to address.

The auditor needs to identify the actual, or potential, effect of the observation. Wherever possible, and reasonably cost-effective, the auditor should seek examples of the effects resulting from a weakness observed. Such evidence, however, may not be readily available. In this case, the auditor should be able to demonstrate the risk associated with the continuation of the current situation. The risk should be plausible and convincing to management. If not, the auditor will likely find it difficult to get management support for recommended changes to reduce or eliminate the weaknesses observed.

This “cause and effect” analysis is difficult. Sometimes clear relationships between observations and the underlying causes cannot be proved. This is where the auditor’s knowledge, experience and communication skills are important. Management need to have confidence in the auditor to accept the recommendations for change.

If the underlying causes of weaknesses are not addressed, the auditor can be sure that each time the area is audited, the same problems will be noted. Except to the extent required as part of a follow-up audit, there is no point in repeating audits and coming up with the same observations. Either the weaknesses are too small to matter, in which case the auditor should not be concerned with the issues, or there is need to correct the problems.

Cause-and-effect analysis ensures that we direct our effort towards the areas that matter and produce meaningful and significant audit observations. This analysis also ensures that we understand the underlying causes, so that we can develop recommendations that address the most important areas.

**Producing Realistic Recommendations.** As the auditors clear findings with the different levels of management within the entity, they should explore potential recommendations. Recommendations that are supported by management are much more likely to get implemented than those that are simply the opinions of the auditor.

Recommendations should address the underlying causes. Where the auditor identifies errors and recommends that management correct them, it is likely that, on the next audit cycle, similar errors will be detected. The auditor must focus on the underlying weaknesses in controls, or other causes of the errors, to be assured that the likelihood of further errors occurring will be significantly reduced.

There are many reasons for errors to occur. Sometimes, it is lack of money to put in the appropriate controls. In this case, a recommendation by the auditor may help to obtain the necessary funding.

When developing recommendations, the auditor should consider:

- The most significant causes of the weaknesses observed (through cause-and-effect analysis) and what needs to be done to strengthen the management framework to correct the underlying cause(s);
- The feasibility and cost of adopting a recommendation (i.e., the benefits of a recommendation should outweigh the cost of implementing it);
- Alternative courses for remedial action; and
- Effects, both positive and negative, that may arise if the recommendations are adopted.

The auditor must guard against recommendations that address situations that lie outside of the control of the manager to which the audit recommendation is addressed. Some auditors specifically identify the manager(s) to whom the recommendations apply. It is not reasonable to direct a recommendation to a manager who is not responsible for the situation. The auditor must recognize where the situation is outside of the control or authority of the manager.
3. Acceptance in a Difficult Environment

Availability of Information
Problems in obtaining access to information, whether due to intentional withholding or poor records, can be a real challenge for the auditor, even to the extent of limiting the auditors’ ability to perform the responsibilities of the office. This can result in delays in getting out the audit reports. The solution is for the auditor to document the difficulties in getting access to the information required to complete the audit and report on these efforts. Uncooperative management or inadequate records are findings in themselves. The auditor is not responsible for a lack of information. The auditor is only responsible for making the effort to access existing information and/or obtaining sufficient evidence to support any reported conclusions. Lack of evidence is in itself a significant matter to be reported.

Rejection of Findings
Often management argues that the findings are incorrect or that the sample is unrepresentative. The auditor must have clear evidence to support the findings. If the material is not available in the briefing session, the auditor should not argue but promise to provide the information at a subsequent meeting. Sometimes, the wording of the finding is not consistent with the evidence. For example, the auditor should not use exaggerated claims, such as “many serious…” when the evidence cannot show that to be the case. In fact, the use of superlatives, or such adjectives as “very”, “serious”, should be avoided – the evidence should allow the reader to come to that conclusion. Where the findings are relating to the non-existence of something, it is often more difficult to convince management. The auditor should be able to explain what efforts were made but obviously a non-existent item cannot be “produced”. In one case, where the auditor claimed that there were few project evaluations conducted by the organization, management argued this was not the case. An effective response by the auditor was to say “there are two hundred projects and we have only found three evaluations; twenty evaluations would be 10% of the total projects - you provide us with twenty evaluations by next week and we shall retract the finding.” The audit finding remained. Some auditors feel that they should always be right. It is more important to be fair, reasonable and prepared to change the report if management can show that the auditor was, for whatever reason, incorrect. There can be no excuses for inadequate audit work but misunderstandings can occur and the focus should be on correcting them.

Lack of Response
Sometimes, management ignores communications from the auditor. An internal auditor inherited over 400 unanswered audit queries when he took over as head of audit in a particular department. Instead of issuing audit queries, one option is to distribute a draft report (which identifies both findings and missing information) and then make clear to management that the report will be published within a given amount of time irrespective of whether the management provides feedback or not. In this way, the auditor takes the initiative rather than waiting for management to answer the queries.

Lack of Corrective Action
An examination of old audit reports often reveals that there is continued repetition of the same weaknesses or malpractices identified in the reports. At one point, the key audit finding is not the current weaknesses but the history of inaction by management. It is not the responsibility of the auditor to improve the situation; only to bring the situation to the attention of senior management to take appropriate actions. Nevertheless, the longer weaknesses continue uncorrected, the more serious is the auditor’s concern.

Care must be taken however to ensure that the audit observations are fair and that the recommendations are realistic and reasonable. Some situations are beyond the control of the managers responsible for the area being audited. A recommendation to spend more money may not be realistic within tight budgets – instead perhaps the auditor can recommend better allocation of scare resources – again it must be emphasized that increased controls are not always cost-effective – small losses may be more beneficial than extensive controls to prevent (or detect) the losses if these controls cost far more than the savings they are intended to produce – in some audit offices, there is a culture that feels that all errors must be detected/reported/punished and or repaid – that is not the best allocation of audit effort – managers are responsible for preventing/detecting errors and correcting them – the auditors’ role is to ensure that the managers are carrying out their responsibilities and where this is not happening identify the problem and where possible recommend corrective action.
Handling Sensitive Issues

The auditor can encounter difficult or sensitive issues and needs to develop skills in presenting the findings in a manner that makes the point without generating too much conflict. An excellent example of this was an audit report that, instead of reporting that monies were inappropriately spent, or wasted, suggested that those responsible for handing out grants should have a better knowledge of the selection criteria. In another case, a draft report on high levels of mis-sorted mail caused management to be very defensive, fearing the public reaction to their mail not reaching their destination properly. The same findings, expressed as high error rates of the sorting machines, were accepted by management. The auditor should avoid exaggerated, inflammatory or over-emphasized statements. Although, of course, some auditors might wish to report in a manner that intentionally gets attention to ensure that the problems are exposed and are given the attention they deserve. The message here is that the style of report writing is very important and that the auditor can, and should, control the style of report writing in a very conscious manner with a clear understanding of what response to expect from the reader.

Changing Role of Auditor

Auditors used to be accused of only looking at the past. The auditor must focus on the future and help the institutions improve the quality of their management over time. Generally, criticisms of past mistakes are not well received and in some environments, serious conflict can be generated from exposing mismanagement. The mode of proceeding depends on the senior auditor, the relationship that he/she has with the various stakeholders and the most appropriate means of carrying out the audit responsibilities. Reduction in waste and mismanagement may be achieved by emphasizing the need for improvements in the future than dwelling on the mistakes of the past. In one case, some waste and poor management had been discovered but had not been reported (it was a small issue and distracted from the key messages of the report). Within a short time, management of the organization visited the audit office to determine what needed to be done to eradicate the weaknesses. In this case, perhaps more action was generated than if the problems had been reported. The fear of exposure was perhaps a greater incentive than the exposure itself.

The role of the auditor is changing. The auditor is there more to assist management improve operations rather than pick up past errors and mismanagement. Whether this new role is accepted by management depends on the trust that develops between the auditor and the audited institutions. There is always a balance between the police officer role (and judge and jury) and the helpful member of the management team. Interpersonal skills in interacting with management of the audited organization are valuable in carrying out the new role of the auditor, particularly within an expanded mandate of performance audit. The auditor should invest some time explaining and “selling” the new approach to these managers. The auditor needs to maintain credibility and that means listening to management and understanding their business and not judging beyond the auditor’s technical knowledge and experience.
# Suggested Work Plan for Public Sector Accounting Reform

*In the Transition from Cash to Accrual Accounting*

Dr. Jesse W. Hughes, CPA, CIA, CGFM

<table>
<thead>
<tr>
<th>Task</th>
<th>Begin Date</th>
<th>End Date</th>
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<tbody>
<tr>
<td>1. Monitor application for IFAC membership</td>
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<td>2. Officially translate the IPSAS</td>
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<td>3. Provide training for implementation of the work plan:</td>
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<td>a. Develop training plan with an emphasis on training of the trainers</td>
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<td>b. Work with training function to provide set of training material for program implementation</td>
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<tr>
<td>c. Work with universities to incorporate training on IPSAS in their degree programs</td>
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<td>d. Coordinate with ACCA and CIPFA to determine if there can be linkage to certification programs</td>
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<tr>
<td>4. Identify all government entities</td>
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<td>5. Define which entities are Government Business Entities (GBEs) using following criteria:</td>
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<tr>
<td>a. Has power to contract in own name</td>
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<td>b. Is assigned financial and operational authority to carry on a business</td>
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<td>c. Sells goods and services to other entities at a profit or full cost recovery</td>
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<td>d. Not reliant on continuing government funding to be a going concern</td>
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<tr>
<td>e. Is controlled by a public sector entity as defined in IPSAS 6</td>
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<td>6. Review and assess the following for each GBE:</td>
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<tr>
<td>a. Determine degree of compliance with IASs by review of Auditor’s Opinion and Management Letter from external auditor</td>
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<tr>
<td>b. Correct deficiencies noted in order to obtain an unqualified auditor’s opinion</td>
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<tr>
<td>c. Prepare Consolidated Financial Statements for all GBEs</td>
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<tr>
<td>7. Review and assess the following requirements per Part 1 of the Cash Basis IPSAS for each governmental entity other than a GBE</td>
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<tr>
<td>a. Prepare Cash Receipts and Payments Statement for own revenues</td>
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<td>b. Contact donors to obtain third party settlements and include in Cash Receipts and Payments Statement</td>
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<tr>
<td>c. Prepare Consolidated Cash Receipts and Payments Statement</td>
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<td>d. Incorporate disclosure requirements for recipients</td>
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<td>Task</td>
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<td>of external assistance (IPSAS ED)</td>
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<td>8. Review and assess additional disclosures as encouraged by Part 2 of the Cash Basis IPSAS for each governmental entity other than a GBE:</td>
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<tr>
<td>a Budget to Actual Comparison (Draft ED)</td>
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<tr>
<td>b Cash Flow Statement in format prescribed by IPSAS 2</td>
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<td>c Investments in Associates as Defined in IPSAS 7</td>
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<td>d Interests in Joint Ventures as Defined in IPSAS 8</td>
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<tr>
<td>e Value of Inventories as Defined in IPSAS 12</td>
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<tr>
<td>f Value of Leases as Defined in IPSAS 13</td>
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<tr>
<td>g Value of Financial Instruments (includes all financial assets and financial liabilities) as Defined in IPSAS 15</td>
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<tr>
<td>h Value of Investment Property as Defined in IPSAS 16</td>
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<tr>
<td>i Value of Provisions as Defined in IPSAS 19</td>
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<tr>
<td>j Amount of Administered Transactions as an agent</td>
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<tr>
<td>k Related Parties as Defined in IPSAS 20</td>
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<tr>
<td>l Value of Property, Plant, and Equipment as Defined in IPSAS 17</td>
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<tr>
<td>9. Implement system of accrual accounting by adopting all IPSASs in effect, and prepare Consolidated Financial Statements as prescribed in IPSAS 6</td>
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<tr>
<td>10. Extract data from accounting system for presentation in the statistical reporting system prescribed by the GFS Manual</td>
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<tr>
<td>11. Review organizational structure to determine changes that might be necessary. Particularly important would be consideration of an Accounting organization headed by a Chief Accountant. Functions for such a department are as follows:</td>
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<tr>
<td>a Maintain Accounting Policy and Procedures Manual</td>
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<td>b Provide Quality Assurance program for financial statements</td>
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<td>c Maintain library of pertinent accounting standards</td>
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<tr>
<td>d Coordinate training needs with training function</td>
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<tr>
<td>12. Work with line ministries to improve the Corruption Perception Index through implementation of good internal control procedures.</td>
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<tr>
<td>13. Design and implement an integrated government financial management system</td>
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<tr>
<td>14. Change laws and regulations as necessary to implement this work plan</td>
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<tr>
<td>15. Coordinate with internal and external auditors on work plan</td>
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2. Credit card #:_____________________________ Expiration Date:_____________________________
3. Signature:_______________________________________________

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ICGFM Board of Directors as of January 1, 2006

January 1, 2006-December 31, 2007

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