László Nyikos

Independent financial audit – the Westminster model

The institution of financial auditing was introduced in Hungary back in 1930 and, based on the English model, was called certified audit. This method of control was rejected by the socialist system and thrown into obscurity. The inland private (enterprise) sector's external and independent financial audit could only start operating again, its regulation based on the English approach, during the process called political system change. This means nearly six decades had to pass, until the compulsory audit of public limited companies and limited companies with a turnover above HUF 50 million was introduced and regulated, again, by law (Companies Act 1988). The Parliament introduced laws (twice already) about enterprise (trading) accounting standards, and made declarations regarding reporting and auditing principles. The Chamber of Hungarian Auditors[1] was set up as an independent public body, legitimated also by law, which adopted the IFAC's (International Federation of Accountants) auditing standards.

Currently in Hungary the independent financial audit of not only the private sector, but also the majority of public finances and public benefit associations, is carried out by private audit firms. This further demonstrates that the Hungarian public sector is also trying to follow the English model of accountability in its approaches, regulations and practices.

However, we are lagging behind on an historic scale. The activities of the Supreme Audit Office, which operated at European standards for eight decades, were understandably very similar to those of the Austrian audit office. Final accounts were prepared by the Supreme Audit Office, in collaboration with the auditing network, already put in place by the government. (In Austria, uniquely in the world, final accounts are still prepared by the audit office to this day.) This unique Austro-Hungarian model was replaced by the "socialist" control, which remained in place for four decades, using Soviet type people's control as its flagship method. When the State Audit Office (SAO) was put in place in 1989, and the constitutional and legal regulations regarding its operation valid to this day were defined; when the Companies Act was created, and later when the Government Control Office's (GCO) predecessor (Central Comptroller's Office) was set up, our legislators did not pay attention to any of this historic legacy. Neither did they take into account that the goals, practices and methods of a financial audit, carried out in line with international best practice, do not depend on whether the audit takes place in the private or public sector, but rather on the purpose of the audit.

Soon after Hungary started talks about joining the European Union, the State Audit

Office entered into a twinning covenant with the United Kingdom's National Audit Office (NAO), with a view to adopting the English method of controlling and regulating the audit of public funds.[2] Four years later the Parliament announced in a resolution *"…it is considered necessary to fully extend the scope of testing the reliability of reports – by using the financial audit methods – when carrying out a central budget audit…"*[3] The objectives of the initially PHARE-funded SAO-NAO collaboration are still valid in principle. The president of SAO confirmed on many occasions, that he considers NAO to be a long-term strategic partner. In the interest of this, he has already entered into two further bilateral agreements, this time funded entirely by Hungarian resources. The first one states *"the State Audit Office, with the help of the Parliament, would like to build up the financial audit system following the English methods"*.[4]

The English influence is present across the world in the field of financial audit. And not just in external (private or public) audit processes. The Hungarian Institute of Internal Auditors recommends adopting the standards of the American *Institute of Internal Auditors* (IIA) to its members. Recently the internal financial audit of Hungarian public finances have also been pushed towards the English methods. Government legislation was created accordingly and the IIA's standards were put on display on the homepage of the Ministry of Finance.

However, here the culture of being responsible, accounting for and being accountable for handling public funds has not yet developed fully. Coupled with this the state of public fund audit is immensely inconsistent. The purpose, the tasks and the methods of both internal and external (independent) audits are surrounded by a number of uncertainties, misunderstandings and misinterpretations. Incomprehension and conflicts of interest are felt overall, making the speed of adaptation slow, what is more, the direction of progress questionable. The professional level and effectiveness of auditing is very low. Neither public opinion (professional press), nor legislators – to be tactful – know enough about the principles, objectives and methods of the English financial audit procedures. Therefore the purpose of this essay is education in the most noblest sense of the word. More specifically the introduction of the *financial audit* legitimated by the Hungarian Parliament and the operational features of the independent financial audit applied in the United Kingdom, the centuries old Westminster model. The author aims to share the results of a decade's research and experiences with anyone wishing to do a lot more to nationally spread this culture of "accounting and being accountable", which is – for historic reasons, if nothing else – so much more developed than ours.

THE PURPOSE AND PROFESSIONAL CONTENT OF FINANCIAL AUDIT

The independent auditing of public funds and public property (by an audit office) in the United Kingdom serves two main objectives:

- to *provide independent assurance,* to the Parliament and the tax payers (in other words the entire society), that the public funds are used lawfully, as well as to give further information and advice based on the audit's findings;
- to quantify and to announce the results, the *added value,* which was achieved as a result of spending the public funds.

Following on from these two general objectives, the number one (classic) task is to determine whether the institutions handling public funds and public property acted in a legal and lawful manner. This is determined using the *financial audit* method. It is none other than examination of economic organisations' (societies, budgetary and other institutions) financial statements by an external and independent party; an auditor or an audit office. The audit always finishes with an auditor's opinion. The auditor's professional opinion gives assurance, that the financial statements and reports contain valid information. They provide complete and accurate information to the users of the report. If the auditor reaches such a conclusion, he gives an *unqualified opinion,* a validation clause. However, should he find significant errors in the financial statements, in other words if he found that they do not represent a *true and fair* view of the financial situation, he gives a qualified opinion, a counter opinion or may even withdraw from giving an opinion. Financial audit then is an examination centred on the financial statements, and therefore it is also known as the audit of financial statements (or financial statements audit). Since financial statements of economic organisations are typically prepared on an annual basis, financial audit is also an annual obligation.

The second (modern) type of audit office examinations aims to uncover what exactly and how much society gained by the spending of public funds and the usage of public property; what did the taxpayers receive in return for their voluntary and obligatory contributions. To promote not only the lawful but also wise spending of public funds and usage of public property. This is carried out during the course of a value for money examination. (The further details of which are beyond the scope of this article.)

> *Audit office examinations therefore have to ensure first of all the correctness of the accounts. Therefore it is not advisable or logical to carry out value for money examinations without a financial audit. If it is not established first whether there are any significant errors in the financial statements, and if there are, these are left undiscovered, then any value for money type examinations could be built on quicksand.[5] (In the United Kingdom, these examinations were only legitimated a quarter of a century ago.[6])*

NAO's mission is to help the nation spend wisely. Its basic activity, the financial audit produces three results.

❶ Ensures that the Accounts Audited by the C&AG give a true and fair view of the budgeting and handling of financial funds; they are correct as they have been prepared in line with the accounting principles and applicable legislation, and the transactions within are the result of appropriate authorisations. This is called certification audit.

❷ Carries out a full assessment of the risks associated with the financial regulation of central budgetary organisations, and reports any significant deficiencies to Parliament. This is called risk audit.

❸ Provides constructive advice to the audited institutions, thus helping with the regulation and processing of their financial matters.

Financial audit = certification audit + risk audit

The independent financial audit of public finances within the public sector is similar in many ways to the audit of companies in the private sector.[7] The reason for this similarity is that the national auditors of budgetary institutions check compliance with accounting principles the same way as private auditors examine the statements of private companies:

- the principle of *existence*[8] means that all assets and resources (active and passive) truly existed on a given day (typically the first or last day of the financial year);
- the principle of *rights and obligations* means that all rights (receivables) and obligations (debts) on the given day belong to

the institution, according to current and relevant legislation;
- the principle of *occurrence* means that a given transaction or financial event really did take place during the financial term in question;
- the principle of *completeness* means that all financial events and transactions, which took place, are accounted for, and there are no assets or resources missing from the books;
- the principle of *valuation* means that the assets and resources are recorded at their appropriate carrying value;
- the principle of *measurement* means that transactions and financial events need to be correctly measurable and income and expenditure need to be accounted for in the correct financial term;
- the principle of *presentation and disclosure* means that the recording, coding and reporting of bookkeeping entries is in accordance with the stipulations of the reporting statement.

These seven requirements (as accounting principles) apply to all financial statements, regardless whether they were prepared in the private or public sector. As a result, the application methods and processes of the accounting principles in this area are identical, no matter if it is an audit company examining a private business or it is the audit office checking a budgetary institution.

There is however an eighth requirement, the principle of *regularity*. In any state under the rule of law the government's jurisdiction comes from the parliament. As a result, internal regulations and decisions regarding the obligations and funding (financial transactions) of budgetary institutions can only come into effect following proper authorisation given by the parliament, and later on the treasury. In the case of private companies the principle does not need to be considered, as the requirement does not exist. Proprietors do not need external authorisation on how they can use their profits after taxation. To them the freedom of enterprise is key. (Naturally there are exceptions: any grants received by the private sector from a government-funded program can only be used according to governing laws or contracts.) In the public sector the reverse is true, any spending of public funds needs to be authorised by the relevant authority.

The audit, examining whether the expenditure (or the collection of funds) took place according to parliamentary authorisation, approved targets and issued state guidelines, is referred to as compliance audit in English specialist literature. Therefore the financial audit carried out by the audit office is more comprehensive than by a private audit firm. It is more extensive than the latter; as it includes checking if there is (parliamentary) authorisation behind every transaction recorded in the books and reported in the financial statements. In this case we can talk about a more comprehensive meaning of the financial audit, the financial and regularity audit.[9]

Certification audit

Budgetary institutions announce a variety of information, data and assertions in their financial statements and in their report of their internal control system's operations. Certification audit is an essential and invaluable part of the financial audit. Its purpose is to check whether the accounts were drawn up following the accounting principles, and whether the report was prepared based on those accounts, furthermore to certify the data and statements included in the report.

Materiality and its role

Certification audit, like any other audit, has three objectives. Above all, it needs to establish for a fact, that the financial statements contain no significant flaws or irregularities. The English approach makes the assumption that the published figures about assets, resources, income and expenditure are never without mistakes. There is no such thing as the perfect statement (the same way that there are no perfect human beings). Therefore it is not the auditor's job to look for and find every single (accidental or deliberate) mistake. This would be impossible in the case of hundreds of thousands or even millions of transactions, but even if it could be done, it would not be practical given the time frame. The purpose of a financial audit is not to find, publicise and put right every problem but to uncover fundamental mistakes. This is why materiality is a basic concept of accounting and financial auditing. Financial audit is not fault finding by nature ("if I am looking for mistakes, I have to find some, no matter what"), but more like a partnership; working together with the audited institution's managers to filter out significant errors and to help produce correct accounts. This is what serves the interests of the taxpayers, the country, the nation, and not making an example of the ones who made mistakes, big or small.

The users of financial statements (proprietors, institutions etc.) do not need absolute precision either, when, having read the statements, they make various decisions. They have no need for the irrelevant details. The question is what makes a piece of information material? The same expense can be important in one case and trivial in another.

> *A man wants to give his friend a bottle of fine quality wine for a special occasion. Scanning the window of speciality shop, he chooses a suitable bottle. When he enters the shop, he finds out that the wine he wanted costs Ft 2000 (circa £5 or $10 – trans.) more than the amount he wanted to spend. He changes his mind and settles for a different bottle of wine. The same man wants to change his car. When he goes to the car dealer's salon, he is informed that the actual price of the car is now Ft 2000 higher than the price published in the prospectus. He acknowledges the information and purchases the car. The difference in price is Ft 2000 in both cases, and in the first instance it is significant and affects the customer's decision, while in the second case it does not.*

However, materiality also has qualitative criteria, dependant on the nature of things, which cannot be measured and expressed in numbers. If, for example, a political party unlawfully accepts a donation for Ft 1 million, then it can be viewed as a significant mistake, even if the budget of the party is five hundred times the donation. Context can also become a qualitative criterion, in which the smaller or larger mistake took place (for example some of the petty cash vouchers and paying in slips at a foreign representative office are missing). Materiality therefore cannot be defined mathematically, as it has not only quantitative but also qualitative aspects. The materiality threshold is not determined by legislation or professional standards, but by the auditor, having examined and studied the subject of the audit, the budgetary institution, their appropriation accounts etc. Any piece of information or data can only be declared as material, knowing the circumstances. This is where the auditor's responsibility lies, amongst others, and it is also the reason for his exceptionally high pay.

> *The same amount of deficit would be viewed differently if it occurred in a financial report about a motorway construction program of the order of HUF 100 billion, than if it was noticed by the auditor of the financial statements of a small village council. In the former case the legitimacy of transactions up to the value of, say, HUF 1 million (spent, for example, on water for the workers) would not be examined, as opposed to the*

> *latter, where the unauthorised drawing of the same amount as standard cost could be classed as material.*

The general concept of materiality is clearly defined in the international standards[10] of IFAC, and following on, INTOSAI: any information is considered material, if the misrepresentation of that information in the financial statements could influence the economic decisions of the user. Omission of such information could be regarded as significant as the misrepresentation of it. (Because, for example, the Parliament would have made a different decision if they had known about the matter.)

Materiality is determined at the level of the financial statement as a whole and also in the case of individual reports, account balances and transaction types. What needs to be determined, is the maximum limit for errors, below which it is still acceptable by the users.

> *Regarding the audit of the Government's financial statements, their final accounts, for example, it is an important piece of information if the central budget is missing, as the precise disclosure of it could be the starting point when making definitive economic policy decisions (e.g. raising taxes). Determining significance is also given to the disclosure of information about the assets and the liabilities of the state. The same way, that the audit office report (their validation clause) is presented to the parliament, which assures the taxpayer that the statements "add up" (or not), because they do not (or do) contain significant errors.*

As materiality cannot be "determined" once and for all, NAO for example does not give an absolute size or measure (which their auditors would need to follow in the case of each audit), but, like other audit institutions, suggests a limit list of priority to its auditors to prepare their decisions about estimates. Of course in certain cases the users of statements (parties of the parliament for example) are more sensitive to smaller errors, as well. They have a lower "tolerance threshold" in the cases of, say, disclosure of their leaders' earnings, foreign travel expenses or unnecessary wasting of money. NAO does not alter the general concept of materiality in these cases either, but "extensifies" the audit processes in areas, where a higher degree of precision can be expected.

The nature of findings

Throughout the course of the audit, the auditor assesses and evaluates the financial statements. He compares the facts (the transactions chosen or "narrowed down" with the help of the materiality threshold) against the accounting principles, the law, relevant legislation and standards, and then, based on his comparison, he determines, whether bookkeeping and the final accounts were carried out in accordance with the various requirements. However, not all pronouncements can be classed as findings. The statement, for example, that "the expenditure on travels abroad is 20% higher than that of last year" is not a finding in itself. It only becomes such, if the auditor has classified the fact (expenditure on travels abroad) as being above the materiality threshold (material information), and in light of this he "further added" the audited budgetary institution's originally authorised expenditure amounts, the reasons for the increase in travel expenses, and he also evaluated the consequences of the extra expenditure. If he has done all of the above (as a result of rating the increased expenditure a material mistake), he would record his assessment in the auditor's report. However, if the fact (expenditure increase) is not a material mistake (wasteful action), but the auditor does not want to ignore it completely, he could contact his relevant superior either face to face or via a management letter. But these forms of communication are not for the general public.

The opinion

It is the responsibility of the budgetary institution's management, to prepare the financial statements and send them to the Parliament and to NAO. It is the C&AG's (The Comptroller and Auditor General) duty and responsibility to form and publish an opinion about the statements, once he or she has acquired enough evidence to do so. The collection and evaluation of necessary data is carried out in accordance with audit standards *(manuals)*.

Following the collection, comparison and evaluation of the facts, the entire statement needs to be validated, which means the announcement of an unequivocal opinion. The "end product", the output, the most important result of the financial audit is the audit opinion. This, as we mentioned earlier, can be an unqualified opinion, in other words validatory, which gives assurance that there are no material errors in the statement. If there are (accidental or deliberate) material mistakes, then a qualified opinion must be given, with an itemised list naming all the material errors.

When the auditor forms an opinion about the examined financial statements, he cannot aim to achieve absolute certainty. Such requirements are not expected by the professional standards. Financial auditing can only be selective in nature, based on sampling, as the examination of each transaction would prove costly and is not practical. Even if, theoretically, one hundred per cent of the transactions could be checked, their correctness could still not be guaranteed, and any foul play involving a possible third party could sometimes still remain undiscovered. This is the reason why the auditor, having finished his task, does not give a full, but only reasonable insurance with his opinion, in other word he does not declare an absolute guarantee, but reasonable assurance.

Besides materiality, reasonable assurance and sampling are such key phrases of the financial audit and its result, the audit opinion (referred to as záradék in the relevant Hungarian Finance Act[11]), that without their definition, without their unequivocal and logical application, the essence of financial audit could not be understood and the audit office's audits could not be carried out successfully. To be able to serve its purpose and be socially beneficial, the opinions about the financial statements have to be convincing. The practical certainty therefore has to be at a high level. International audit standards set the certainty level target at 95 per cent. SAO also adopted this figure.[12] This means that there is a maximum 5 per cent chance of the auditor giving an untrue or "unfair" opinion about the statements.

During validatory audits NAO aims to gather sufficient appropriate audit evidence and acts in line with SAS standards[13]. Audits are typically produced annually, put forward in Parliament and made available for general public inspection. Occasionally there may be mid-year validatory audits, following the Parliament's request for the establishment of a new institution or due to a Government reshuffle (for example the restructuring of a ministry).

Risk audit

Validatory or assurance audit is complemented by a work program, which contains three aspects: risks to regularity, risks to propriety and risks to financial control. Risk assessment is the work needed to be carried out to form an opinion about the financial statements, keeping in mind the C&AG's responsibility towards the entire Parliament, as a statutory auditor.

While the certification audit gives annual assurance about the financial statements, risk audits are not linked to the statements of a particular year

- they do not close by a formal opinion, but with a report, which is written for the budgetary institution or the Parliament;

- they focus primarily on the audited institution and its procedures, not on its financial statements;
- they do not examine the audited institution in its entirety, but the major areas at risk in a certain time period.

Risks to regularity

We have mentioned that compliance audit is an integral part of the auditing of public funds. This is the part, which makes the financial audit of budgetary institutions "more extensive" than those of enterprises, private companies. The difference is due to the business' freedom principle. At the end of the day, all of the activities of central budgetary institutions are based on parliamentary authorisation. Therefore it is the Parliament's legitimate interest, to ensure that their authorisation is followed even if the transactions are for relatively small amounts, considering the total expenditures. It follows that the C&AG must always assess the methods developed to avoid such irregularities. As a result NAO's activities to audit financial statements are extended by risk audits.

Risks to propriety

The demand for propriety, which is difficult to sum up in one word in Hungarian, means that income and expenditure should be treated according to parliamentary expectations.[14] The way it is appropriate to deal with public matters, according to unspoken rules – with the blessing of the Parliament, more specifically, its "audit panel", the *Public Accounts Committee (PAC)*. While the regularity audit tries to determine, whether the financial transactions took place following proper authorisation, propriety is about compliance with professional and ethical principles, known as standards. The latter, though laws or regulations may not describe it, is generally accepted by handlers of public funds. When NAO announces its position about propriety, it usually tries to avoid setting compulsory regulations for others to follow. As much as possible, it tries to examine the measures, which were introduced by the audited institution, following the guidance and suggestions of PAC or other central departments.

Risks to financial control

Internal control system means the system of those management and process methods, which aid the correct keeping (stewardship) and reporting of public funds (accountability), and which prevent or seek out irregularities and unlawful acts. Although the examination of these processes and rules is also a feature of the certification audit, it is not necessary to give an opinion about their effectiveness from a risk point of view. NAO examines the effectiveness of internal financial control, and prepares a report for the budgetary institution's management, or in certain cases, if there are serious discrepancies, for the Parliament, too. Public Internal Financial Control (PIFC) had an important role to play everywhere when joining the EU.[15]

NAO's certification and risk audit activities also deal with regularity, but for different reasons. During the course of a certification audit about the correctness of financial management, for example, they can often find risk factors, which they "shift over" into risk audits. (NAO also has professional guidelines about auditing specific risks.)

Client service

The Westminster model's financial audit is carried out, not least to allow giving clients constructive advice. Therefore the reaction to partners' requests and the replies to their questions need to be positive. This could mean tasks pointing beyond the normal audit activities. Advisory activity, based on the individual's audit experience and the auditor's professional knowledge, could be the following

- advice about the accounting system already in place or under development;
- advice about membership in controlling or consulting bodies;
- organising training for the financial and accounting apparatus;
- lecturing at seminars and conferences organised by the partners.

NAO always suggests caution, pointing to the risks of damaging its independence and avoiding conflicts of interest. Besides the official written opinion, face to face advice given during the audit also has a role to play, which are usually about the possibilities to correct small financial deficiencies. At the end of the audit management letters are written, where more significant matters are brought to the attention of management (for example the auditor's experience about the work of the internal control system), followed by advice given to them. These documents are not for the public. About 500–600 of them are written every year, suggesting 1500–2000 substantive changes, the majority of which is accepted by the addressees. The reason being that NAO's financial auditors are highly qualified professional accountants.[16] This is what allows them to answer hundreds of questions from the Members of Parliament every year. (The main features of financial audit are summarised in *Table 1.*)

INSTITUTIONAL STRUCTURE AND SCOPE OF AUTHORITY OF FINANCIAL AUDIT

In the United Kingdom the roots of auditing public funds reach back as far as the fourteenth century, but the outlines of its current structure were only drawn up in the middle of the nineteenth century as part of the reform of the central administration of the time. This is when it was first specified, that all government departments, which were given public funds by the

Table 1

<table>
<tr><th colspan="3">PURPOSES OF FINANCIAL AUDIT</th></tr>
<tr><td colspan="2">1. Certification audit</td><td>2. Risk audit</td></tr>
<tr><td>▪ compliance with accounting principles
▪ nature of certainty
• practical certainty (95%)
• materiality depending on
◆ size of transaction
◆ nature of transaction
◆ context</td><td>▪ compliance audit
(regularity audit)</td><td>▪ regularity
▪ propriety
▪ financial control – PIFC</td></tr>
<tr><td colspan="2">opinion on financial statements</td><td>management letter</td></tr>
<tr><td colspan="3">3. Constructive advice</td></tr>
</table>

government, had to prepare comparative reports every year and send them to the House of Commons for independent inspection. In 1861, following Prime Minister *Gladstone's* proposal, the Parliament established the Committee of Public Accounts, which has remained the most important institution for public audit to this day. It was at this time that the position of Comptroller General was created.[17]

Accounting Officer

The preparation of financial statements is the duty of the key figure of the state accounting system, the *Accounting Officer*, who is responsible for keeping to the accounting rules. Every budgetary institution has its own officer. He has to ensure that the public funds under his supervision are used lawfully, in other words in the same scale and for the kind of purposes authorised by the Parliament.[18] He needs to make sure, that expenses are in line with the relevant authorisations. His area of authority and responsibilities were put in law in the United Kingdom nearly a century ago[19].

As we have seen, the English approach does not expect "dead certain" auditor's opinion. The same way they do not expect absolute perfection from financial statements either. Their starting point is that there is no internal control, which could guarantee the completeness of accounting documents and the flawless bookkeeping of economic events. Nothing can give a total guarantee against accidental mistakes or deliberate foul play and fraud. With that in mind, the Accounting Officers appointed by the Treasury, who prepare the statements, are still expected to give a true and fair view of the economic management, and present correct reports and information. They are helped in this by the centrally determined structure of the statements. The Accounting Officer's responsibilities include, amongst others, effectively operating, developing and risk managing the internal control system. He informs every member of staff about

- the institution's vision, mission and values statement, in order to enable employees to clearly understand their roles, and to make the institution's objectives their own;
- the employee handbook, which serves as a manual for employees, to make them understand fully the behavioural standards when representing the institution and as private individuals.

At the same time as preparing the annual financial statements, he gives a Statement of the Accounting Officer's Responsibilities and a Statement on Internal Control. The former sums up his responsibilities, which are mainly about preparation of the financial statement about resource accounts expenditure. Nowadays it is prepared on an accrual basis, using the Treasury's Resource Accounting Manual. The Memorandum, published by PAC, contains the accounting principles of asset management. NAO audits the Accounting Officer's Statements together with the Financial Statement sent in.

Independent Audit Institutions

National Audit Office – NAO

In the United Kingdom the chief auditor has his own office, as opposed to being the manager of an office established by law. The Comptroller and Auditor General (C&AG) is an officer of the House of Commons and is personally responsible for the auditing of public fund management. The managers at the top of his organisation are selected by him and are answerable to him alone.[20]

> *The originally French word comptroller refers to the function of the C&AG as Comptroller General to authorise the funding of central gov-*

ernmental and other public institutions. Public expenditure is voted by the Parliament to the Queen, therefore no expenses can be charged to the Treasury without her consent. The C&AG also has to authorise the ministries' issuing of public funds. This function has now become a formality, conducted by two or three officers of NAO and essentially carried out by the Treasury.

The chief auditor's actual activities are represented by his legal duties, which, above all, originate from his *Auditor General* function: certifying the accounts of all Government Departments, which can mean a number of statements in the case of some ministries, furthermore the certification audit of a long line of public institutions and public sector bodies. Besides the above, he also audits the revenue and store accounts.[21] Central government organisations send over 500 financial statements to NAO for auditing (certification) purposes. Every statement and the auditor's opinions issued about them are made public. They are placed, together with the chief auditor's certificate and report, inside the Parliament.

Today England's state audit system is unified. Since 2000, central government departments prepare their annual financial statements on an accrual basis, according to nationally accepted and logically adopted accounting principles. Earlier they used cash based accounting in this sector.[22] The finance administration prepared the central budget's 2004/05 final accounts in consolidated form, as a Consolidated Central Government Account. The Whole of Government Account (WGA) was prepared first in the financial year ended 31 March 2007.

■ NAO annually audits the financial statements of institutions funded by the National Loans Fund.[23] All of the Government's borrowing transactions and most domestic lending transactions are processed via the fund's account held at the *Bank of England.* This includes the financial statements of institutions such as the *British Railways Board*, the *British Waterways Board* or the *Post Office.*

■ The next group of annual statements is from organisations where NAO carries out a non-statutory certification audit. About 50 or 60 audits are carried out every year, following a request from the Treasury or an agreement with the relevant minister, or possibly as a result of an agreement with a specific public organisation (England-Germany Foundation, different investment funds et cetera).

■ The next group of annual statements is from Central Budget's Executive Agencies. Amongst the members of the list of roughly 80 organisations are the *Central Office of Information*, the *Debt Management Office*, the *Highways Agency*, *HM Prison Service*, *Land Registry*, the *Meteorological Office*, the P*assport Agency*, the *Patent Office*, the *Royal Mint*, *Royal Parks*, *State Veterinary Service* and dozens more.

■ From the financial audit point of view, the largest group is made up of the White Paper Accounts, the statements of those public institutions, which do not belong directly under the jurisdiction of a ministry, but over which the Parliament has budgetary rights. Libraries *(British Library)*, museums *(British Museum)*, various authorities (*Coal Authority)* and commissions (*Commission for Equality and Human Rights)*, foundations (*New Opportunities Fund)*, agencies (*North West Development Agency)*, boards *(Northern Ireland Policing Board)* and other organisations belong to this group (altogether circa 200).

■ NAO also validates the financial statements of numerous international organisations (International Accounts), where the state is involved in the operations of that organisation *(International Labour Organization – ILO, International Atomic Energy et cetera).*

Last, but not least, we need to mention the "classic" budget statements *(Resource Accounts)*. These, as we stated earlier, are now prepared in the commercial style. This is where we find the statements of ministries (Ministry of Defence), departments (Department for Education and Employment, Department of Health, Her Majesty's Treasury etc.) and major government offices (Cabinet Office, HM Revenue and Customs, House of Lords etc.).

NAO carries out more than 500 financial audits every year. Around half of its 850 employees are occupied with this task. The number of audits resulting in a qualified opinion is around 2 to 3 per cent (in 2005 13 qualified opinions were issued).[24] In these cases (and only in these cases!) a detailed financial audit report is prepared, which uncovers the reasons and circumstances behind the opinion. The majority of these reports are also discussed by the relevant parliamentary committee[25], but the others are dismissed. (If the accounts are in order, there is no reason to discuss them…)

If NAO's own auditors cannot handle all the statutory financial audits in a given year, then they involve others (private auditors) in their audit work. Of course, responsibility still lies with the C&AG, as the task of auditing financial statements is legally assigned to him. (*Table 2* describes the primary function of financial audit).

Audit Commission

The largest part of the United Kingdom's economy is audited by private auditors. NAO carries out about a third, and the remaining eighth is done by other government institutions. The largest and most well known of these is the *Audit Commission*, which was established in 1982. It is managed by a governing board. Its remit covers the audit of the financial statements of local government bodies, and also health and other organisations (housing, fire and rescue, community safety services etc.), altogether eleven thousand audited and inspected public bodies.[27] The independent auditors of local government bodies' and health organisations' statements are appointed by the Audit Commission. (The majority of the latter are carried out by in house auditors, and a smaller portion is done by private audit firms.) It does not operate in the whole of the United Kingdom, only in England. With its 2300 employees, it audits the financial statements of over 250 local government offices, as well as carrying out examinations using performance indicators mostly in the health services sector. The findings are then published. (Every local government report is available on the internet.) As an independent watchdog, it does not audit for the Parliament but for the Government. The principal source of income is fees from audits, which is further supplemented by funds from the office of the Deputy Prime Minister.

Table 2

NAO'S ANNUAL EXPENDITURE FOR 2005 BROKEN DOWN ACCORDING TO THE FIVE MAIN OBJECTIVES[26]

(GBP million)

1. Certifying and reporting on accounts	38.0
2. Examining and reporting on risks	8.6
Financial audit subtotal	**46.6**
3. Value for money work	22.3
4. Other work for Parliament and the public	12.4
5. Comptroller function	0.2
Total	**81.5**

Audit Scotland, Wales Audit Office, C&AG for Northern Ireland

Since the millennium, Scotland has its own Parliamentary financial audit organisation,[28] which combines the apparatus of the earlier *NAO Scotland* with the *Accounts Commission* (like the Audit Commission, an institution responsible for the auditing of local government bodies). In 2005 the *Wales Audit Office*[29], was established as a new, single organisation, and the position of Comptroller and Auditor General for Northern Ireland had already been established in 1921.

Parliament committees

Committee of Public Accounts (PAC)

In the United Kingdom, PAC has been, for nearly a decade, the most important institution in Parliamentary control to turn state audits into reality. It was established as part of the public administration's reform, with the purpose of tightening Parliamentary control over the spending of public funds. It is not the C&AG, but this institution that reports to the Parliament from time to time[30] (primarily about the propriety of public expenditure – whether they are in accordance with Parliamentary authorisations). Originally the objective of PAC's investigations were, using the C&AG's certification audits, to check compliance with the accounting principles, and to ensure public expenditure is according to Parliamentary authorisations and intentions. It kept its interest in these questions to this day. Its members can ask questions about any financial statements they are presented with. In recent decades PAC has also added the questions of economy, efficiency and effectiveness to its circle of activities. This is reflected in the fact that NAO's value for money (vfm) investigation reports form a part of its agenda. There are around sixty of these reports every year. Most of them become items on the committee's agenda.

PAC is nominated by the House of Commons. The terms of office are in line with election cycles. The maximum number of members is fifteen. The *quorum*[31] is made up of four members, where every party of parliament is represented. The chairman of the committee is traditionally appointed by the opposition party. It is within the committee's scope of authority to call in documents, and to invite (to a hearing) not just official, but occasionally private persons, too, and also to make visits outside of the Parliament. However, it cannot form subcommittees. It operates on a professional basis, using a non-party attitude. It aims to make objective statements and suggestions, when advising the Government. Although it does not have enforcement competencies, it can only give suggestions or present its opinion, its reports for the Parliament still carry a lot of weight. Its recommendations are usually accepted by the executive power. When the Parliament is in session (between November and July), the Committee holds its meetings regularly on Monday and Wednesday afternoons. Most meetings are open to the public. The chief witness at these meetings is the Accounting Officer or the Chief Executive of the organisation, which was audited by NAO. A limited number of his staff can also be present and provide him with extra information, but they are only allowed to speak in exceptional circumstances, to further elaborate on the Accounting Officer's answer. The C&AG and the chief auditor of the NAO audit are present at the meetings, as well as a representative from the Treasury. They can all receive questions from the Committee.

The meetings are recorded in the Minutes of Evidence, which is later on published, together with the relevant PAC report. (Of course, this is not the case with information regarding state or service secrets.) The committee's meeting to discuss their report for the Parliament is conducted in private. Most of the reports relate to NAO's value for money investigations.

Government bodies have an obligation to study PAC's reports about their organisation, and upon consulting the treasury, to issue a reply to the Parliament. The reply is presented to the Parliament by the Treasury. The latter also prepares Treasury Minutes and when there are half a dozen of these (including PAC's relevant reports and ad verbatim minutes), then a lobby of Parliament is scheduled, to which PAC is also invited.

Public Audit Commission

Compared with PAC, the *Public Audit Commission,* which is the other Parliament committee checking public funds, is relatively new. It has been in existence since 1984[32], and has three main duties

- appoints the person responsible for NAO's accounting system (the organisation's Accounting Officer), who is practically non other than the C&AG, and whose assistant acts as a deputy for him in this capacity;
- appoints NAO's auditor;
- examines NAO's annual budget plan, and having considered PAC's and the Treasury's suggestions, it makes necessary modifications and submits it to the Parliament.

The Audit Commission is made up of nine members of parliament. Two of them, PAC's Chairman and the Leader of the House of Commons, are ex officio members. The further seven (non-government) committee members are recommended by the Parliament, from its own members, until the end of term. In contrast to PAC, this committee holds regular meetings. The meetings are normally non-public. It reports to the Parliament periodically.[33]

Civil organisations

The Public Audit Forum and the Consultative Forum

The *Public Audit Forum* was established in 1997 by the leaders of the institutions responsible for the audit of public funds in the United Kingdom. The objective of this association is to promote a consistent approach to audit and to develop common professional standards. The chairman of the forum is NAO's Comptroller General. Its members are from the management of the institutions discussed in 2.2. They have three foremost principles to consider

- the independence of public fund auditors (from the audited);
- the various types of public fund audits (financial statement audit, compliance audit, propriety audit, ethical investigation, value for money);
- to protect freedom of information regarding the results of audit.[34]

There is also an operative *Consultative Forum,* which holds meetings three times a year. The members, besides the managers of independent audit organisations, are audit professionals from ministries, local government associations and audit firms.

Internal and external quality control

In the United Kingdom, the professional quality of financial audit type investigations carried out by independent public fund audit organisations is also checked externally. The assigned institution in NAO's case, for example, is the Quality Assurance Directorate, which acts in the name of the ICAEW *(Institute of Chartered Accountants in England and Wales)*, when they evaluate NAO's work regarding professional standards.

NAO also has its own Audit Committee. The chairman of this however, is not a public auditor, but the former Chairman of CIPFA

(Chartered Institute of Public Finance and Accountancy); and its members are two further external experts and three members of NAO's management. This committee holds its meetings three times a year, and is mostly concerned with issues raised by NAO's internal and external auditors; furthermore it advises in internal and external quality assurance matters.

EPILOGUE (THE CLOSED AUDIT SYSTEM)

English technical terminology distinguishes between *stewardship* and *accountability*. The former refers "only" to someone (the *steward*) safekeeping someone else's possessions. Good safekeeping ensures that the possessions are used lawfully and with reason. In this instance the accounting obligation is financial in nature, it is primarily to do with the accounting balance sheets and income and expenditure statements and the auditing of these. The term accountability on the other hand, is concerned with someone's actions in connection with public funds, and his responsibility for his behaviour in his function. Therefore it is not purely an accountancy question, but much more: it belongs to the question of democracy, in the broadest sense of the word. It is present in various forms about public organisations; during the course of an election, in reporting duties towards organisations being higher up in the hierarchy, in the media etc.

The culture of accountability in the United Kingdom (the Westminster model) has developed over centuries. In its centre is the executive power's Parliamentary liability. It is not the audit institution (NAO) that they are accountable to, but the Parliament, via its official committee, PAC. The five phases of the accountability process illustrates this well.

- *Phase one* – NAO report (NAO sends its reports to Parliament, and makes them publicly available);
- *Phase two* – PAC hearing (PAC includes most of the reports in its agenda, and gives the relevant office representative a hearing;
- *Phase three* – PAC report (PAC publishes its detailed recommendations aimed at preventing reoccurrence of mistakes);
- *Phase four* – government response (the government reacts to each and every committee recommendation, and publishes its response);
- *Phase five* – NAO/PAC post examination (NAO monitors how the measures, which were introduced to implement the recommendations, are carried out).

NOTES

1 Act 55/1997, The Structure and Functions of the Chamber of Hungarian Auditors.

2 L Nyikos: EU financial audit conformity with twinning covenant, *Public Finance Quarterly, 6/1996*

3 Resolution 9/4 of Act 35/2003 accepting the Annual Report on the Activities of the State Audit Office for 2002

4 Árpád Kovács: Diary of the official visit at the British National Audit Office, script, *SAO Library, 27 March 2003*

5 The "ten commandments" of best practice state: (We need to) have effective financial auditing before moving to performance auditing. See: Managing Public Expenditure (A Reference Book for Transition Countries) *OECD (SIGMA), 2001. p. 26*

6 The Comptroller and Auditor General (C&AG) "may carry out examinations into the economy, efficiency and effectiveness…" *National Audit Act 1983. c.44, Part II*

7 UK National Audit Office – State Audit in the European Union. Published in December 2005

8 Paragraph 15-16 of the current Hungarian Accounting Act (C/2000) lists fourteen principles to

consider when preparing statements. These principally contain the English system of standards, but some of our principles cover a smaller or larger meaning than their English counterparts. Therefore the English phrases were not translated in the Hungarian text.

9 Public Sector Accounting, third edition, *Pendlebury, 1992. p. 210*

10 Proposed International Standards on Auditing 320 (revised and redrafted). Materiality in Planning and Performing an Audit. *Auditing Practices Board, December 2004* (Auditing Standards – ISAs /UK and Ireland/)

11 Section f of the Act C/2000 declares "either issuing an opinion (validatory, limited, negative) or refusing to issue an opinion".

12 The same measure is used by NAO and the European Audit Office.

13 Statements on Auditing Standards. These are published by the American Institute of Certified Public Accountants – AICPA.

14 See Propriety and Audit in the Public Sector *Public Audit Forum, May 2000*

15 Following the eruption of the infamous ENRON scandal, the very quickly published Sarbanes-Oxley Act (SOX) makes it compulsory for auditors to validate the management's internal control report. According to section 404 of SOX, this statement forms a part of the annual report. Management is required to issue a declaration regarding the effectiveness of the internal control system. The auditor's task is to evaluate the management system. His statement about it is a fundamental part of his report. He needs to form an opinion about three independent questions: has management judged the effectiveness of the internal control system correctly; is the internal control working effectively; is the financial statement correct?

16 It is compulsory to spend a minimum of 220 hours on further professional training every three years, and have an understanding of the professional standards, operating rules and principles of the three main institutions for registered auditors.

17 The full title: Comptroller General of the Receipt and Issue of Her Majesty's Exchequer and Auditor General of Public Acconts. The shorter title: Comptroller and Auditor General. Abbreviated: C&AG. In theory, it is the monarch, who audits the handling of public funds, therefore it is the monarch who appoints the C&AG.

18 The Responsibilities of an Accounting Officer. HM Treasury, April 2000

19 Section 1 (1) Exchequer and Audit Department Act 1921

20 According to legislation introduced in 1866, the C&AG had a responsibility to check each and every item of public funding and expenditure. Due to the expansion of government activities this responsibility was increasingly difficult to fulfill, therefore new law was introduced in 1921, which allowed financial auditing based on sampling.

21 The Accounting Officer responsible for NAO's accounting system is the same person as the C&AG. In this capacity an assistant acts as a deputy for him. Besides being comptroller general and auditor general, this is the C&AG's third function.

22 For more information on the two different views and their regulation see for example: Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities, *IFAC PSC April 2002. Study 14*

23 See Accounts Audited by the C&AG (www.nao.org.uk)

24 NAO Annual Report 2006, page 5

25 Committee of Public Accounts

26 NAO Annual Report 2006, page 37

27 See Annual Review 2005/2006 Getting Better Value from Public Services

28 See The Public Finance and Accountability Act (Scotland) 2000

29 See The Public Audit (Wales) Act 2005

30 See House of Commons Standing Order No 122.

31The quorum determines the minimum number of members needed to be present at a committee meeting, for the meeting to be able to proceed and make valid decisions.

32 See National Audit Act 1983 (section 2)

33 See for example The Public Accounts Commission Twelfth Report, Presented to the House of Commons in pursuance of section 2(3) of the National Audit Act 1983, Ordered by The House of Commons to be printed 17 January 2005

34 Public Audit Forum: The Principles of Public Audit, www.public-audit-forum.gov.uk