

Public Financial Management: Audit and Compliance

Module Introduction and Overview

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1 Introduction to the Module

Welcome to the module *Public Financial Management: Audit and Compliance*. Audit is an evolving function in the public sector. It has evolved from simply checking that money has been spent in the ways that governments intended and ensuring that none was stolen or misappropriated. Now it is also concerned with evaluating whether the application of funds represents good value for the taxpayer and, more recently, to evaluating whether government policies have been effective. The early functions of audit (*ie* the detection of fraud and technical errors in accounting) still remain but have now been overlain with new, more evaluative, functions.

The institutions carrying out audit have also evolved. All governments have some form of national auditing body or Supreme Audit Institution. These institutions are often very old (the French Cour des Comptes dates back to 1319), but some, such as China's Audit Administration, established in 1983, are more recent. As with the evolution of the audit function, these national audit bodies have also expanded their role over time, and many, as you will see in this module, now include forms of policy evaluation in their remit. At the same time, there is internal audit, offering an independent assessment of an organisation's risk management, control and governance processes, from within the organisation itself.

The purpose of this module is to give you an understanding of the different roles and purposes of audit and to enable you plan and commission audits. In addition, it will enable you to carry out some of the functions of the auditor. This is an ambitious aim, and the module ranges over the spectrum of audit activities, drawing examples from detecting fraud to evaluating the success of policies.

The module will use a range of examples and case studies to illustrate the theoretical principles and assist you in understanding and applying auditing in the international context. There are also many review questions and exercises incorporated into the module to facilitate your learning.

After completing this module, you should be able to discuss the international scientific framework of auditing and evaluate its importance and its linkage with governance. You will also become aware of how the audit department can help the highest level of management to discharge their responsibilities.

2 The Module Authors

John Aston holds six degrees and professional qualifications covering a wide area, including theology, accountancy, finance and management. He has worked in local government, in private practice and for the Chartered Institute of Public Finance and Accountancy in their technical division. He has carried out a range of roles such as Principal Accountant, Head of Audit, Assistant Secretary and Director.

John has worked as an academic at Brunel University, where he was subject head, and at SOAS University of London. He is a visiting fellow or associate at University College London, Glyndwr University London, Henley Business School, College of Estate Management and The London School of Commerce. He has taught in many countries of the world, ranging from the Bahamas to Thailand. He has also trained executives from some of the world's largest companies including IBM, DHL, Friends Provident and Cable and Wireless.

Alberto Asquer is the Academic Director of the Public Policy and Management Programme at the Centre for Financial and Management Studies, SOAS. He holds a degree in Economics from the University of Cagliari and a Research Doctorate from the University of Salerno, Italy. He also holds an MSc in Management and obtained his PhD at the London School of Economics. Before joining SOAS, he taught financial accounting and management control in public sector organisations at the University of Cagliari, Italy.

His studies on regulatory reform of infrastructure, privatisation and liberalisation of utilities, and organisational change in public sector organisations, have been published in the following: *Governance; International Public Management Journal; Public Management Review; Annals of Public and Cooperative Economics; Journal of Comparative Policy Analysis; International Journal of Public Administration; Utilities Policy; Water Policy and Competition and Regulation in Network Industries*. He is also a chartered accountant and accounting auditor in Italy.

Norman Flynn is the Director of the Centre for Financial and Management Studies, SOAS, as well as Academic Director of the Public Financial Management programmes there. He has also been Chair Professor of Public Sector Management at City University of Hong Kong and has held academic posts at London School of Economics, London Business School and the University of Birmingham.

He has written about public sector management in the United Kingdom, Europe and Asia, public sector reform in developing countries and about the relationship between business government and society in Asia. Recent books include *Public Sector Management; The Market and Social Policy in China* (edited with Linda Wong); *Miracle to Meltdown in Asia: Business, Government and Society* and (with Franz Strehl) *Public Sector Management in Europe*.

Antonio-Martin Porras-Gomez is a lawyer and an economist by training, who has been working as a researcher on issues of public policy and public administration for more than eight years. He holds Degrees in Law and in Business Administration, studied International Relations and Diplomacy at the Spanish Diplomatic School, has an LL.M in Constitutional Law and a PhD in Law by University of Seville (2013). He has worked with the London School of Economics, SOAS and now the American University of Beirut.

3 Study Resources

This study guide is your main learning resource for the module as it directs your study through eight study units. Each unit sets specific reading tasks from the key text and module readings. The module also comprises a range of case studies.



Key text

There is one key text for this module:

Marlene Davies and John Aston (2011) *Auditing Fundamentals*. Harlow UK: Prentice Hall

This key text is comprehensive and written in an informative and helpful manner. It provides a comprehensive insight into the growing area of auditing as an important science. The main thrust of the module and the key text is about risk identification, compliance with policies and the law, testing and providing assurance to management, politicians and all other stakeholders.

In addition, there are module readings, containing academic articles and audit reports.

4 Module Overview

The module is structured around eight units, which should be studied on a weekly basis. It is expected that studying each unit, including the recommended readings and activities, will take between 15 and 20 hours. However, these timings may vary according to your familiarity with the subject matter and your own study experience. You will receive feedback through comments on your assignments, and there is a specimen examination paper printed at the end of this introduction to help you prepare for the final examination.

Unit 1 Public Sector Auditing

- 1.1 Introduction to Auditing
- 1.2 Accountability in the Public Sector
- 1.3 External Audit in the Public Sector
- 1.4 Internal Audit in the Public Sector
- 1.5 Political Power and Control
- 1.6 The Control of Public Spending in the Genesis of Constitutionalism
- 1.7 The Purposes of Budgetary Control
- 1.8 Conclusion

Unit 2 The Public Finance Control System

- 2.1 The Control Pyramid
- 2.2 Internal Control
- 2.3 External Control
- 2.4 Jurisdictional Control
- 2.5 Political Control

- 2.6 Social Control
- 2.7 Conclusion

Unit 3 External Audit and Reporting

- 3.1 The Role of External Audit
- 3.2 Reporting on Financial Statements
- 3.3 Probity Audit
- 3.4 Verification Audit
- 3.5 Supreme Audit Institutions
- 3.6 Conclusion

Unit 4 Internal Audit and Control

- 4.1 What is Internal Audit?
- 4.2 Internal Audit and Internal Control
- 4.3 Ethical Issues and the Internal Auditor
- 4.4 Public Sector Internal Audit Standards
- 4.5 Internal Control
- 4.6 Cybernetic Control Theory
- 4.7 Conclusion

Unit 5 Risk Assessment and a Systems-Based Approach

- 5.1 Introduction to Risk
- 5.2 Policy and Risk
- 5.3 Risk Management
- 5.4 Systems-Based Auditing
- 5.5 System Documentation
- 5.6 Sampling
- 5.7 An IT Approach to Sampling
- 5.8 Conclusion

Unit 6 Performance Audit I

- 6.1 Introduction to the Concept of Performance Audit
- 6.2 Auditing Performance: Economy, Efficiency and Effectiveness
- 6.3 Performance Audit Criteria
- 6.4 Conclusion

Unit 7 Performance Audit II

- 7.1 Performance Audit in Contemporary Public Administration
- 7.2 The Political Dimension of Performance Control
- 7.3 Performance Audit, Between Accountability and Learning
- 7.4 Performance Audit in the Age of Multi-Level Governance
- 7.5 Implications of the Elaboration of the Audit Agenda
- 7.6 The Learning Component of Performance Audit
- 7.7 Evaluating the Performance of a Good Performance Audit
- 7.8 Conclusion

Unit 8 Fraud

- 8.1 The Problem of Fraud
- 8.2 Fraud and Irregularity

- 8.3 Corruption and Risk in Public Procurement
- 8.4 Preventing Fraud through Internal Control: COSO
- 8.5 Conclusion

This module introduces the core auditing concepts and explores the audit and assurance framework and standards currently available for public sector organisations.

Unit 1

Unit 1 sets the scene by providing an overview of public sector audit, clarifying the similarities and differences between auditing in the private and public sectors. It also considers fundamental issues regarding the position of the public audit function in a democratic, constitutional State, looking at specific empirical examples.

Unit 2

Unit 2 offers an integrated understanding of the public finance control system in democratic states. It offers a comprehensive perspective, where different control subsystems (internal, external, jurisdictional, political and social) build their activities upon each other. Exploring the rationale of each control subsystem, and the interlinkages between them, are the major goals of this unit.

Unit 3

Unit 3 offers a perspective on the role of external audit and the verification approach, against a backdrop of accrual accounting.

The unit also considers and reflects on the role and value of the supreme audit institutions. In this instance, the European Court of Auditors will be compared with the Government Accountability Office in the United States of America and the Auditor General of the Republic of South Africa.

Unit 4

Unit 4 focuses in turn on the approach of internal control and more specifically internal audit, which is quite different from the approach undertaken by the external auditor. The unit covers the internal audit standards. Cybernetic control theory is explained, together with its importance in the public sector. We will also review and discuss the relationship between internal and external auditing, and the role that internal auditors play within public sector organisations.

Unit 5

Unit 5 covers the important area of risk management. Identification and measurement of risk are an integral part of the risk management process. A modern system of assurance is studied here. The auditor will use a systems-based approach – *ie* defining system-control objectives and key controls, and then testing them using compliance and substantive testing. The importance of flowcharting and sampling techniques is studied here, and we also

examine computer-assisted auditing techniques (CAATs), which are used for interrogating large databases and retrieving data that does not conform to a particular pattern.

Unit 6

Unit 6 introduces the important question of performance audit. Together with financial audit and compliance audit, performance audit constitutes the basic function of Supreme Audit Institutions. The unit distinguishes between financial, compliance and performance auditing, delineating the conceptual contours of each one of these audit activities. It analyses the activity of performance audit, breaking it down into the three basic elements of economy, efficiency and effectiveness. It ends with an introduction on possible audit criteria that can be used to audit the economy, efficiency and effectiveness of public programmes and organisations.

Unit 7

Unit 7 continues the discussion on the activity of performance audit. It begins by offering a view on the importance of performance audit in the contemporary public administration, where the verification that ‘the right things are being done’ becomes very important, especially in comparison with the verification that ‘things are being done right’. It offers a perspective on the political dimension of performance audit, and the challenges that this poses to the legitimacy of the performance audit function. The challenges and opportunities for performance audit in a multi-level governance context are also considered, together with a guide on how to evaluate the activity of the performance auditor.

Unit 8

Finally, Unit 8 introduces you to the concept of fraud. This covers fraud, theft and irregularities and the investigation procedures and systems. This unit will show the interconnections between all these concepts. Of course, prevention must always come before detection, and this unit will emphasise the importance of internal control, and control theory. The aim is to highlight the importance of understanding the legal boundaries and enable you to know how to collect valid and reliable evidence.

5 Learning Outcomes

When you have completed your study of this module, you will be able to:

- explain the public finance control function as an activity that involves different actors in the constitutional system
- explain the different rationales with which the different control actors operate in a democratic state
- make comparisons between the different control subsystems
- explain and compare the different forms of audit reporting

- examine the International Public Sector Internal Audit Standards applicable and effective from 1 April 2013 and other internal audit guidelines
- outline the advantages of cybernetic control theory
- carry out a systems-based approach to audit
- use compliance and substantive testing
- explain the various sampling techniques and demonstrate how to use IT to test the whole population
- discuss the concept of performance audit, and what it consists of
- differentiate the role of performance audit from evaluation activity
- define the concepts of economy, efficiency and effectiveness, and evaluate the performance of a public programme or organisation through these elements
- use audit criteria to determine the economy, efficiency and effectiveness of a public programme or organisation
- value the importance of performance audit in the contemporary public administration
- discern the fuzzy delineation between political and external control when it comes to performance audit
- distinguish the two main functions of performance audit: accountability and organisational learning
- assess the performance of a performance auditor
- situate the function of fraud combat within the broader architecture of budgetary control
- discuss how a fraud investigation is carried out, including the legal framework and evidence collection
- explain the main types of classical and contemporary fraud which exist in all countries, developed or developing.