

Performance auditing in governments

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Abstract

Governments function differently from business organizations. Thus, performance or operational auditing becomes necessary to replace the measure of success evidenced by the latter through the measurement of profit.

Governments are evaluated through performance auditing by measuring efficiency, economy, and effectiveness. Unique planning, specialized staffing, government oriented scope and government management reporting constitute the parameters of a performance auditing model appropriate for government officials and stakeholders.

Introduction

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

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

The concept of internal auditing in government was not a new idea, relatively speaking. It was practiced in China about 4,000 years ago. There the validity of the handling of the emperor's resources was the subject and the auditing paralleled the early development of inventory accounting methods. This concept has continued to flourish in business practice, however it was not until the mid 1900s that the expansion into performance auditing was started in the US states of Michigan and California, and in several of the larger US local governments.

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

Uniqueness of the government operations

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

There are significant operational differences between the public and private sectors[1].

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

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- reward employees for political activities or seniority rather than for efficiency and productivity.
- *Intense scrutiny by the media and public-interest groups.* Since government resources come from the public in the form of taxes, the government is fair prey for the media and public-interest groups. Government officials, thus, exert much time and effort in protecting themselves, which is counterproductive to innovation and risk taking.
 - *Emphasis on stability and reliability.* The emphasis in government is on reliability, accountability, and legality rather than on maximum effectiveness and flexibility.
 - *Atmosphere of control and mistrust.* Since the government worker is subject to strict controls designed for the lowest common denominator in capability and trust, the capable and trustworthy employee may conform to these low expectations.
 - *Difference in status.* Working for the government is, in many ways, considered a lower-status occupation than working for private-sector organizations. This situation is a morale problem in many government agencies.

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

Basic premises

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

Public officials and others entrusted with handling public resources are responsible for applying those resources efficiently, economically, and effectively to achieve the purposes for which the resources were furnished.

Public officials and others entrusted with public resources are responsible for complying with applicable laws and regulations.

Public officials and others entrusted with public resources are responsible for establishing and maintaining effective controls to ensure that appropriate goals and objectives are met; resources are

safeguarded; laws and regulations are followed; and reliable data are obtained, maintained, and fairly disclosed.

Public officials and others entrusted with public resources are accountable both to the public and to other levels and branches of government for the resources provided to carry out government programs and services.

Audit of government reporting is an essential element of public control and accountability.

Public officials have a responsibility to provide audit coverage that is broad enough to help fulfill the reasonable needs of potential users of the audit report. Auditors can assist public officials and others in understanding the auditors' responsibilities and other audit coverage required by law or regulation. This comprehensive nature of auditing also highlights the importance of auditors clearly understanding the audit objectives, the scope of the work to be conducted, and the reporting requirements.

Performance auditing contributes to providing accountability because it provides an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision making by parties with responsibility to oversee or initiate corrective action.

To realize governmental accountability, the citizens, their elected representatives, and program managers need information to assess the integrity, performance, and stewardship of the government's activities.

The comprehensive nature of auditing places on the audit organization the responsibility for ensuring that:

- the audit is conducted by personnel who collectively have the necessary skills,
- independence is maintained, and
- applicable standards are followed in planning and conducting audits and reporting the results.

A recommended plan for government performance auditing

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

- Every government should use performance auditing to help management to maintain comprehensive internal controls – especially for areas where there is a high degree of risk.

- The performance audit operation should be established formally by legal charter.
- The audits should be conducted in accordance with a body of professional standards such as the *US Government Audit Standards (Yellow Book)*.
- Performance auditors should report to the head or deputy head of the government or to an executive branch audit committee. (Note: in many cases such reporting is made to a legislative committee or highly placed official.)
- The head of the performance audit function should hold a college degree, possess adequate experience, and have a professional certification.
- All audit reports should be available to a government audit committee.
- External impairments such as: external influences or limitations on audit scope; interference on audit procedures; time restrictions; interference in the personnel management processes; restrictions of available resources; authority to override audit judgment; jeopardizing continual employment of audit staff members.

On an overall basis performance auditors should be removed from the political process.

Politics can completely destroy the element of independence. Also, there must be a presumption of independence as well so as to establish the credibility of the audit process.

Scope of the performance audit

Governments are not operated on a profit or loss basis. There is no direct relationship between the revenues received by a government and the various outputs and outcomes achieved by the government organization. Thus, there is no direct relationship between the input of resources by the government and the results of the government's operation as there is in the private sector. This phenomena was recognized in the early 1970s when the US government developed its *Government Audit Standards (The Yellow Book)* and the governmental work group that generated these standards believed it expedient to substitute certain other relationships to replace the traditional profit and loss approach and to expand the scope of the usual audit process.

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

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

Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency.

Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other

Use of appropriate staff to conduct the audits

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

1 Qualifications

- The staff should collectively possess the knowledge and skills necessary for the performance auditing operation. For example: government operations, management principles, and interpersonal relationships.
- The staff should have a complete knowledge of government operations, accounting, and auditing procedures.
- Where specialized skills are not present, such skills should be obtained through the use of outside sources.
- The audit staff should be required to participate in continuous education activities.
- The staff should be proficient in communication and in the behavioral aspects of the audit process.
- The staff should be computer literate.

2 Independence

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

authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

These aspects of auditing also can be applied to organizations in the private sector. However, they are more diagnostic and indicative of problem areas. Thus government they are substitutes for the wellbeing status of the government.

There is an additional area of coverage in governmental performance audits that is unique. That is the attention by the auditor to compliance with statutes, laws, and regulations. Because the government may do only the things that it is authorized to do, and in many cases using the methods that are prescribed. Thus the compliance audit assumes a major part of the governmental audit activity, not necessarily replicated to the same degree in the private sector. The compliance audit also applies to determining compliance with contracts, grants and other instruments both direct and indirect.

The audit of internal controls

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

- lack of segregation of duties;
- lack of reviews of transactions, accounting and systems output;
- lack of safeguarding of assets;
- intentional override of control systems;
- absence of control tasks such as reconciliations;
- absence of control consciousness in the organization; and
- deficiencies in design of control systems e.g. internal check and documentary controls.

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

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

Privileged and confidential information

Governments are unique in that there is usually information that is prohibited from general disclosure. The information is provided on a need-to-know basis only to persons authorized by law or regulation to receive it (*US Government Audit Standards*, 1994, p. 97). If the audit report omits such information, the audit report should state the *nature* of the information omitted and the reason why it is omitted.

Implied here is the requirement that the auditors who are working in the area where such information is available must be cleared for the exposure to the restricted information. It also means that the audit organization must have secured areas for the storage of the restricted information. Where the transfer of information is necessary, adequate security provisions must also be provided.

Government performance audit reporting

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

- be available to the public[3];
- be open to the media on a timely basis;
- provide timely information to all appropriate levels of government management.

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

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

- Noteworthy accomplishments by the auditee.
- Items needing further study.

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

Conclusion

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

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

Before setting spending priorities, government leaders need to know:

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

In today's economy, all levels of government face serious funding problems. Demand for government services continues to grow, but

available funding is not keeping pace. Citizens are unwilling to tolerate tax increases, but the responsibilities of governments are increasing. Performance auditing can contribute materially to the resolution of this situation.

Notes

- 1 The list of unique aspects of government are those used by the author in lectures, augmented by ideas obtained from Eddy (1981).
- 2 The premises are stated in abbreviated form. Reference to *Government Audit Standards* published by the US General Accounting Office, June 1994, pages 8 to 10, should be made for the complete explanatory language.
- 3 Except for classified or confidential reports or information that is excluded in compliance with statute or regulation (see previous section). Presumably includes those with a "need to know" and those who, for further coordination, should be informed.

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