

Credibility of Governments, Role of SAIs and International Good Practices on Financial Audit



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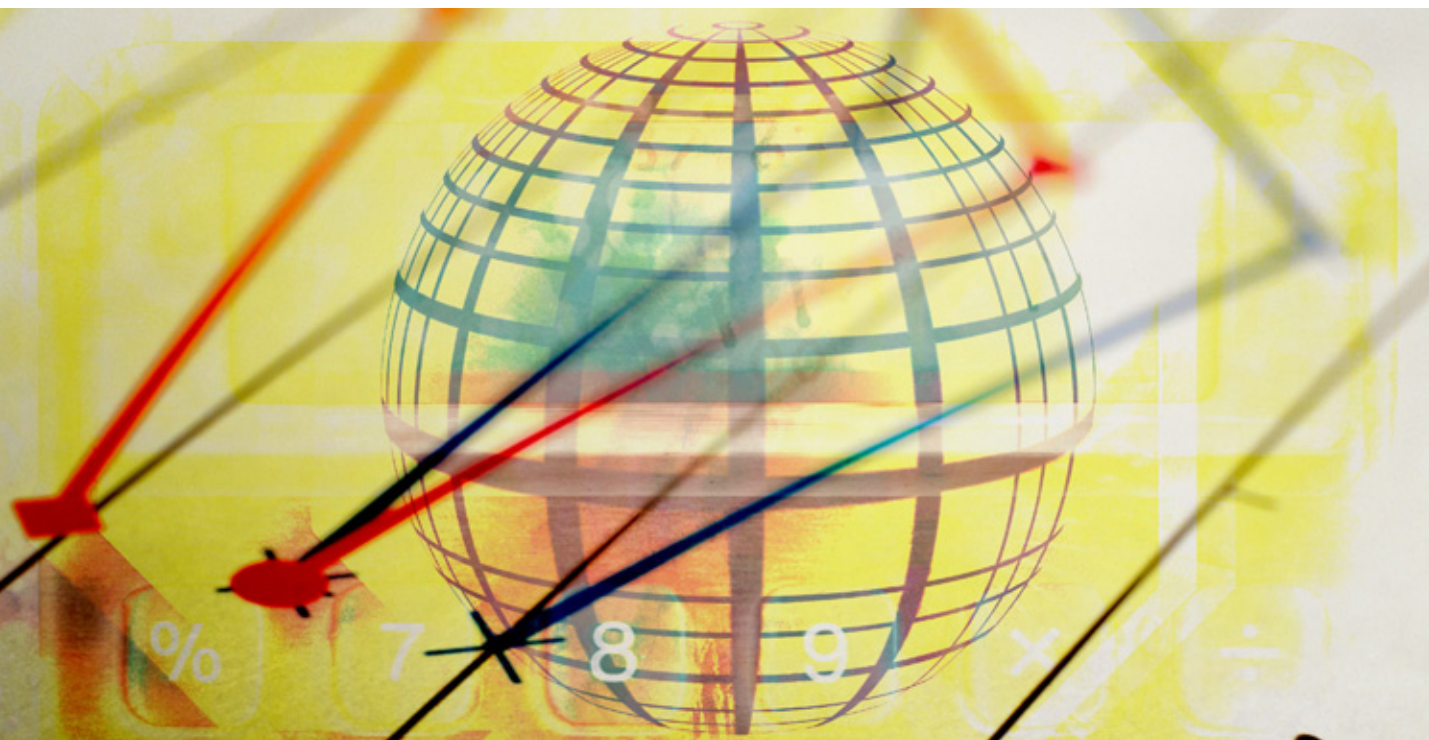


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SUMMARY

The Federal Court of Accounts – Brazil (TCU) has the mission of overseeing public administration improving it in the benefit of society. Therefore, the challenges faced by TCU vary as public management economic, political and administrative scenarios evolve. In the present state of fiscal and global crises, TCU has an important institutional role, which is to build trust in society. In line with the strategic vision of being known as an institution of excellence in oversight and that contributes to the improvement of public administration, the Court attempts to converge its financial audit practices to the international standards and good practices. This paper presents some of the results of this convergence process, particularly the findings obtained through a survey on good practices in Supreme Audit Institutions (SAIs) of developed countries. The survey is structured in four main dimensions: i) mandate and objectives; ii) resources and organization; iii) methods and procedures; and, iv) reports and impacts. The main conclusions were: i) financial audit is part of the mandate of all the SAIs surveyed; ii) there are structures and specialized professionals for this audit tool; iii) there is great concern in ensuring that international standards are being applied, by means of IIT solutions that are leaders in the market and by the SAIs submitting themselves to periodic



peer reviews; and iv) the main benefits of this type of audit are the strengthening of accountability, transparency, integrity, internal controls and public sector governance.

Keywords Credibility. Financial audit. Good practices. SAI. Trust.

1. INTRODUCTION

The current national and international scenario has shown the importance of the word trust in the relationship between government and society. According to Easton (1965), trust in governments represents citizens' trust in the actions of a government taken to do what is right and fair. In a democracy, this relationship is contractually agreed upon through the voting system, which symbolizes not only the choice of political representatives but also an event that is well defined in time and space. Each citizen hopes that their candidates, if elected, will make sound decisions regarding the paths to be followed by the country as a whole and, directly or indirectly, by each of its inhabitants.

The role of government in steering society has increased with the consolidation of social rights and the need to preserve macroeconomic stability. For this reason, issues such as tax burden, social spending, social security, public debt and assets concern not

only experts, but the entire community affected by the quality of public finance management.

Given the social and economic risks arising from the loss of credibility of governments, Supreme Audit Institutions (SAIs), which is the generic name given to foreign agencies similar to the Federal Court of Accounts (TCU), have been increasingly concerned with conducting audits designed to make the population, as well as representatives elected to legislative houses, feel secure.

After the global economic and financial crisis, the governments of the most affected countries took several measures as a response. In Europe, the fiscal austerity policies prevailed. In the United States, attention should be drawn to the acquisition of banks in critical financial situations, through the TARP (Trouble Asset Relief Program) program. Such measures have different objectives: to reestablish the health of public accounts and recover the financial system. However, both are related to the same strategy: bring stability to the economy.

This scenario created new expectations on the part of society regarding the SAIs, resulting in new institutional challenges. Nagy (2012) mentions the taxonomy of the Finland SAI as to the stages of crisis management to identify the role of the SAI (CRAFF - Crisis-Related Auditing Functions and Features): i) preparedness; ii) immediate response; iii) management of crisis; iv) exit strategies; e, v) new

order. Among the functions of an SAI, financial audit plays an important role both in the initial stage of preparedness as in the stages of management and recovery from the crisis.

According to the international standards (ISSAI 200), financial audit has the purpose of increasing the level of trust of users of financial information of governments. To that end, the SAIs must be sure that the accounts of the governments are trustworthy and present an accurate picture of the reality of the situation and of their financial performance. Thus, financial audit is a fundamental tool for the SAI in measuring credibility of government finances.

In a study requested by the European Commission, it was found that the majority of the public bodies in Europe submit themselves to annual financial audits and that there is a high level of homogeneity regarding the characteristics of this type of audit in the region due to the adoption of international standards (ERNST & YOUNG, 2012).

Aware of this institutional, political, economic and social role of SAIs, TCU signed a grant agreement with the World Bank in 2011 with the aim of strengthening the financial audits of government accounts, more known as audits of the General Cash Balances of the Union (*Balanços Gerais da União - BGU*). This agreement intends to bring TCU practices regarding its financial audit function to the level of international standards and best practices. In view of this, this paper has the purpose of disseminating part of this project.

2. METHODOLOGY

The main method used to collect data on International good practices was a questionnaire sent to SAIs of developed countries.

Several comparative studies identify that in developed markets financial audit is more traditional and disseminated in the culture of those nations (SAUDAGARAN E DIGA, 1997; NOBES, 1998; ELLIOT E ELLIOT, 2002; e, NIYAMA, 2005). The main characteristics that differentiate these countries are the nature of the legal system (code law or common law), the source of funding the level of influence of legislation on accounting, professional education, the theoretical framework, and the strength of the profession.

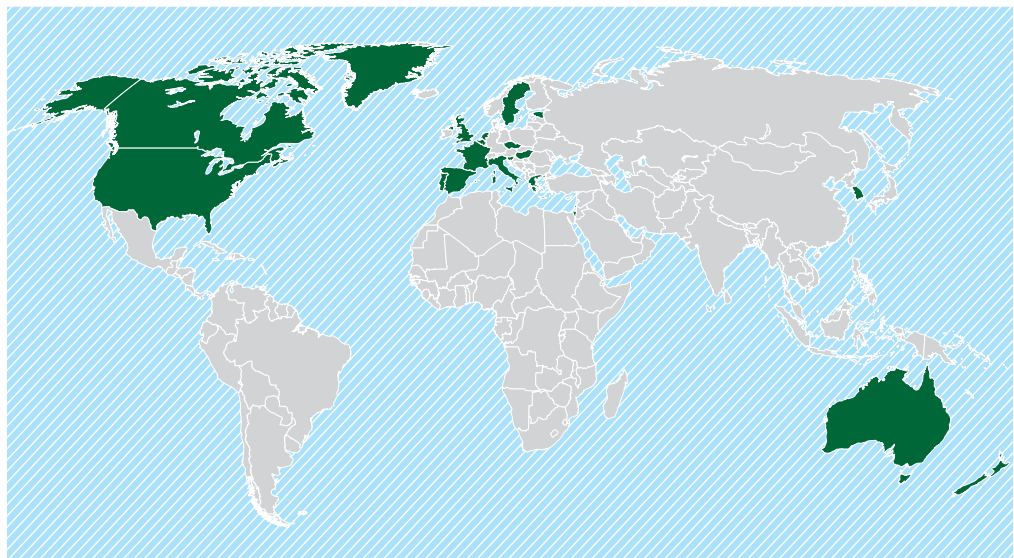
The questionnaire was sent to SAIs of countries with a high *per capita* income and a high Human Development Index (HDI), under the premise that such SAIs, in some measure, have an influence on the high level of social and economic development. Twenty-one SAIs answered the questionnaire. The Figure 1 shows the geographic origin of the institutions that took part in the survey.

Among the respondents, there are nine Courts of Audit (Belgium, Slovenia, Spain, France, Greece, Italy, the Netherlands, Portugal and European Union) and twelve General Audit Offices (Australia, Canada, Korea, United States, Estonia, Hungary, Israel, New Zealand, Czech Republic, Sweden, Switzerland and United Kingdom).

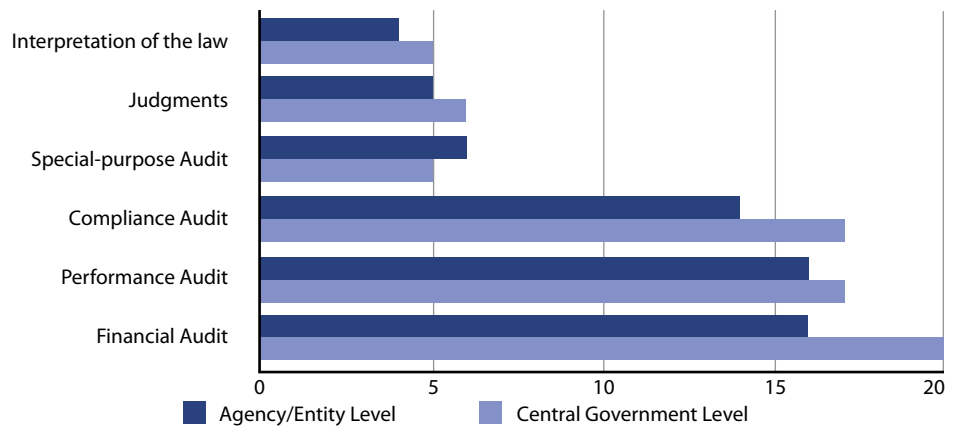
The survey covered four important aspects: a) mandate and objectives; b) resources and

Figure 1:

Geographic origin of SAIs that participated in survey



Graphic 1:
Mandates of the surveyed SAIs



organization; c) methods and procedures; and d) reports and impacts. These demensions cover all the elements of the managerial cycles that are usually observed in public sector reforms, including: socio-economic demand, inputs, resources, processes, outputs, results, and impacts (POLLITT e BOUCKAERT, 2004). These are also the elements analyzed in performance audits, aiming at assessing efficiency, efficacy and effectiveness of the audited objects (TCU, 2010). This methodology is also applicable in SAI diagnostics. Proof of this is that it is aligned with the SAI performance measurement framework, known as SAI PMF.

3. MANDATE OF SAIS: SOCIETY'S EXPECTATION?

The mandate of a SAI is usually provided for in a constitution or in the law. It is sort of a contract between the constituent/legislator and the SAI. The different mandates of SAIs are intended to materialize yearnings of society and even of the market in relation to external control of public administration.

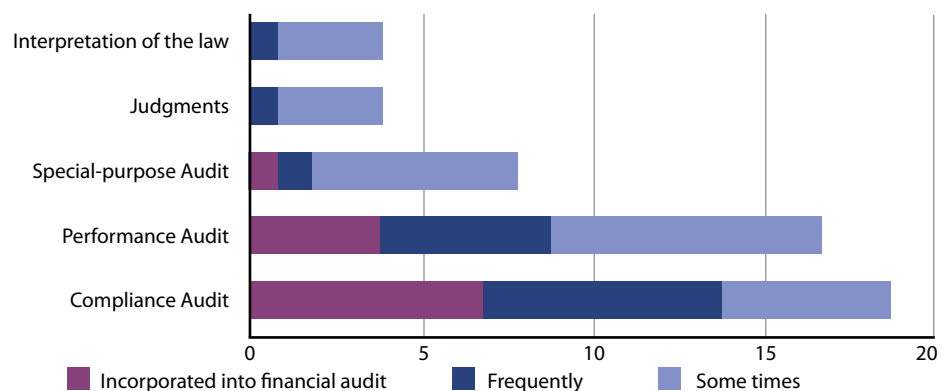
The results of the survey confirm what the International Organization of SAIs (INTOSAI), academic doctrine and international publications had already established, i.e. the most common control mechanisms are represented in the three main types of government auditing: financial, operational and compliance auditing.

In some models, especially in countries with a Court of Accounts, mandates for judging accounts, conduting special-purpose audits and interpreting law were also observed.

All the SAIs indicated that they have a mandate to conduct financial audit. Only one of them does not carry out this kind of audit at central government level, but performs this function at the level of agency and entity. The survey debunks the conventional notion that financial auditing is a typical function of the General Audit Office model and also shows that this function is the most recurrent one among the SAIs included in the sample.

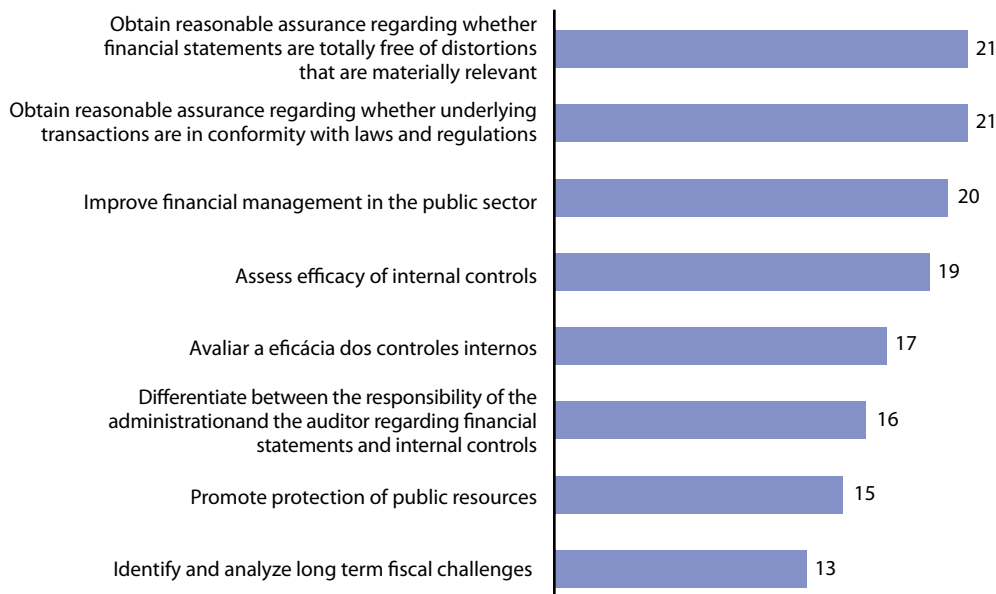
However, the results indicate that there is no absolute segregation between external control tools. Financial audit is highly integrated into compliance audit in attestation engagements, in line with the

Graphic 2:
Level of integration between Financial Audit and other mandates of SAIs



Graphic 3:

Financial audit objectives according to the surveyed SAIs



fundamental Principles of Government Audit (ISSAI 100, 30). In addition, a significant level of interaction between the “financial” and “performance” audit types was found. Special-purpose audits, judgments, and interpretation of the law are also impacted by financial auditing, although less frequently.

There is no doubt about the importance given to financial audit by the surveyed SAIs. However, what does this audit tool mean to them? What would be its purpose in the legal and institutional framework of their countries? One of the questions included in the survey questionnaire addressed this issue and many conclusions can be drawn from it.

The first conclusion is that the primary function of financial audit in all the SAIs is to ensure the quality of financial information disclosed by government entities, in line with what is set forth in INTOSAI’s international standards (ISSAI 200). But all the SAIs also highlighted that this type of audit is also intended to check legal compliance of financial transactions during the accounting year that the financial statements refer to. This confirms that financial audit is an appropriate tool for certifying the level of reliability and regularity of public accounts.

4. RESOURCES AND ORGANIZATION: BETTER STRATEGIES FOR INSTITUTIONAL EFFICIENCY AND PRODUCTIVITY?

The questionnaire also addresses managerial aspects of financial audit, in particular choices in terms of organizational structure and of the profiles

and skills of the professionals working in this area of inspection.

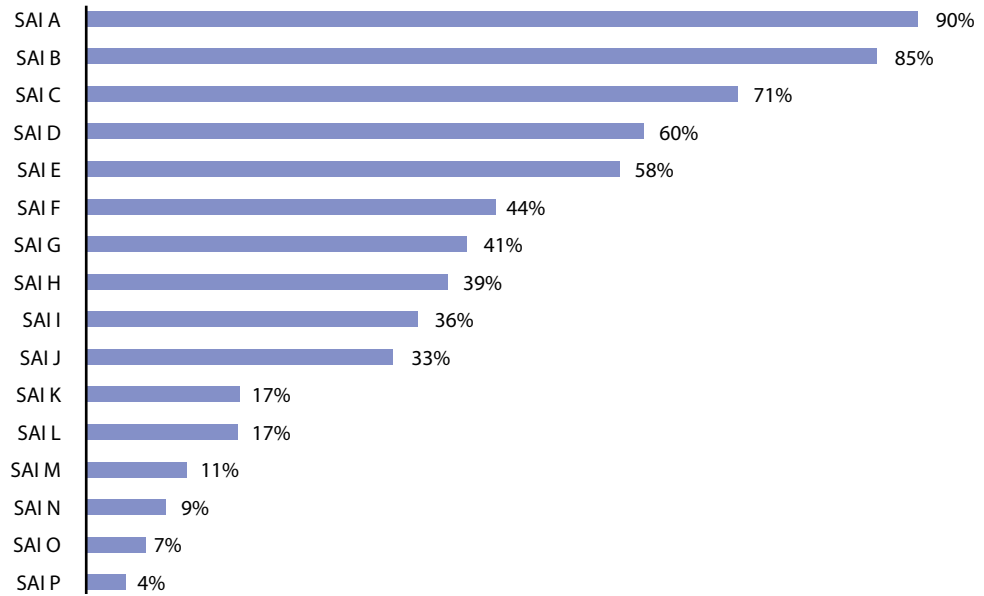
The questions about the “mandate and objectives” dimension provide an insight into what SAIs do, but they don’t reveal the intensity with which they fulfill each of their institutional competences. One of the questions included in the questionnaire was precisely meant to identify the share of resources allocated to financial audit in relation to the total of the SAI auditors.

On average, 16 SAIs that answered this question allocate approximately 40% of their inspecting staff to this type of audit. This percentage changes significantly among the countries included in the sample. Without identifying the SAIs, it can be seen in the Graphic 4 that while at one extreme only 4% of all human resources are allocated to audits of financial statements, at the other this indicator rises to 90% for another SAI. Among the SAIs that adopt the Audit Court model, the average drops to 25%, probably due to the fact that they have other mandates, as already mentioned in the previous section.

In some countries, the option was made to outsource part of the financial audit function, i.e. instead of the SAI conducting this type of audit, independent audit firms from the private sector are hired to perform this task. However, this is an exception. On average, only 12.6% of the financial auditors have no formal employment ties with the SAI. Seven SAIs reported that they only outsource a small portion of their activities and three others reported that they rely quite heavily on independent audit firms. The remaining eleven do not resort to this alternative.

Graphic 4:

Percentage of financial auditors in relation to all the auditors of the surveyed SAIs



As for the professional qualification of financial auditors, 16 SAIs provided information on this topic. On average, half of their financial auditors have professional certification in accounting and auditing, meaning that they are more technically qualified for their job. This percentage varies greatly from one country to another. In countries with a longer tradition in financial audit, this percentage is higher.

A large discrepancy in the use of internal audit was also observed. Over two-thirds of the surveyed SAIs reported that they use internal audit. However, the intensity of its use varies. As a matter of fact, only four of them use it more intensively. The remaining eleven don't use it very much, as shown in Graphic 5. In the comments provided in connection with the question, some SAIs reported that using internal audit may be important to reduce the amount of financial audit tests. However, as a rule, they warn on the risks of using them and also point out that only in a few cases it is possible

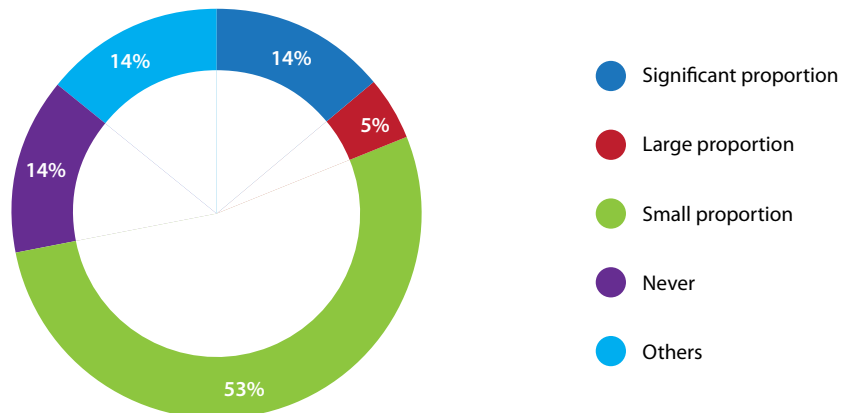
to have full confidence in these activities as audit evidence. In short, such use should vary according to the level of confidence of the SAI auditors in the internal audit of each agency or entity.

The survey also showed that experts are widely used to support the financial auditors, which is a proposal contained in the INTOSAI standards (ISSAI 1620). Almost all the SAIs rely on the services of IT experts. They also mentioned statisticians, actuaries, engineers, economists and lawyers.

Financial auditors are distributed in the organizational structure of each of the SAIs in different ways. A third of them opted for centralizing the financial audit function in a specific department. Approximately one quarter of them adopted matrix structures, with smaller financial audit organizational units spread in various departments. About a fifth of them adopt a combination of a centralized department with other decentralized units.

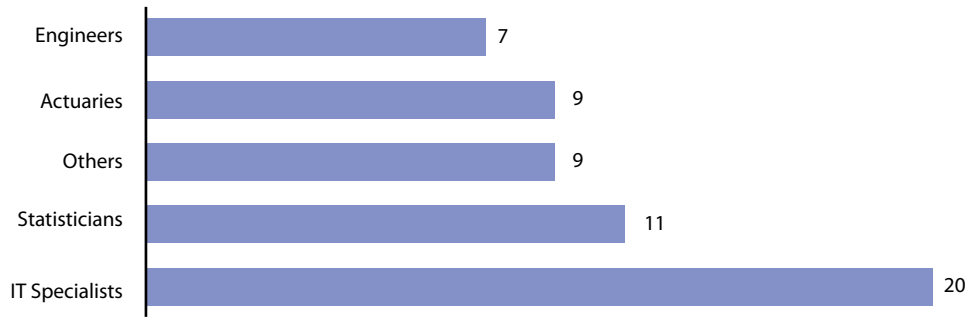
Graphic 5:

Use of internal audit work in the surveyed SAIs



Graphic 6:

Experts more frequently used in the financial audits of the surveyed SAIs



Other structures were mentioned. One of the SAIs mentioned that any department can perform all types of audits, so that almost all audit reports cover all types of audits. The structure of another one is grouped by geographic regions, where each group performs a financial audit function.

It was seen that, as a rule, financial audit has an organizational identity in both a matrix structure and in a centralized structure. This favors the specialization of auditors and supervisors in the methodology prescribed according to INTOSAI's international standards.

5. METHODS AND PROCEDURES: TOOLS TO APPLY INTERNATIONAL STANDARDS?

The best financial audit practices in terms of methods and procedures are related to some

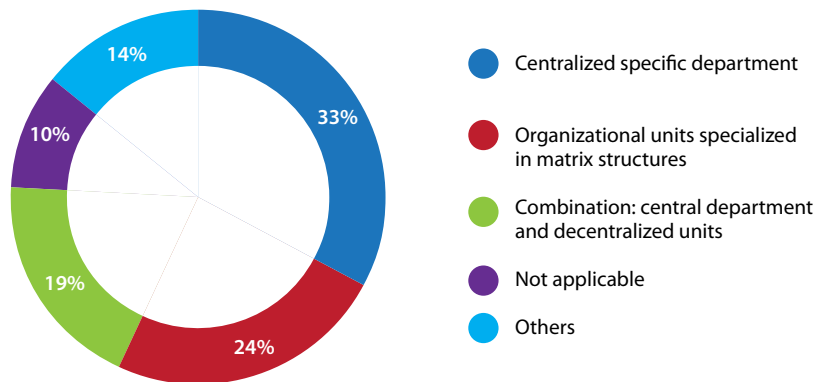
fundamental principles, with a focus on: credibility, quality, professionalism, efficiency, risk, relevance and materiality.

In this spirit, the survey confirms the importance of using leading-edge IT solutions, statistical sampling, minimum levels of materiality for analysis of relevance and also peer reviews. These methods and procedures enhance the efficiency and reliability of financial audits, generating greater value added for society.

Regarding IT solutions for financial audit documentation, a slight prevalence of a specific software was observed among the surveyed SAIs. Without identifying the solutions that were presented, Graphic 8 demonstrates this prevalence. Almost half of the surveyed SAIs use the same IT solution, indicating the importance of methodological standardization in this kind of inspection.

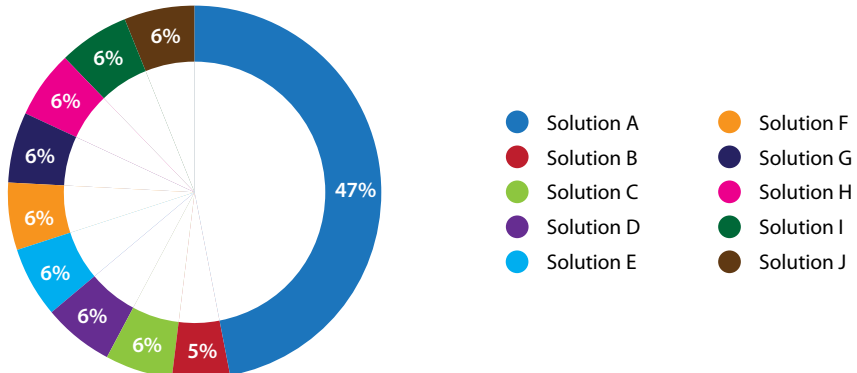
Graphic 7:

Financial audit in the organizational structure of SAIs

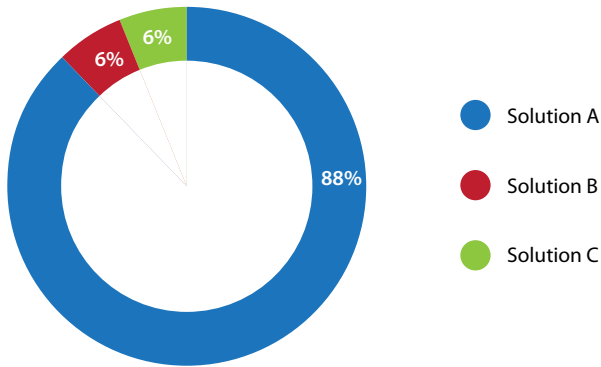


Graphic 8:

IT solutions for financial audit documentation in the surveyed SAIs



Graphic 9:
IT solutions for statistical sampling used by the surveyed SAIs



As for IT solutions for statistical sampling, this concentration is even higher. Almost all the SAIs that answered this question use the same software. Possibly, all the solutions provided are appropriate. However, the high level of concentration found in this survey indicates a good level of usability of the technological tool.

Still with respect to statistical sampling, the survey allowed for an observation of the level of use of this technique in financial auditing, for both testing internal controls and for substantive testing of accounting records and their underlying documents and transactions. Graphic 10 illustrates the results.

Statistical sampling is essential for account certification, since one must form opinions on the set of acts and facts of management and not only on actually tested items. It is necessary to extrapolate conclusions to all of the items of the set that the sample refers to. The survey confirms this logic, but it highlights the differences between tests of control and

tests of detail, in line with ISSAI 1530, that deals with audit sampling.

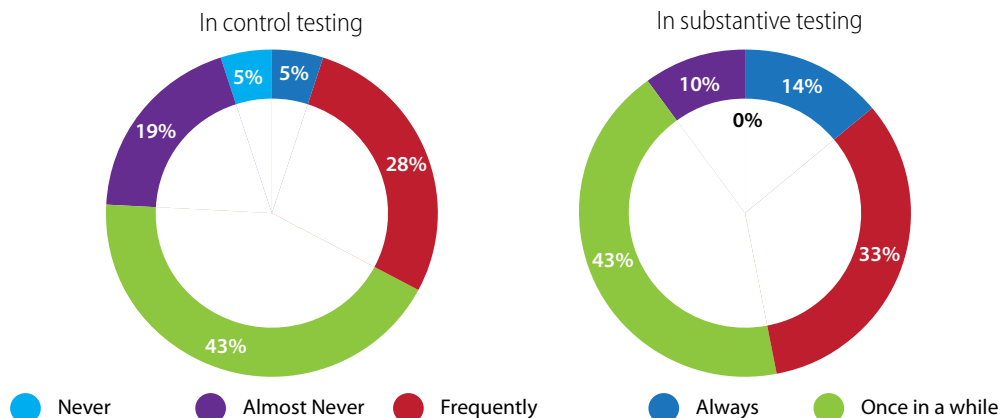
In the risk-based audit approach, knowing, evaluating and testing internal controls is critical for an auditor to develop a conviction, issue an opinion and certify quality for numbers and the regularity of management as a whole. The survey also allows for identifying the importance of audit evidence obtained by evaluating internal controls. In Graphic 11, one can analyze the level of use of evidence derived from substantive procedures and evaluation of controls.

In addition to these sources of evidence, many SAIs also indicated that they rely on the work of other auditors, whether they are internal or outsourced independent auditors, in line with the international standards (ISSAIs 1600 and 1610). This posture, coupled with evaluations of internal controls, shows that, given the complexity and comprehensiveness of government agencies, it is not possible to concentrate all the responsibility for management control in a single institution. More and more, the need for integrated, cohesive and efficient public management control systems becomes clear.

As a last observation about this dimension of the survey, peer review is another key factor to ensure that financial audit procedures and techniques are being adopted in tune with international standards and best practices. In the survey SAIs were asked how often they subject their financial audit function to external quality reviews by peers.

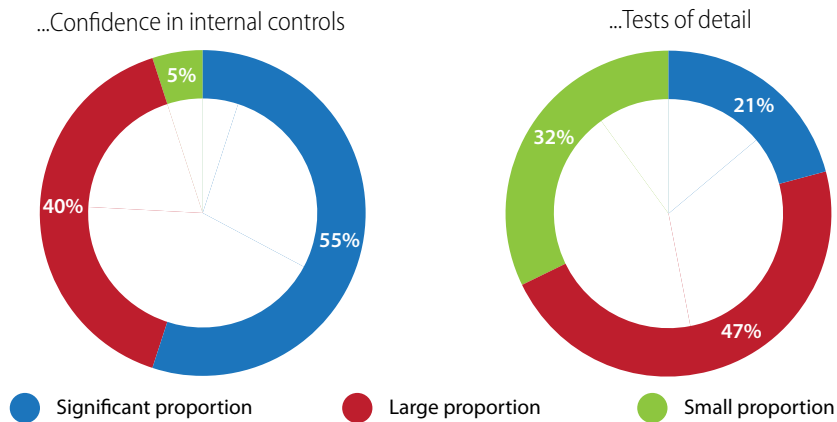
Most of the 19 SAIs that answered this question submit themselves to periodic external quality reviews. The periodicity of such reviews varies. Three of them reported that they go through annual reviews; two of them, at three-year intervals. Four others go through peer review every four years or more. One of SAIs

Graphic 10:
Level of use of statistical sampling



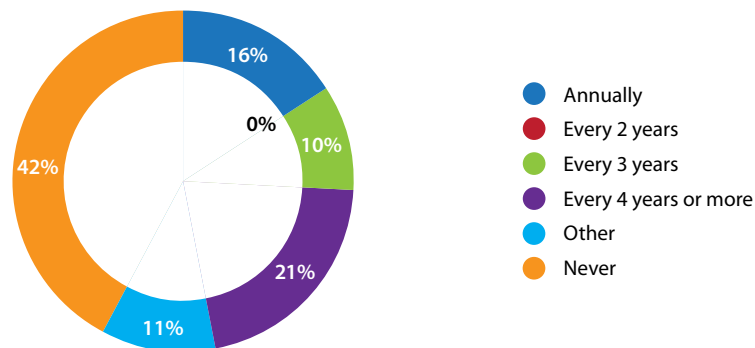
Graphic 11:

Proportion of evidence obtained from...



Graphic 12:

Periodicity of peer reviews of the financial audit function



that answered “other” periodicity remarked that it had a peer review for the first time in 2013. In short, one observes that the use of peer reviews is a trend, even as a way of following INTOSAI guidance (2007).

6. REPORTS AND IMPACTS: HOW TO COMMUNICATE RESULTS?

The first step in assessing the impact of an activity is identifying its objective and target audience. The objectives of a financial audit have been already identified at the beginning of this paper. The main users of audit opinions on financial statements will now be presented according to the surveyed SAIs.

The legislature, the media, the general public (citizens, taxpayers and users of public services) and

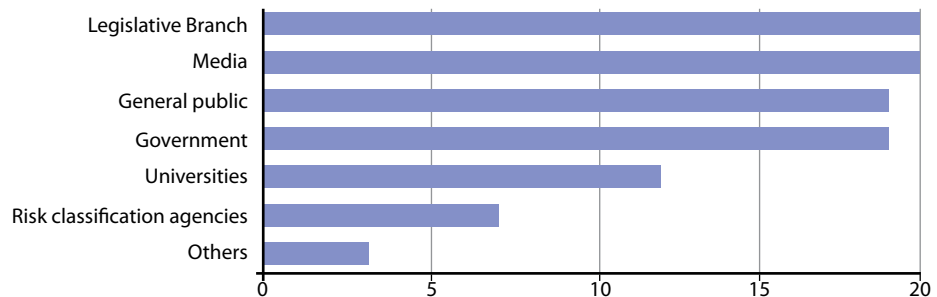
the government are the main users. For users who are external to government, a clear and objective opinion is what is most important: is it possible to trust the government or not? For government, in turn, financial audits lead to several recommendations for strengthening internal controls, thus allowing for the risk of errors in government figures to be reduced.

The SAIs were also asked about audit opinions on the consolidated accounts of their respective governments in three distinct moments: the year before (2012, since the survey was carried out in 2013), five years before and ten years before.

Some pieces of information can be drawn from Graphic 14. One of them is related to the prevalence of opinions without reservations, revealing the high quality of the financial reporting of the governments referred to

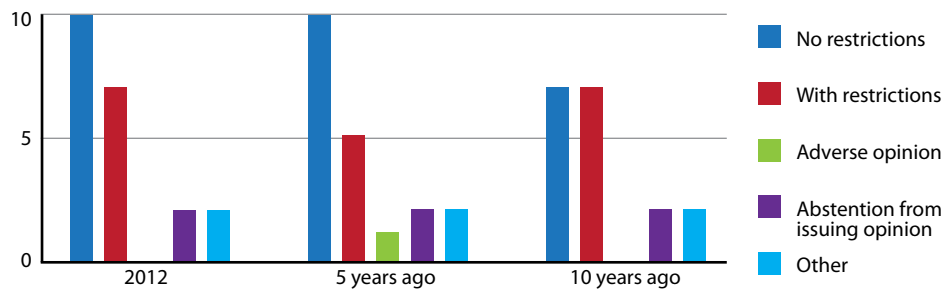
Graphic 13:

Main users of financial audit reports in the surveyed SAIs



Graphic 14:

Audit opinions on consolidated financial statements of the governments of the surveyed countries



by the SAIs that marked this option in the questionnaire. Another one refers to the increase in opinions without reservations. The disappearance in 2012 of the adverse opinion indicated by a SAI five years before is also worthy of mention. Finally, special mention should also be made of the use of the so-called “disclaimer of opinion” by two of the surveyed SAIs, indicating their inability to obtain sufficient and appropriate evidence to form an opinion.

The SAIs were also asked about the main errors that lead them not to issue an opinion without reservations. The following issues were mentioned:

- incomplete reporting of actuarial liabilities of public servants and contingent liabilities arising from lawsuits;
- insufficient quality of inventories and assessments of military and real estate assets;
- flaws in accounting records related to investments;
- inconsistent evaluations of highways;
- errors in the consolidation of transactions between government agencies; and
- weaknesses in internal controls related to IT, management of non-financial assets, people management, among others.

From the perspective of the impacts of financial audits, two questions are insightful and are intrinsically related. One of them is related to the risks of not having a strong financial audit function in a SAI. The other one refers to the benefits observed by SAIs in conducting audits of financial statements.

The question on risks was open, to be filled out freely. Nevertheless, some of the highlighted risks were recurrent among the SAIs. The main risks they indicated are the following ones:

- weak public governance;
- increased risk of fraud and corruption;
- materially relevant errors in financial statements;

- flaws in transparency and accountability on the use of public funds;
- noncompliance with laws and regulations;
- low confidence in the accuracy of information provided in financial statements;
- negative impact on the reputation and credibility of SAIs, as well as on their capacity to fulfill their mandates;
- increased risk of weak internal controls;
- increased risk of Parliament not being well informed about the financial management of government agencies; and
- increased risk of not identifying other areas that should be the object of an operational audit or a special-purpose audit.

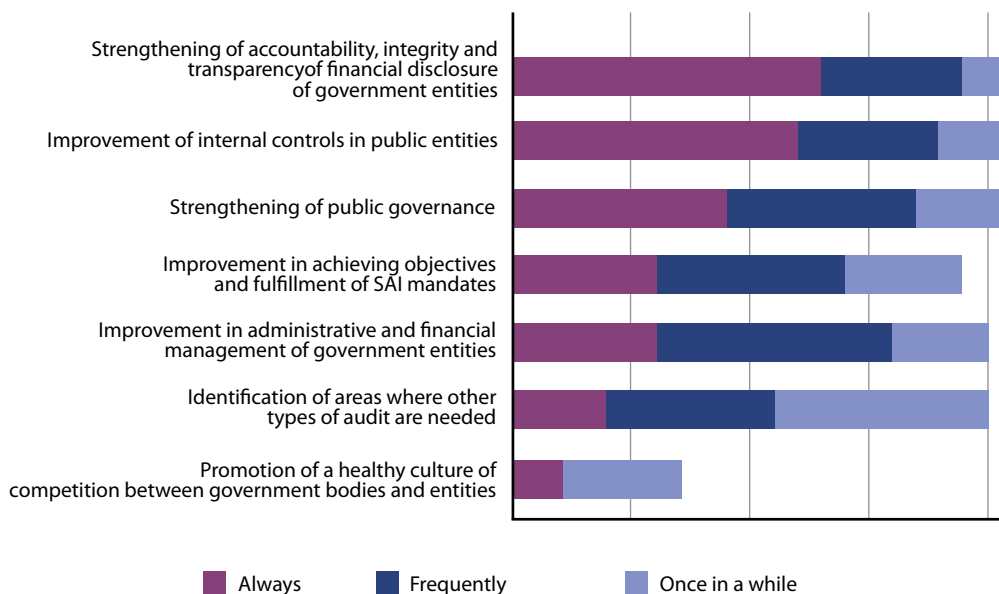
Therefore, the risks that were pointed out range from institutional and managerial risks to economic and social risks. The other side can be observed in the benefits of conducting financial audits, according to the surveyed SAIs. Graphic 15 summarizes the benefits that are obtained to some extent.

The benefits corroborate what was highlighted as risks derived from the lack of a strong financial audit function in a SAI. Strengthening of accountability, integrity, transparency, governance, internal controls and financial management in the public sector creates a positive political and administrative environment for implementing public policies and for foreign investment in the country (IIA, 2012).

7. CONCLUSION

After analyzing this huge amount of information, one can better understand what financial audit in the public sector is and what it is intended for. In the introduction of this paper, the importance of the word trust was mentioned. The greater the confidence, the lower the asymmetry in information and the less conflicts of interests will occur.

Graphic 15:
Key benefits of the financial audit function of the surveyed SAIs



To conclude this text, the value of the word certainty, which can be seen as the other side of the coin, must be highlighted. When one is certain about something, his or her predisposition to trust will be greater. In this regard, the role of SAIs is to make stakeholders in government certain of the level of commitment to comply with legal provisions and with contracts and agreements in a transparent and efficient manner. The greater the trust, the lower the cost of mistrust on the part of third parties in relation to governments, i.e. members of parliament, suppliers, investors, citizens, taxpayers or users of public services. Maintenance of credibility by promoting public trust can improve competitiveness and productivity and lead to innovation in the public sector as well as in the private sector (NAGY et al, 2012).

A good example of the effect of lack of confidence can be observed in the Brazilian budgetary process. Excessive detailing of budgets reflects the need of the Legislative Branch to oversee closely what the Executive Branch is executing. TCU has a key role to play in reducing this mistrust between the two branches. Another example can be seen in recent downgrades of debt risks of sovereign debt and of several banks and extensive use of investments in government securities.

There should be no doubts about the reliability of figures that have a direct influence on the Brazilian political, economic and social systems. Some examples are: i) amount of revenues that

are to be shared with states and municipalities; ii) indicators used to monitor tax limits and minimum amounts to be allocated to the education and health care sectors; iii) social security and actuarial deficits; iv) debt stock and interest expenses; v) tax, social security, and property revenues; and vi) depreciation of public assets.

Accordingly, independent, annual and comprehensive certification of the accounts rendered regarding allocation of public resources is essential to ensure credibility to governments and security to society (IFAC, 2013). To this end, financial audit is a tool at the same time traditional – due to its disseminated use all over the world for several decades – and modern – because of the new approaches based on risk and on timely correction of flaws.

It is worth noting that financial audit is not a remedy for all problems regarding financial health of governments. If we compare the auditor to a doctor, financial audit would be the equivalent to some cases in family medicine in which routine appointments are very important in order to avoid bigger problems in the future. That said, this type of audit completes the portfolio of audit tools of the SAIs and have a preventive and corrective role that is fundamental to ensure proper functioning of government bodies and entities and, consequently, ensure greater capacity and productivity in the delivery of public goods and services.

Based on the results of the survey presented in this paper and on several diagnosis made during

the past three years, in partnership with the World Bank, TCU is structuring a strategy to strengthen its financial audit function, seeking excellence by adopting international standards and good practices. Consequently, it will be able to add increasing value to Brazilian society.

With these final observations, I would like to thank the SAIs that participated in the survey and the World Bank for its financial support that enabled implementation of the financial audit project.

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