Auditing and Finance Management

Mahesh Tripathi

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Preface

Audit is one such initiative which is gaining ground and it encompasses all the three elements. With the enactment of the NREGA, The Audit has become mandatory and is widely talked and written about. However, the Audit is still an emerging and evolving concept and not much literature in terms of guidelines or handbook or manual is available for use by either the development functionaries or civil society organisations.

This book is designed to help officials and representatives of people's organizations and movements who want to facilitate the process of audit and finance. This book describes the characteristics of auditing and finance management. It also describes the relationship between the finance management and auditing and includes all the topic related to the auditing and finance management like finance poverty in India. Auditing for social change in the context of the millenium development goals. The role of auditing and public finance management and media and audit. This book also contains examples of how these general principles of auditing and finance can be applied to various programmes and schemes.

We have collected the material from Several academic institutions and research centres. It is a comprehensive work published for the first time in India, keeping in view

the needs of syllabus of university level and higher education systems. It is earnestly hoped that planners, administrators in the field of auditing, finance management as well as the general public and the teachers and students will find this work extremely useful.

Mahesh Tripathi

Contents

	Preface	*v*
1.	An Introduction to Finance Management	1
2.	Financial Poverty in India	23
3.	Auditing for Social Change in the Context of the Millennium Development Goals	49
4.	The Role of Auditing and Public Finance Management	68
5.	Audit and Legislative Oversight: Developing Country Perspective	100
6.	Learning from Civil Society Initiatives	125
7.	Media and Audit	146
8.	Audit and Evaluation : Integrating Politics and Public Involvement	167
9.	Governance and Accountability : A Legal Approach to Auditing	198
10.	History and Evaluation of Social Accounting	225
11.	Social and Environment Auditing Theory and Practice	234
	Bibliography	261

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1

An Introduction to Finance Management

To begin our study of financial management, we address two central issues. First: What is corporate, or business, finance and what is the role of the financial manager? Second: What is the goal of financial management?

Before we plunge into our study of "corp. fin.," we think a quick overview of the finance field might be a good idea. Our goal is to clue you in on some of the most important areas in finance and some of the career opportunities available in each. We also want to illustrate some of the ways finance fits in with other areas such as marketing, management, and accounting.

THE FOUR BASIC AREAS

Traditionally, financial topics are grouped into four main areas :

1. Corporate finance
2. Investments
3. Financial institutions
4. International finance

Corporate Finance

The first of these four areas, corporate finance, is the

main subject of this book. We begin covering this subject with our next section, so we will wait until then to get into any details. One thing we should note is that the term *corporate finance* seems to imply that what we cover is only relevant to corporations, but the truth is that almost all of the topics we consider are much broader than that. Maybe *business finance* would be a little more descriptive, but even this is too narrow because at least half of the subjects we discuss in the pages ahead are really basic financial ideas and principles applicable across all the various areas of finance and beyond.

Investments

Broadly speaking, the investments area deals with financial assets such as stocks and bonds. Some of the more important questions include:

1. What determines the price of a financial asset such as a share of stock?
2. What are the potential risks and rewards associated with investing in financial assets?
3. What is the best mixture of the different types of financial assets to hold?

Students who specialize in the investments area have various career opportunities. Being a stockbroker is one of the most common. Stockbrokers often work for large companies such as Merrill Lynch, advising customers on what types of investments to consider and helping them make buy and sell decisions. Financial advisers play a similar role, but are not neces-sarily brokers.

Portfolio management is a second investments-related career path. Portfolio managers, as the name suggests, manage money for investors. For example, individual investors frequently buy into mutual funds. Such funds are simply a means of pooling money that is then invested by a portfolio manager. Portfolio managers also invest and manage money for pension funds, insurance companies, and many other types of institutions.

Security analysis is a third area. A security analyst researches individual investments, such as stock in a particular company, and makes a determination as to whether the price is right. To do so, an analyst delves deeply into company and industry reports, along with a variety of other information sources. Frequently, brokers and portfolio managers rely on security analysts for information and recommendations.

These investments-related areas, like many areas in finance, share an interesting fea-ture. If they are done well, they can be very rewarding financially (translation: You can make a lot of money). The bad news, of course, is that they can be very demanding and very competitive, so they are definitely not for everybody.

Financial Institutions

Financial institutions are basically businesses that deal primarily in financial matters. Banks and insurance companies would probably be the most familiar to you. Institutions such as these employ people to perform a wide variety of finance-related tasks. For example, a commercial loan officer at a bank would evaluate whether a particular business has a strong enough financial position to warrant extending a loan. At an insurance company, an analyst would decide whether a particular risk was suit-able for insuring and what the premium should be.

International Finance

International finance isn't so much an area as it is a specialization within one of the main areas we described above. In other words, careers in international finance generally involve international aspects of either corporate finance, investments, or financial institutions. For example, some portfolio managers and security analysts spe-cialize in non-U.S. companies. Similarly, many U.S. businesses have extensive overseas operations and need employees familiar with such international topics as exchange rates and political risk. Banks frequently are asked to make loans

across country lines, so international specialists are needed there as well.

Why Study Finance?

Who needs to know finance? In a word, you. In fact, there are many reasons you need a working knowledge of finance even if you are not planning a finance career. We explore some of these next.

Marketing and Finance

If you are interested in marketing, you need to know finance because, for example, marketers constantly work with budgets, and they need to under-stand how to get the greatest payoff from marketing expenditures and programs. Analyzing costs and benefits of proj ects of all types is one of the most important aspects of finance, so the tools you learn in finance are vital in marketing research, the design of marketing and distribution channels, and product pricing, just to name a few areas.

Financial analysts rely heavily on marketing analysts, and the two frequently work together to evaluate the profitability of proposed projects and products. As we will see in a later chapter, sales projections are a key input in almost every type of new product analy-sis, and such projections are often developed jointly between marketing and finance.

Beyond this, the finance industry employs marketers to help sell financial products such as bank accounts, insurance policies, and mutual funds. Financial services marketing is one of the most rapidly growing types of marketing, and successful financial services marketers are very well compensated. To work in this area, you obviously need to under-stand financial products.

Accounting and Finance

For accountants, finance is required reading. In smaller businesses in particular, accountants are often required to make financial decisions as well as perform

traditional accounting duties. Further, as the financial world continues to grow more complex, accountants have to know finance to understand the implications of many of the newer types of financial contracts and the impact they have on financial statements. Beyond this, cost accounting and business finance are particularly closely related, sharing many of the same subjects and concerns.

Financial analysts make extensive use of accounting information; they are some of the most important end users. Understanding finance helps accountants recognize what types of information are particularly valuable and, more generally, how accounting information is actually used (and abused) in practice.

Management and Finance

One of the most important areas in management is strategy. Thinking about business strategy without simultaneously thinking about financial strategy is an excellent recipe for disaster, and, as a result, management strategists must have a very clear understanding of the financial implications of business plans.

In broader terms, management employees of all types are expected to have a strong understanding of how their jobs impact profitability, and they are also expected to be able to work within their areas to improve profitability. This is precisely what studying finance teaches you: What are the characteristics of activities that create value?

Perhaps the most important reason to know finance is that you will have to make financial decisions that will be very important to you personally. Today, for example, when you go to work for almost any type of company, you will be asked to decide how you want to invest your retirement funds. We'll see in a later chapter that what you choose to do can make an enormous difference in your future financial well-being. On a different note, is it your dream to start your own business? Good luck if you don't under-stand basic finance before you start; you'll end up learning it the

hard way. Want to know how big your student loan payments are going to be before you take out that next loan?

May be not, but we'll show you how to calculate them anyway. These are just a few of the ways that finance will affect your personal and business lives. Whether you want to or not, you are going to have to examine and understand finan-cial issues, and you are going to have to make financial decisions. We want you to do so wisely, so keep reading.

Financial Management Decisions

As our discussion above suggests, the financial manager must be concerned with three basic types of questions. We consider these in greater detail next.

Capital Budgeting

The first question concerns the firm's long-term investments. The process of planning and managing a firm's long-term investments is called *capital budgeting*. In capital budgeting, the financial manager tries to identify investment oppor-tunities that are worth more to the firm than they cost to acquire. Loosely speaking, this means that the value of the cash flow generated by an asset exceeds the cost of that asset. Regardless of the specific investment under consideration, financial managers must be concerned with how much cash they expect to receive, when they expect to receive it, and how likely they are to receive it. Evaluating the *size, timing,* and *risk* of future cash flows is the essence of capital budgeting. In fact, whenever we evaluate a business decision, the size, timing, and risk of the cash flows will be, by far, the most important things we will consider.

Capital Structure

The second question for the financial manager concerns how the firm obtains the financing it needs to support its long-term investments. A firm's *capital structure* (or financial structure) refers to the specific mixture of long-

term debt and equity the firm uses to finance its operations. The financial manager has two concerns in this area. First: How much should the firm borrow? Second: What are the least expensive sources of funds for the firm?

In addition to deciding on the financing mix, the financial manager has to decide exactly how and where to raise the money. The expenses associated with raising long-term financing can be considerable, so different possibilities must be carefully evaluated. Also, businesses borrow money from a variety of lenders in a number of different ways. Choos-ing among lenders and among loan types is another job handled by the financial manager.

Working Capital Management

The third question concerns *working capital* management. The term *working capital* refers to a firm's short-term assets, such as inventory, and its short-term liabilities, such as money owed to suppliers. Managing the firm's working capital is a day-to-day activity that ensures the firm has sufficient resources to continue its operations and avoid costly interruptions. This involves a number of activities related to the firm's receipt and disbursement of cash.

Some questions about working capital that must be answered are the following:

(1) How much cash and inventory should we keep on hand?

(2) Should we sell on credit to our customers?

(3) How will we obtain any needed short-term financing? If we borrow in the short term, how and where should we do it? This is just a small sample of the issues that arise in managing a firm's working capital.

Conclusion

The three areas of corporate financial management we have described—capital budgeting, capital structure, and

working capital management—are very broad categories. Each includes a rich variety of topics, and we have indicated only a few of the questions that arise in the different areas. The chapters ahead contain greater detail.

FORMS OF BUSINESS ORGANIZATION

Large firms in the United States, such as IBM and Exxon, are almost all organized as corporations. We examine the three different legal forms of business organization—sole proprietorship, partnership, and corporation—to see why this is so.

Sole Proprietorship

A sole proprietorship is a business owned by one person. This is the simplest type of business to start and is the least regulated form of organization. For this reason, there are more proprietorships than any other type of business, and many businesses that later become large corporations start out as small proprietorships.

The owner of a sole proprietorship keeps all the profits. That's the good news. The bad news is that the owner has *unlimited liability* for business debts. This means that creditors can look to the proprietor's personal assets for payment. Similarly, there is no distinction between personal and business income, so all business income is taxed as personal income.

The life of a sole proprietorship is limited to the owner's life span, and, importantly, the amount of equity that can be raised is limited to the proprietor's personal wealth. This limitation often means that the business is unable to exploit new opportunities because of insufficient capital. Ownership of a sole proprietorship may be difficult to transfer since this requires the sale of the entire business to a new owner.

Partnership

A partnership is similar to a proprietorship, except that there are two or more owners (partners). In a *general*

partnership, all the partners share in gains or losses, and all have unlimited liability for *all* partnership debts, not just some particular share. The way partnership gains (and losses) are divided is described in the *partnership agreement.* This agreement can be an informal oral agreement, such as "let's start a lawn mowing business," or a lengthy, formal written document.

In a *limited partnership,* one or more *general partners* will run the business and have unlimited liability, but there will be one or more *limited partners* who do not actively participate in the business. A limited partner's liability for business debts is limited to the amount that partner contributes to the partnership. This form of organization is common in real estate ventures, for example.

The advantages and disadvantages of a partnership are basically the same as those for a proprietorship. Partnerships based on a relatively informal agreement are easy and inex-pensive to form. General partners have unlimited liability for partnership debts, and the partnership terminates when a general partner wishes to sell out or dies. All income is taxed as personal income to the partners, and the amount of equity that can be raised is limited to the partners' combined wealth. Ownership by a general partner is not easily transferred because a new partnership must be formed. A limited partner's interest can be sold without dissolving the partnership, but finding a buyer may be difficult.

Because a partner in a general partnership can be held responsible for all partnership debts, having a written agreement is very important. Failure to spell out the rights and duties of the partners frequently leads to misunderstandings later on. Also, if you are a limited partner, you must not become deeply involved in business decisions unless you are willing to assume the obligations of a general partner. The reason is that if things go badly, you may be deemed to be a general partner even though you say you are a limited partner.

Based on our discussion, the primary disadvantages of sole proprietorships and part-nerships as forms of business organization are (1) unlimited liability for business debts on the part of the owners, (2) limited life of the business, and (3) difficulty of transferring own-ership. These three disadvantages add up to a single, çentral problem: The ability of such businesses to grow can be seriously limited by an inability to raise cash for investment.

Corporation

The *corporation* is the most important form (in terms of size) of business organization in the United States. A corporation is a legal "person" separate and distinct from its owners, and it has many of the rights, duties, and privileges of an actual person. Corporations can borrow money and own property, can sue and be sued, and can enter into contracts. A corporation can even be a general partner or a limited partner in a partnership, and a corporation can own stock in another corporation.

Not surprisingly, starting a corporation is somewhat more complicated than starting the other forms of business organization. Forming a corporation involves preparing *articles of incorporation* (or a charter) and a set of *bylaws.* The articles of incorporation must con-tain a number of things, including the corporation's name, its intended life (which can be forever), its business purpose, and the number of shares that can be issued. This information must normally be supplied to the state in which the firm will be incorporated. For most legal purposes, the corporation is a "resident" of that state.

The bylaws are rules describing how the corporation regulates its own existence. For example, the bylaws describe how directors are elected. The bylaws may be amended or extended from time to time by the stockholders.

In a large corporation, the stockholders and the managers are usually separate groups. The stockholders elect the board of directors, who then select the managers.

Management is charged with running the corporation's affairs in the stockholders' interests. In principle, stockholders control the corporation because they elect the directors.

As a result of the separation of ownership and management, the corporate form has several advantages. Ownership (represented by shares of stock) can be readily transferred, and the life of the corporation is therefore not limited. The corporation borrows money in its own name. As a result, the stockholders in a corporation have limited liability for corporate debts. The most they can lose is what they have invested.

The relative ease of transferring ownership, the limited liability for business debts, and the unlimited life of the business are the reasons why the corporate form is superior when it comes to raising cash. If a corporation needs new equity, it can sell new shares of stock and attract new investors. The number of owners can be huge; larger corporations have many thousands or even millions of stockholders. For example, the General Electric Company (better known as GE) has about 10 billion shares outstanding and 4 million shareholders.

The corporate form has a significant disadvantage. Since a corporation is a legal person, it must pay taxes. Moreover, money paid out to stockholders in the form of dividends is taxed again as income to those stockholders. This is *double taxation,* meaning that corporate profits are taxed twice: at the corporate level when they are earned and again at the personal level when they are paid out.

Today all 50 states had enacted laws allowing for the creation of a relatively new form of business organization, the limited liability company (LLC). The goal of this entity is to operate and be taxed like a partnership but retain limited liability for owners, so an LLC is essentially a hybrid of partnership and corporation. Although states have differing definitions for LLCs, the more important scorekeeper is the Internal Revenue Service (IRS). The IRS

will consider an LLC a corporation, thereby subjecting it to double taxation, unless it meets certain specific criteria. In essence, an LLC cannot be too corporation like, or it will be treated as one by the IRS. LLCs have become common. For example, Goldman, Sachs and Co., one of Wall Street's last remaining partnerships, decided to convert from a private partnership to an LLC (it later "went public," becoming a publicly held corporation). Large accounting firms and law firms by the score have converted to LLCs.

The corporate form has many variations around the world. Exact laws and regulations differ, of course, but the essential features of public ownership and limited liability remain. These firms are often called *joint stock companies, public limited companies,* or *limited liability companies.*

THE GOAL OF FINANCIAL MANAGEMENT

To study financial decision making, we first need to understand the goal of financial management. Such an understanding is important because it leads to an objective basis for making and evaluating financial decisions.

Profit Maximization

Profit maximization would probably be the most commonly cited business goal, but this is not a very precise objective. Do we mean profits this year? If so, then actions such as deferring maintenance, letting inventories run down, and other short-run, cost-cutting measures will tend to increase profits now, but these activities aren't necessarily desirable.

The goal of maximizing profits may refer to some sort of "long-run" or "average" profits, but it's unclear exactly what this means. First, do we mean something like ac-counting net income or earnings per share? As we will see, these numbers may have little to do with what is good or bad for the firm. Second, what do we mean by the long run? As a famous economist once remarked, in the long run, we're all dead! More to the point, this goal doesn't tell us the appropriate trade-off between current and future profits.

The Goal of Financial Management in a Corporation

The financial manager in a corporation makes decisions for the stockholders of the firm. Given this, instead of listing possible goals for the financial manager, we really need to answer a more fundamental question: From the stockholders' point of view, what is a good financial management decision?

If we assume stockholders buy stock because they seek to gain financially, then the answer is obvious: Good decisions increase the value of the stock, and poor decisions decrease it.

Given our observations, it follows that the financial manager acts in the shareholders' best interests by making decisions that increase the value of the stock. The appropriate goal for the financial manager in a corporation can thus be stated quite easily:

The goal of financial management is to maximize the current value per share of the existing stock.

The goal of maximizing the value of the stock avoids the problems associated with the different goals we discussed above. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the *cur-rent* stock value. Of course, maximizing stock value is the same thing as maximizing the market price per share.

A More General Financial Management Goal

Given our goal as stated above (maximize the value of the stock), an obvious question comes up: What is the appropriate goal when the firm has no traded stock? Corporations are certainly not the only type of business, and the stock in many corporations rarely changes hands, so it's difficult to say what the value per share is at any given time.

As long as we are dealing with for profit businesses, only a slight modification is needed. The total value of the

stock in a corporation is simply equal to the value of the owners' equity. Therefore, a more general way of stating our goal is :

With this goal in mind, it doesn't matter whether the business is a proprietorship, a partnership, or a corporation. For each of these, good financial decisions increase the market value of the owners' equity and poor financial decisions decrease it.

Finally, our goal does not imply that the financial manager should take illegal or unethical actions in the hope of increasing the value of the equity in the firm. What we mean is that the financial manager best serves the owners of the business by identifying goods and services that add value to the firm because they are desired and valued in the free marketplace. Our nearby *Reality Bytes* box discusses some recent ethical issues and problems faced by well-known corporations.

Sarbanes-Oxley Act

In response to corporate scandals involving companies such as Enron, WorldCom, Tyco, and Adelphia, Congress enacted the Sarbanes-Oxley Act in 2002. The Act, which is better known as "Sarbox," is intended to strengthen protection against corporate accounting fraud and financial malpractice. Key elements of Sarbox took effect on November 15, 2004.

Sarbox contains a number of requirements designed to insure that companies tell the truth in their financial statements. For example, the officers of a public corporation must review and sign the annual report. They must attest that the annual report does not contain false statements or material omissions and also that the financial statements fairly represent the company's financial results. In essence, Sarbox makes management personally responsible for the accuracy of a company's financial statements.

CORPORATE ETHICS

Large companies are sometimes guilty of unethical behavior. Often this unethical behavior takes the form of false or misleading financial statements. In one of the largest corporate fraud cases in history, energy giant Enron Corporation was forced to file for bankruptcy in December 2001 amid allegations that the company's financial statements were deliberately misleading and false. Enron's bankruptcy not only destroyed that company, but its auditor Arthur Andersen as well.

Of course, ethical problems are not confined to the United States. For example, in late 2003 the Italian dairy firm Parmalat SpA announced it had liquidity problems. What followed was an investigation into the largest corporate fraud scandal in European history. At one point, the company was forced to disclose that it did not actually have a $4.8 billion bank account it had claimed on its financial statements.

The difference between ethical and unethical behavior can sometimes be murky. For example, many U.S. companies have relocated to Bermuda for reasons beyond the beautiful pink beaches; namely, Bermuda has no corporate income taxes. With a population of less than 65,000, the island is home to more than 13,000 international companies. Stanley Works, the well-known maker of Stanley tools, was among the U.S. corporations that chose to move to the island paradise. By doing so, Stanley estimated that it would save $30 million per year in taxes. Since the goal of the corporation is to maximize shareholder wealth, this would seem like a good move, and the practice is entirely legal. But is it ethical? What are the issues?

Another recent corporate activity that has generated much controversy is the practice of outsourcing, or offshoring, jobs to other countries. U.S. corporations engage in this practice when labor costs in another country are substantially lower than they are domestically. Again, this is

done to maximize shareholder wealth. But the ethical dilemma in this case is even trickier. Some U.S. workers do lose jobs when offshoring occurs. On the other hand, the Milken Institute estimated that every $1 spent on offshoring a service job to India generated a net value to the United States of $1.13, along with another $.33 to India. And it gets even more complicated: What about foreign companies such as BMW and Toyota who "insource" jobs by building plants in the United States? Is it unethical to outsource U.S. jobs while, at the same time, insourcing jobs from other countries?

THE AGENCY PROBLEM AND CONTROL OF THE CORPORATION

We've seen that the financial manager in a corporation acts in the best interests of the stock-holders by taking actions that increase the value of the firm's stock. However, we've also seen that in large corporations ownership can be spread over a huge number of stockhold-ers. This dispersion of ownership arguably means that management effectively controls the firm. In this case, will management necessarily act in the best interests of the stockholders? Put another way, might not management pursue its own goals at the stockholders' expense? We briefly consider some of the arguments below.

Agency Relationships

The relationship between stockholders and management is called an *agency relationship.* Such a relationship exists whenever someone (the principal) hires another (the agent) to represent his or her interest. For example, you might hire someone (an agent) to sell a car that you own while you are away at school. In all such relationships, there is a possibility of conflict of interest between the principal and the agent. Such a conflict is called an agency problem.

Suppose you hire someone to sell your car and you agree to pay her a fiat fee when she sells the car. The agent's incentive in this case is to make the sale, not necessarily to

get you the best price. If you paid a commission of, say, 10 percent of the sales price instead of a fiat fee, then this problem might not exist. This example illustrates that the way an agent is compensated is one factor that affects agency problems.

Management Goals

To see how management and stockholder interests might differ, imagine that a corporation is considering a new investment. The new investment is expected to favorably impact the stock price, but it is also a relatively risky venture. The owners of the firm will wish to take the investment (because the share value will rise), but management may not because there is the possibility that things will turn out badly and management jobs will be lost. If man-agement does not take the investment, then the stockholders may lose a valuable opportu-nity. This is one example of an *agency cost.*

It is sometimes argued that, left to themselves, managers would tend to maximize the amount of resources over which they have control, or, more generally, business power or wealth. This goal could lead to an overemphasis on business size or growth. For example, cases where management is accused of overpaying to buy another company just to increase the size of the business or to demonstrate corporate power are not uncommon. Obviously, if overpay-ment does take place, such a purchase does not benefit the owners of the purchasing company.

Our discussion indicates that management may tend to overemphasize organizational survival to protect job security. Also, management may dislike outside inter-ference, so independence and corporate self-sufficiency may be important goals.

Whether managers will, in fact, act in the best interests of stockholders depends on two factors. First, how closely are management goals aligned with stockholder goals? This ques-tion relates to the way managers are compensated.

Second, can management be replaced if they do not pursue stockholder goals? This issue relates to control of the firm. As we will discuss, there are a number of reasons to think that, even in the largest firms, management has a significant incentive to act in the interests of stockholders.

Managerial Compensation

Management will frequently have a significant economic incentive to increase share value for two reasons. First, managerial compensation, particularly at the top, is usually tied to financial performance in general and oftentimes to share value in particular. For example, managers are frequently given the option to buy stock at a fixed price. The more the stock is worth, the more valuable is this option. The second incentive managers have relates to job prospects. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing stock-holder goals will be in greater demand in the labor market and thus command higher salaries.

In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards. For example, Rueben Mark, CEO of consumer products maker Colgate-Palmolive, received about $148 million in 2004 alone, which is less than Mel Gibson ($210 million), but way more than Bey once Knowles ($21 million). For the five-year period ending 2004, Larry Ellison of software giant Oracle was one of the top earners, receiving over $835 million.

Control of the Firm

Control of the firm ultimately rests with stockholders. They elect the board of directors, who, in turn, hires and fires management. The mechanism by which unhappy stockholders can act to replace existing management is called a *proxy fight*. A proxy is the authority to vote someone else's stock. A proxy fight develops when a group solicits proxies in order to replace the existing board, and thereby replace existing management.

Another way that management can be replaced is by takeover. Those firms that are poorly managed are more attractive as acquisitions than well-managed firms because a greater profit potential exists. Thus, avoiding a takeover by another firm gives management another incentive to act in the stockholders' interests. Information on executive compensa-tion, along with a ton of other information, can be easily found on the Web for almost any public company. Our nearby *Work the Web* box shows you how to get started.

Sometimes it's hard to tell if a company's management is really acting in the share-holders' best interests. Consider the 2005 merger of software giants Oracle and PeopleSoft. PeopleSoft repeatedly rejected offers by Oracle to purchase the company. In November 2004, the board rejected a "best and final" offer, even after 61 percent of PeopleSoft's shareholders voted in favor of it. So was the board really acting in shareholders' best interests? At first, it may not have looked like it, but Oracle then increased its offer price by $2 per share, which the board accepted. So, by holding out, PeopleSoft's management got a much better price for its shareholders.

The available theory and evidence are consistent with the view that stock-holders control the firm and that stockholder wealth maximization is the relevant goal of the corporation. Even so, there will undoubtedly be times when management goals are pursued at the expense of the stockholders, at least temporarily.

Stakeholders

Our discussion thus far implies that management and stockholders are the only parties with an interest in the firm's decisions. This is an oversimplification, of course. Employees, customers, suppliers, and even the government all have a financial interest in the firm. These various groups are called *stakeholders* in the firm. In general, a stakeholder is someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

Primary versus Secondary Markets

Financial markets function as both primary and secondary markets for debt and equity securities. The term *primary market* refers to the original sale of securities by governments and corporations. The *secondary markets* are those in which these securities are bought and sold after the original sale. Equities are, of course, issued solely by corporations. Debt securities are issued by both governments and corporations. In the discussion that follows, we focus on corporate securities only.

Primary Markets

In a primary-market transaction, the corporation is the seller, and the transaction raises money for the corporation. Corporations engage in two types of primary market transactions: public offerings and private placements. A public offering, as the name suggests, involves selling securities to the general public, whereas a private place-ment is a negotiated sale involving a specific buyer.

By law, public offerings of debt and equity must be registered with the Securities and Exchange Commission (SEC). Registration requires the firm to disclose a great deal of information before selling any securities. The accounting, legal, and selling costs of public offerings can be considerable.

Partly to avoid the various regulatory requirements and the expense of public offer-ings, debt and equity are often sold privately to large financial institutions such as life insurance companies or mutual funds. Such private placements do not have to be registered with the SEC and do not require the involvement of underwriters (investment banks that specialize in selling securities to the public).

Secondary Markets

A secondary-market transaction involves one owner or creditor selling to another. It is therefore the secondary markets that provide the means for trans-ferring ownership

of corporate securities. Although a corporation is only directly involved in a primary-market transaction (when it sells securities to raise cash), the secondary markets are still critical to large corporations. The reason is that investors are much more willing to purchase securities in a primary-market transaction when they know that those securities can later be resold if desired.

Dealer Versus Auction Markets

There are two kinds of secondary markets: *auction* markets and *dealer* markets. Generally speaking, dealers buy and sell for themselves, at their own risk. A car dealer, for example, buys and sells automobiles. In contrast, brokers and agents match buyers and sellers, but they do not actually own the commodity that is bought or sold. A real estate agent, for example, does not normally buy and sell houses.

Dealer markets in stocks and long-term debt are called *over-the-counter* (OTC) markets. Most trading in debt securities takes place over the counter. The expression *over the counter* refers to days of old when securities were literally bought and sold at counters in offices around the country. Today, a significant fraction of the market for stocks and almost all of the market for long-term debt have no central location; the many dealers are con-nected electronically.

Auction markets differ from dealer markets in two ways. First, an auction market, or exchange, has a physical location (like Wall Street). S econd, in a dealer market, most of the buying and selling is done by the dealer. The primary purpose of an auction market, on the other hand, is to match those who wish to sell with those who wish to buy. Dealers play a limited role.

Trading in Corporate Securities

The equity shares of most of the large firms in the United States trade in organized auction markets. The largest such market is the New York Stock Exchange

(NYSE), which accounts for more than 85 percent of all the shares traded in auction markets. Other auction exchanges include the American Stock Exchange (AMEX) and regional exchanges such as the Pacific Stock Exchange.

In addition to the stock exchanges, there is a large OTC market for stocks. In 1971, the National Association of Securities Dealers (NASD) made available to dealers and brokers an electronic quotation system called NASDAQ (NASD Automated Quotations system, pronounced "naz-dak"). There are roughly three times as many companies on NASDAQ as there are on NYSE, but they tend to be much smaller in size and trade less actively. There are exceptions, of course. Both Microsoft and Intel trade OTC, for example. Nonetheless, the total value of NASDAQ stocks is significantly less than the total value of NYSE stocks.

There are many large and important financial markets outside the United States, of course, and U.S. corporations are increasingly looking to these markets to raise cash. The Tokyo Stock Exchange and the London Stock Exchange (TSE and LSE, respectively) are two well-known examples. The fact that OTC markets have no physical location means that national borders do not present a great barrier, and there is now a huge international OTC debt market. Because of globalization, financial markets have reached the point where trading in many instruments never stops; it just travels around the world.

Listing Stocks that trade on an organized exchange (or market) are said to be *listed* on that exchange. In order to be listed, firms must meet certain minimum criteria concerning, for example, asset size and number of shareholders. These criteria differ for different exchanges.

NYSE has the most stringent requirements of the stock markets in the United States. For example, to be listed on NYSE, a company is expected to have a market value for its publicly held shares of at least $60 million and a total of at least 2,000 shareholders with at least 100 shares each. There are additional minimums on earnings, assets, and number of shares outstanding.

2

Financial Poverty in India

Introduction

Since the early national plans, independent India's government has emphasized the link between improving access to financial markets and reducing poverty, a stance that has had influence globally. The early strategy gave the lead role to state-run banks, who were charged with loosening the grip of traditional informal-sector moneylenders through the use of targeted low-priced loans (Reddy, 1999). Newer approaches in India include the partial deregulating of interest rates, new institutional forms for cooperatives that put the emphasis back on intermediating the savings of their members; and a nationwide attempt, pioneered by nongovernmental organizations and now supported by the state, to create links between commercial banks, NGOs, and informal local groups ('self-help groups', or SHGs). Surveys show, however, that informal-sector lenders remain a strong presence in rural India, still able to deliver services that are not yet provided as well by the formal and semi-formal sectors.

Much has changed in India since the early credit strategies. The rural economy has diversified, the cash economy has expanded, the service sector has developed, and mobility has increased. These changes have gained speed in the past decade, and with those changes come

opportunities to re-think financial sector interventions, including new ways of thinking about how the poor use financial services and which kinds of services they require. Users were once seen primarily as small farmers, nearly always male, needing credit for crop production or livestock rearing at better terms than those available from informal lenders. The 1990s saw something of a shift to women's needs for credit, to support opportunities for investment in off-farm microbusinesses. Now, typical microfinance clients might be better understood as men and women from poor households seeking a wide range of savings and loan services to support a diverse set of consumption needs and investment opportunities.

Although the SHGs, and the work of NGOs such as SEWA, a women's group, are receiving increasing international attention, the best-known recent innovations in financial services for the poor have happened outside of India. The microfinance sector is booming in Bangladesh, with too much competition, rather than too little supply, emerging as a tension. In Indonesia, the Bank Rakyat Indonesia, a state-owned commercial bank, has developed an efficient, profitable arm that serves roughly three million rural and urban borrowers and nearly ten times as many savers. Elsewhere, smaller programs are piloting new approaches like flexible savings accounts, insurance services, and novel applications of information technology. In an economy as large and varying as India's, there should be even greater scope for diversity and new approaches, and the government has an important role to play in creating space for innovation and a flexible architecture for new, independent institutions. What might they look like?

Even in a relatively homogenous economy like Bangladesh, diverse approaches have emerged. The group-based microcredit model of the Grameen Bank operates alongside the integrated vision of BRAC (providing training, inputs, and marketing assistance alongside credit); the highly-efficient minimalist approach of ASA; the financial

product differentiation featured by BURO, Tangail; and the flexible saving and borrowing vehicles of *SafeSswe*. Recently the Grameen Bank itself introduced a new approach ("Grameen Bank II") and rolled out new loan, pension, savings, and insurance products (Yunus, 2002).

Despite the diversity of approaches to microfinance in Bangladesh and Indonesia, common elements underlie the most successful innovations, and India can learn from the story of how financial services for poor people developed in the last twenty-five years elsewhere in Asia and beyond. Our aim is to describe the elements that we feel have contributed most and that are most relevant for India.

The clearest lessons are about understanding the core features of good microfinance, and these are dealt with in Part I of this paper. The more complex questions about how India is to achieve good microfinance on a massive scale are discussed in Part II. Part III uses the insights to consider the most innovative and exciting recent development in Indian microfinance, the movement to link self-help groups to banks. Part IV draws conclusions.

Good Microfinance

Our discussion of microfinance begins with what we know about its users and potential users. Research shows that poor people value financial services, want more of them, worry when they don't have them, but are often frustrated by them when they do get them. They know that managing money is important, and that managing money well gives them a better chance to manage their lives and livelihoods well. Those lives and livelihoods are complex, diverse, dynamic and vulnerable, and the poor want their financial services to respond by being reliable, convenient, continuous, and flexible. They understand that financial services help them spend, at one time, income earned in other times, and because those incomes tend to be small, irregular and unreliable, they need the full armoury of intermediating modes - saving up for future spending, taking advances against future savings, and building cash

reserves that can be called on at any time. They are aware that their most dependable forms of social security are their own money and asset-management skills, so they need a wide range of intermediating terms, from a tiny advance of a few dollars to tide over a current food shortage, through loans for investment opportunities, to long term saving instruments that help them manage retirement, widowhood or disability.

How poor households in urban and rural settings in Bangladesh and in India go about satisfying these needs has been revealed in depth through the 'financial diaries' collected by researchers from Manchester University's Institute for Development Policy and Management (IDPM) in a study done in 1999-2001. 'Diaries', each a full year in duration, were prepared by poor, very poor and near-poor households through the help of two-weekly visits by researchers. They reveal the respondents patching a wide array of informal services and devices together with semi-formal and formal services. All households in the samples, no matter how poor, engage in money-managing practices, and on average the Bangladeshi households push or pull through financial services and devices each year a sum of money ($839) equivalent to two-thirds of their annual cash income. In the Indian case, households enter a fresh financial arrangement - with a moneylender, money guard, savings club, or formal provider, among others - on average every two weeks. In Bangladesh, a sample of just forty-two households were found to have used, between them, thirty-three types of service or device during the year: no household used less than four, and a third of them used more than ten.

These households see financial services as a day-to-day activity, not as a right or privilege nor as a reward or enticement for engaging in some form of approved behavior. When they look for financial service providers they seek reliable workmanlike partners rather than patrons. For example, they do not see loans as a social good in short

supply of which they should receive their fair share, but as a tool to manage their financial lives. They do not believe that credit should be available only to women, nor invested only in microbusinesses, nor that financial services must be conducted only in a group setting nor invariably accompanied by other social development activities. They do not ask to be taught how to save, but seek opportunities to save, sometimes needing very liquid savings instruments, sometimes wanting longer-term less accessible savings plans, always preferring to have the choice of either or both. They do not expect to have all their financial service needs met by just one provider, or by just one type of provider: they are used to multiple portfolios.

In short, poor people want what many of the less poor already enjoy: reliable, convenient, and flexible ways to store and retrieve cash and to turn their capacity to save into spending power, in the short, medium and long term. And they want it on a continuing, not a one-off, basis.

In some parts of Asia poor people are beginning to enjoy such services. How this came about varies from place to place, and evolved over time, with pioneers contributing key elements rather than the full package, so there is no single blueprint to study.

The case of Bangladesh illustrates this. Grameen Bank made the biggest breakthrough, but it has taken time for all of us - including Grameen itself - to distinguish the truly essential elements of its contribution. Because Grameen's highly successful strategy worked through groups, because those groups soon became almost exclusively female, because Grameen promoted credit as 'a human right', downplaying the role of savings, and because borrowers promised to invest their loans in ways that would directly generate income, it looked for a long time as if the key messages of microfinance were to do with women, group solidarity, microbusinesses, and loans. Early microfinance practitioners also saw microfinance as just a short-term jumping-off point before customers were able to enter into

relationships with mainstream commercial banks, making "graduation" another message. It now looks more likely that the true key messages were more abstract and more universal: convenience, reliability, continuity and flexibility - the core values of basic banking services.

To see this, we need to shift our perspective to that of the users themselves. Before Grameen, Bangladeshi villagers made do with a variety of informal money-management systems. Such systems offered a wide range of ways of managing money, but none was both convenient and reliable. Saving money at home -dropped into a mud bank, tucked between roof-sheets, or tied into petticoats - was convenient enough, but very hard to protect from myriad tiny spending needs, and from the predations of mothers-in-law and cousins with hard-luck stories. Moneylenders were few in number, and might or might not be prepared to lend to you: even if they were prepared to lend they may not lend in the right amount, at the right time, or over the right term, and their price may include all sots of inconvenient non-cash elements. Money guards and casual debtors might or might not be able to repay you when you needed the money back. Savings and loan clubs proved hard to manage on an ongoing basis: good book-keeping is hard for the illiterate and without good book-keeping such devices are prone to abuse, carelessness, and collapse.

Then, starting in the late 1970s, came Grameen Bank. Suddenly, villagers found themselves offered the opportunity to pay in small sums on a weekly basis, and to take the value of a year's worth of those pay-ins in the form of an advance. All this was done at a meeting point in the village, requiring no travel greater than a short walk. Rain or shine, the well-behaved bank workers turned up on time every week. They kept immaculate records. Unbelievably, they gave the advances in the sums promised.

Astonishingly, as soon as one advance was paid down, a new, often bigger one, was immediately available.

Grameen encouraged borrowers to invest the loans in

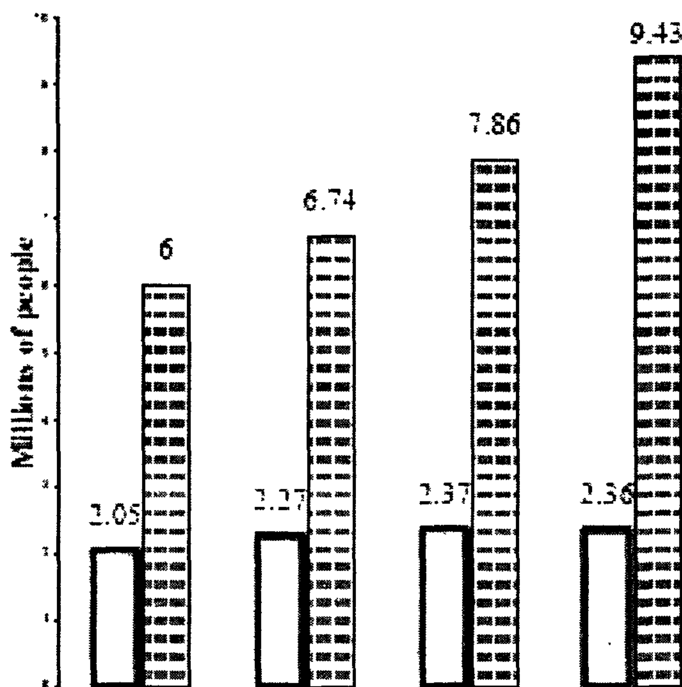


Chart 1: Growth of microfinance membership, Bangladesh: Grameen Bank (white rectangles) and all NGOs (grey)

microbusinesses, and discouraged certain forms of expenditure such as dowry. These messages were reinforced through the 'sixteen decisions' that the clients, gathered in their forty-strong groups, recited at each weekly meeting. But in practice this did not stop borrowers from using the service in whatever way appeared most rational to them at the time. Here was a way of turning their capacity to save, conveniently and reliably, into usefully large chunks of spending power, and it released a wave of spending that allowed households to retire older more expensive debt, to invest in education, medical care, home improvement, land, and marriage alliances, to export surplus labour to the cities or abroad, as well as to put more cash into their regular

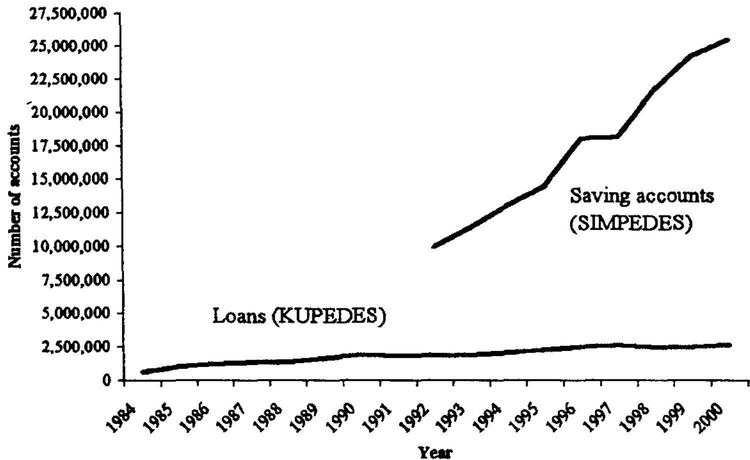
livelihood activities on or off the farm. Able to manage money better, they managed their lives better.

Spurred on by its well-deserved popularity, Grameen expanded. Hundreds of emulators joined in (see chart 1). By the mid 1990s Grameen and Grameen look-alikes were serving several million rural and urban households. The key breakthrough had been achieved. A new way of doing business with poor people - the regular, mundane, everyday business of helping poor people manage their cash flow and turn their savings into spending power - had been established.

Meanwhile, and increasingly since the mid-1990s, the essence of the Grameen experience became better understood. This sometimes uncomfortable process involved the dropping away of some features and their replacement by others. The focus on investing loans only in microbusinesses softened: practitioners came to see that in reality microfinance users spent their money in a wide variety of ways, and that since money is fungible (that's why it was invented) there is little point in trying to prescribe the way it is spent. The gendered nature of Bangladesh microfinance practice continued - most microfinance institutions (MFIs) still have a registered clientele that is mainly or exclusively female -but practitioners became more comfortable with the observed fact that once loans entered the household they may well be used and serviced by men. The group came to seem less and less important: some major MFIs quietly dropped the insistence on group meetings, sending workers to the village to meet with clients at a central spot on a regular date and time, but not requiring a meeting, and not enforcing any strong form of joint liability. Credit lost its privileged position as the only form of personal financial intermediation offered to clients: several MFIs began expanding the range of savings plans available, including open pass-book schemes, time deposits, and contractual plans, and early experiments with insurance began.

At the same time, the maturity of microfinance in Bangladesh - its twenty-five years of experience - has begun to pay dividends in another way. In the early days standardisation was, quite properly, understood as a vital instrument of internal control - a necessary antidote to rent-seeking and a way of keeping things transparently simple. The fixed-value compulsory weekly saving, and the invariable one-year loan term with its fixed-value weekly repayments (on which pre-payments were not allowed) had been established early on as norms. More recently, the disadvantages of these rigidities have been recognised at precisely the same time that the MFIs' vast experience is giving them the confidence to experiment with alternatives. For example, very poor households, such as those that depend on seasonal work like agricultural labour, find it hard to make a fixed value payment week-in week-out for a full year, and this problem lay behind the realisation that despite much rhetoric about reaching 'the poorest of the poor' it was in fact the case that many such households dropped out of MFIs, or never joined. For those households, more flexible repayment schedules, or shorter term loans, or both, make sense. The desire to match services better to the cash-flows of the very poor became one of the motivations behind recent experiments with more variable terms and schedules.

A similar story of increasing flexibility can be told at the other end of the low-income spectrum: MFIs are also designing loan products with terms and schedules attractive to upper-poor businessmen and women. This is in keeping with the waning of enthusiasm for the idea of graduating top customers to mainstream commercial banks. Top customers have, as a result, shown little interest in moving on, and keeping top customers has been an important way to enhance profitability for MFIs. The bigger savings of these upper-end clients provides a source of modestly-priced capital, and their higher-value loans contribute to larger retained earnings, enabling the institution to expand its outreach to all kinds of clients more rapidly.



Thus, one by one, the keywords of the 1980s and 1990s - women, groups, microbusinesses, credit, and graduation - have given way to those of the new century - convenience, reliability, continuity, and a flexible range of services. 'Grameen IF, a fundamental redesign of the way the Grameen Bank does its business, features loans with a range of terms and with variable repayment schedules, new savings instruments including a hugely popular contractual plan (the 'Grameen Pension Scheme'), some of which are offered to the general public (including men and children) as well as to group members, and new arrangements for the extreme poor under which they do not need to join groups. By mid 2002 Grameen II had been introduced into all of Grameen's branches, which number over one thousand.

Bank Rakyat Indonesia has also made convenience, reliability, continuity, and flexibility core elements of its mission. To do this, it underwent a radical make-over in 1983. The bank had started as a government-owned rural development bank in 1968, charged with helping to spur agricultural production. To help both borrowers and depositors, the government mandated that borrowers pay interest rates of 12% while depositors received 15% under the national savings program *Tabungan Nasional*

(TABANAS). The intentions were good but the negative interest rate spread was untenable, and by the late 1970s the bank was suffering huge operating losses. Indonesia de-regulated banks in 1983, and BRI transformed itself with the aim of becoming financially viable without subsidies. The staff turned to the villages to studylocal financial markets to better understand what households really needed, and in 1986, after a year of field work, BRI rolled out the new "village savings" product, *Simpanan Pedasaan* (SIMPEDES). It was quickly popular, despite not paying interest at all on small deposits and paying at most 12% for the largest deposits - relative to the 15% returns offered by TABANAS. But while TABANAS restricted withdrawals to two times per month, SIMPEDES offers unlimited withdrawals. Patten and Rosengard (1991, p. 72) argue that "although very few TABANAS savers actually withdraw funds twice a month, this limitation is an important psychological barrier to the people in rural areas, who seem to fear that they will not have access to their TABANAS savings when they need them."

With BRI's extensive network (at the end of 2002 it had 3,916 unit offices), depositors can bank close to work or home, and as a fully-regulated institution, depositors know that the security of their savings are guaranteed at BRI. Convenience and reliability have thus proved more important to customers than having the very lowest cost. Today, BRI handles over 25 million individual SIMPEDES accounts with an average balance of $75 (the population of Indonesia was roughly 225 million people in 2000). Chart 2 shows that in the wake of the financial crisis of late 1997, BRI in fact attracted depositors, rather than lost them. By the end of 2000, the total size of BRI's deposits was two and a half times the size of BRI's loan portfolio.

Targeting

Microfinance involves, by definition, banking for the poor. Each institution may define what it means by "poor" somewhat differently, but it's hard to escape the need for a

clear vision of the target population. Microfinance in Bangladesh has earned a reputation for maintaining a focus on women from functionally landless households (although, as we noted, this has softened in practice). BRI has also focused on serving the under-served, but, in contrast, it has focused on low-income households (and not just those below the poverty line) and most clients are men.

The dual pursuit of social ends and financial profits is an ongoing tension for all in microfinance. Mission drift is a common fear as pressures mount to serve richer clients with larger loans (and thereby to earn higher profits per loan since transactions costs per rupee tend to fall with loan size). Keeping focused on their respective target populations has thus been central to the missions of the successful institutions in Asia.

Still, there has been much debate about how stringently to target, and how best to do it in practice. Grameen and BRAC employ eligibility rules to restrict attention to households holding under a half acre of land. Grameen expands the definition to also exclude households with more than the equivalent of an acre's worth of assets. BRAC similarly excludes households without a manual laborer. Others, like *SafeSavc,* rely on geographic targeting, restricting attention to specific slums in Dhaka.

The eligibility rules, though, are less stringent than they would seem at first. In practice, both Grameen and BRAC staff make exceptions to the half-acre rule, and some estimates suggest that as many as 30% of borrowers may be over the half-acre line. The deviations may reflect that land is low-quality or that households are large so that per capita holdings are relatively low. At other times, the rules may be stretched simply to give access to community members who will be promising program members.

The stretching of rules is kept in check by other practices which have a strong bearing on who is attracted to microfinance and who is turned away. Those practices include how products are designed, how staff are

compensated, what messages are delivered from headquarters, and who is recruited onto staff.

Highly-educated staff members, for example, may be good colleagues, but may not work comfortably with the poorest clients. In response, *SafeSavs* hires its deposit and loan collectors from the slums in which they work (CGAP, 2000). Similarly, rewarding staff for the volume of loans they make, rather than the number of clients served, can push staff toward making large loans to fewer people, rather than seeking to get smaller loans to more people. Keeping true to mission may also be rewarded explicitly. Under Grameen Bank II, for example, staff are given rewards both for maintaining high repayments and for poverty reduction in their branches.

Product design is another means of targeting. Lending in groups and sending staff to villages has been credited with much of microfinance's appeal in Bangladesh. A critical but less-heralded breakthrough for Grameen was to create a loan product that allowed borrowers to repay in small, weekly installments. This suited poor households well, since they could repay out of the regular bits of income coming in daily or near-daily. When BRAC experimented with repayments every two weeks, arrears jumped up as poor households had difficulty holding onto money over the two-week interval; BRAC quickly went back to weekly collections . BRI too asks for weekly repayments from its smaller-scale clients. Charging appropriate interest rates has also helped stem leakage of resources from target populations to those richer or politically-favored, as we discuss further below.

On the savings side, BRI has tried to encourage broad access by maintaining very low minimum balances ($0.57 or 27 Rs.) and low minimum deposits for opening accounts. New depositors can start an account with 10,000 rupiah (just over $1 or 53 Rs.), and the new savings products have given BRI its most notable success in serving the poor. On the borrowing side, BRI requires borrowers to put up

collateral to secure loans, but the bank has chosen to be very flexible in what it will accept, so that collateral is not a major constraint when seeking poor clients. A survey completed in 2000, for example, shows that 88% of non-customers had acceptable collateral of some sort. In order to push still further, BRI has instituted products that require no collateral at all for loans up to Rp. 2 million ($ 225 or 10,658 Rs.), offered at the discretion of the unit manager.

Interest Rates

Few issues in microfinance have been as contentious as those surrounding interest rates, but the experience in Bangladesh and Indonesia show that debates may have been unnecessarily polarizing. A large part of the success of microfinance in Bangladesh and Indonesia has been to find a comfortable middle ground. Programs have taken important lessons from those who argue that if interest rates are raised to cost-covering levels, programs can ensure sustainability over time, thereby guaranteeing their ability to offer clients long-term continuous service. They have also been sympathetic to the concern that raising interest rates too high may undermine the social and economic impacts on clients and steer deserving customers away from microfinance.

The middle ground has involved working hard to keep costs low so that interest rates can be kept relatively low as well. Once fees are added in, leading institutions charge roughly between 24% and 48% per year, with the Grameen Bank at the bottom of the range and most others in the center of the range (with annual inflation rates hovering around 10% in most years in both countries).

Microlenders have also worked hard to maintain quality standards, with the aim to charge a fair rate for a good product. By stressing convenience, reliability, continuity, and flexibility, programs have delivered products that are both much cheaper than those available from the informal sector and *higher quality* as well. The transformation at BRI in the mid-1980s did not involve simply raising fees.

The important shift was from delivering lower-quality products at lower interest rates under the national BIMAS loan program to delivering new, higher-quality products at prices that covered costs.

Over time, microlenders in Bangladesh and Indonesia also came to see that raising interest rates to cover costs has helped them to better serve target populations. Some have argued that interest rates should be raised to allow institutions to serve a greater number of under-served households, and the fact that millions of clients are served in Bangladesh and Indonesia attests to the assertion. But microfinance organizations have found that raising interest rates has allowed them to improve quality as well.

If interest rates were simply costs imposed on borrowers, it would strengthen the brief for minimizing interest rates in the cause of social progress. But interest rates play other important roles; most importantly they function as rationing and incentive mechanisms, and they provide organizations with resources to reward savers. In Bangladesh and Indonesia, cost-covering interest rates have helped to steer loans to the most efficient users to such a degree that fears of diversion of loans to non-target groups or to the politically privileged have been minimized. In addition, microfinance institutions can now afford to pay depositors interest rates that foster accumulation. The Grameen Bank's popular new pension product, for example, will nearly double the money of depositors who make steady monthly deposits for ten years.

Part of the shift in Bangladesh and Indonesia also involved reducing hidden costs that clients had often had to pay when dealing with highly-subsidized programs (non-interest fees, perhaps bribes, and costs associated with applying and waiting for loans). By unburdening borrowers of these hidden costs, the difference in the "true cost" of borrowing from a microlender at, say, 36% per year and the true cost of borrowing at substantially-subsidized "below-market" rates elsewhere turns out to be far narrower than

the difference in advertised interest rates suggests (Reddy, 1999).

Credit plus? Assessing integrated service provision

When we write that poor people value convenient, reliable, continuous, and flexible financial services, we are not saying that is all that they value. Access to other kinds of interventions and opportunities may be even more critical to helping people effectively invest for the future, cope with periodic difficulties, and maximize the use of resources. In Bangladesh, BRAC in particular has coupled microfinance with other kinds of services. BRAC borrowers may send their children to BRAC schools, get health problems seen to at BRAC clinics, learn about legal rights at BRAC training sessions, and sell merchandise through BRAC retail outlets.

BRAC is not alone in thinking beyond finance. Grameen Bank started a schools program early on, for example, and ASA originally put a half hour aside at weekly meetings for discussions of health and social issues. Given that a well-targeted group of poor but motivated villagers were already assembling each week for microfinance transactions, it made sense to begin adding such activities. Recent evidence suggests that many of those sessions have been meaningful for clients.

Over time, though, those activities have been de-emphasized at Grameen and ASA, and BRAC does much of its development work outside of the context of weekly microfinance meetings. In part, the activities were reduced not because they failed, but rather because they were successful. Partly because of the early work by NGOs, health, hygiene, and social practices have now taken root, and the microfinance institutions realized that continuing training sessions would for many amount to little more than triple-underscoring well-understood messages. Rather than being a valued add-on, sitting through repeat training sessions would start to impose growing costs. At the same time, other, specialized NGOs and the government became

better able to take on training tasks and the provision of basic health and education. ASA and Grameen could then make the development of good microfinance their core business.

De-emphasizing integrated services also gave ASA and Grameen the freedom to make microfinance work better for their clients. If ASA had kept its training sessions, it would have meant keeping the original group meeting format. By moving away from training, ASA was able to drop formal group meetings, allowing clients the freedom to transact their microfinance business quickly, one-on-one with loan officers. De-emphasizing training also allowed ASA and Grameen to train staff to be competent at finance, without needing to worry about whether they were particularly good educators as well. This has been critical to maintaining efficient, low-cost operations. ASA, in particular, has made a virtue of simplifying its practices so that less-educated staff can handle financial tasks with ease. As a result, most of their credit officers are young and lack college degrees; they are highly-motivated but not especially well-equipped to sit with village women and discuss, authoritatively, oral rehydration therapies, breast feeding best practices, or options for divorce.

Access to non-financial services remains important for microfinance clients in Bangladesh. The microfinance institutions played an important role when they helped to provide them. But they have played an equally important role by de-emphasizing the activities at the right time. By not locking into particular modes of operating, the institutions have continued to innovate, ensuring that clients still have convenient, reliable, continuous, and flexible financial services.

Aligning Incentives of Management and Staff

Much attention in microfinance circles has been paid to the issues discussed above, and with good reason. Since they arise anew with microfinance, debates around targeting,

interest rates, and added services have animated the microfinance "industry" as practitioners and policymakers have had to work out new solutions and assess contrasting views. No less important, though, are bread and butter management issues. A lesson from Bangladesh and Indonesia is the importance of creating professional institutions (irrespective of their being subsidized or profit-making) in which staff clearly understand rules and in which incentives are aligned from the top of the organization to the bottom.

Some, like the main institutions in Bangladesh, maintain appropriate incentives for staff mainly through the promise of security of employment, reliable if modest salaries, and of advancement within the institution - very attractive characteristics in a country with severe underemployment and weak labor laws. Clear simple targets help staff understand the behavior that leads to rapid promotion, and 'awards' are used to publicly distinguish well-performing individuals and branches. Organizations have also been successful in making staff feel that they belong to a special kind of culture, peculiarly committed to serving the poor, and in this they both reflect and are helped by microfinance's historic evolution out of socially-committed private development agencies. Their staff training programs encourage this commitment: an applicant for a job at Grameen Bank, for example, is required to interview and write up a case history of a poor rural woman. Indonesia's BRI, on the other hand, with its strongly commercial orientation, creates "high-powered" incentives by basing a large fraction of staff pay on the performance of their unit; incentive-based pay is typically twice as great as basic salary. The decision to allow some workers to earn more than others in similar posts was controversial at first, but because incentives were designed so that everyone can in principle gain through hard work (there is no "zero-sum game"), the move has been both popular and effective within the system.

Similarly, pushing for strong management information systems and timely reporting has aided oversight and the ability to quickly identify problems in time to avoid larger ones. Until recently, this has been managed without universal computerization, but increasing computerization has made the work quicker, cheaper, and easier. Quick access to clients' transaction records is a powerful aid to making services more reliable and making service providers more accountable to their clients.

The Opportunities of Self-help Groups

There has been growing excitement about the Indian 'Self-Help Group Bank Linkage' movement, and some believe it is destined to become the country's dominant system of mass-outreach banking for the poor. It certainly appears to fit Indian history and circumstances. The idea of local savings-and-loan clubs enjoying access to formal financial services by becoming corporate customers of banks is a good one and is practiced in a small way in many countries. A well-run club can keep its reserves at the bank and take bulk loans which it can on-lend to its members at a premium, covering its costs and rewarding its savers in the process.

The Indian version of this practice, the SHG movement, was started in the 1980s by social-development NGOs, many of whom took up group-formation (especially of women) as their main tool. Having group members learn how to pool savings into loans - mostly small short-term consumption loans - was seen as empowering disadvantaged women, socially and politically as well as financially. By 1992 the NGOs had, heroically, persuaded government to take the idea seriously. Legal obstacles were removed and subsidies made available so that SHGs could take bulk loans from banks that could be on-lent to group members who could use them to take up or expand microbusinesses. Banks were allowed to count such lending towards their legal obligation to direct a fraction of their loans to the poor, and they were given access to subsidized NABARD

refinancing to do so. It seemed an ideal way to realize an old Indian dream - to make the vast network of rural banks key suppliers of loans to the poor. Growth in the numbers of SHGs formed, and the scale of their interaction with banks, has been very fast in the last three or four years, and is still accelerating. NABARD hopes to see a million SHGs serving 20 million households by 2008.[32]

However, in countries where mass-market pro-poor retailers such as Grameen and BRI have emerged, such 'linkage' schemes have not become widespread among the poor. Like the not-so-poor, poor people, given the choice, prefer an individual service, prefer the simplicity of having a reliable retailer look after the bookkeeping instead of having to do it themselves, and prefer to avoid the risks involved in owning and managing their own mini-financial institution. This is especially true of the very poor, who are often illiterate and ill-equipped to maintain a good set of books for anything but the simplest inflexible transactions over short periods.

The prospects for the SHG movement are therefore far from certain. Even its most enthusiastic supporters recognize that much work needs to be done to upgrade and mainstream SHGs: ideas on how this may be done are set out in Seibel 2001, for example . This is because the present system is unsustainable, for lack of clarity about who is to play the key role of maintaining quality, and how the costs of doing so are to be met. If NGOs remain involved as promoters and 'minders' of the groups, they will need to be paid to do so, yet in the long run, with their social-development perspective, NGOs are not ideal candidates for this role, and nor is it clear who are to be their long-term paymasters. But the banks themselves, whose business *is* financial services, are unlikely to want to do more than ensure that their loans are safe, and will not take on the time-consuming task of helping groups manage the bookkeeping of their internal savings and loan accounts. Left to themselves, without outside assistance, most groups

will have great difficulty maintaining quality, and the poorer they are the truer this will be. Mathew Titus reminds us that we shouldn't be naive enough to believe that, just because a group of poor women come together to run a savings-and-loan club, they will be immune from the corrosive effects of poor management, confused accounting, capture of assets by the leadership, and other kinds of abuse. If the SHG movement is to offer poor people reliable and convenient services on a continuous basis, it is most likely to do so by undergoing a transition into a more stable institutional form, such as the Credit Union system. Even then, the movement will find it difficult to compete with mass-outreach retailers of the Grameen or BRI kind, should they emerge in India.

There is a view that the SHG movement can, at minimum, serve as a quick way to deliver microfinance in an "interim" period, before other institutions can be developed or adapted. The idea is to then graduate SHG members to these other institutions where they can access standard "individual" loans, possibly on a fully commercial basis. An immediate problem arises in that there are no obvious lenders for SHG customers to graduate to - none yet are close to offering the reliability, convenience, continuity, and flexibility of good microfinance for low-income customers. Nor is the notion of graduation built explicitly into the SHG design. In Indonesia, in contrast, Bank Rakyat Indonesia has worked closely with (and in fact supervises) the Badan Kredit Desa network, which has for some been a feeder to BRI. Even so, there is relatively little graduation overall from the BKDs to BRI, partly because BRI is only now developing products that work well for the smallest-scale clients. In Bangladesh, the pretext of graduation has been universally abandoned for lack of an appealing next step—and for the desire of NGOs to continue working with clients with whom they have developed relationships over many years.

If the idea of graduation is a serious one in India, strong efforts must be made now to reform institutions like the

Regional Rural Banks with an eye to designing services and products appropriate for SHG clients. Moreover, it should be made clear what is to happen to the NGOs should their clients eventually graduate—can they simply be left to wither? The cumulative Asian evidence suggests that the most promising strategy is instead to aim for good, reliable, responsive, long-term institutions for the poor - rather than to focus on second-best "interim" measures.

Conclusions

Poor households face many constraints in trying to save, invest, and protect their livelihoods. They take financial intermediation very seriously and devote considerable effort to finding workable solutions. As a result, the informal sector in India teems with lenders of different sorts and mechanisms offering widely varying ways to save and insure. The informal sector has, until recently, offered low-income households convenience and flexibility unmatched by formal intermediaries. But the informal sector also has many weaknesses and cannot do what a well-functioning formal sector institution can.

The microfinance movement is thus striving to match the convenience and flexibility of the informal sector, while adding reliability and the promise of continuity, and in some countries it is already doing this on a significant scale. Getting to this point - reaching poor people on a massive scale with popular products on a continuous basis - has involved rethinking basic assumptions along the way, and programs in Bangladesh and Indonesia are still developing new products and approaches. In Bangladesh, the unveiling of "Grameen Bank II" is the most dramatic recent example. BRAC too has been innovating, most recently with new ways to reach the very poor through its specialized Targeting Ultra Poverty program. *SafeSavc,* an innovative cooperative, is building on its successes in the Dhaka slums to try new approaches in rural areas.

These developments can be attributed in large part to leaders with the self-confidence to learn from mistakes and

the boldness to try new ideas in the face of counter-arguments. This has proved more important than legal identity, institutional type, or funding source, all of which vary considerably among the successful programs of Asia.

The past few years in India have demonstrated a welcome willingness to innovate and to think afresh about financial services for poor people. Off-the-shelf models designed for other contexts have been viewed with caution in India, and this attitude is sensible as long as it does not restrain local advocates of those models from experimenting in India if they wish to, so it is good to see MFIs like SHARE growing rapidly. The Indian self-help group-bank linkage model is an important example of home-grown innovation, and is currently receiving a much-deserved increase in attention at home and abroad.

But because SHGs are a very mixed bag in practice, their already rapid expansion will need to be matched by serious attention to their structural and funding weaknesses, and with much more thought about their long-term position in the national financial system.

Lessons from Bangladesh and Indonesia provide guides for what better solutions should look like. Necessary steps include: raising interest rates well above "cheap credit" levels (no matter what one's view on subsidy); clearly targeting customer groups (whether by product design, location, or explicit eligibility criteria); judiciously providing (or not providing) non-financial inputs; and managing and rewarding staff according to clear, performance-based criteria. Creating diverse, responsive institutions will also mean avoiding an exclusive focus on credit, or on "microenterprise credit", or on group-based solutions.

For the government's part, there is a role to play in further de-regulating interest rates to allow a broader array of institutions to serve the poor. Being permitted to raise interest rates has proved critical for Asian programs, even for successful pro-poor NGOs that remain subsidized. As a general rule, programs that take in savings should be

regulated in order to protect depositors, though the Bangladesh experience shows that well-established lending programs can safely be allowed to accept both compulsory and voluntary savings from their clients, if not from the general public. Bangladesh - where most MFIs are lightly supervised by an NGO Bureau rather than by the central bank - also shows that programs that offer credit-only services can be safely left to evolve with little or no regulation. All programs, though, should be held to high professional standards with regard to timely and transparent financial reporting, an accomplishment not yet fully achieved in Bangladesh (and sorely missing with regard to the Indian SHGs).

The commitment in India to microfinance has been longstanding, starting well before the global movement was even given a name or considered a movement. But many early ideas did not work as expected, and the Indian economy has changed a great deal in the past twenty years, opening space for new approaches. In seeking those new ideas, lessons from elsewhere in Asia point to both cautionary lessons and important opportunities for India.

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3

Auditing for Social Change in the Context of the Millennium Development Goals

Not too long ago, public demands for accountability and transparency in gover-nance were given less priority. The end of the cold war era, rising democratization of countries and emergence of strong civil societies and open media are creating new and more radical demands of transparency and accountability in the public sector. These demands are cantered on stronger monitoring and evaluation and more rigorous audit of public expenditure. At the same time, an increasingly active citizenry is championing the call for responsive government, for policies that fos-ter equity and development, for a budgetary planning process which is open and subject to scrutiny, for eradication of graft and corruption, and for enhanced and demonstrated results. However, despite these recent positive trends, studies show that many developing countries perform poorly with respect to holding its govern-ment to account and in efforts to control corruption, in the equitable distribution of services and in effective decentralization.

Managing the public sector in todays environment of constant change has become a demanding challenge for policy makers, service delivery managers, and civil servants — a challenge that is especially daunting for those in

developing coun-tries and countries with economies in transition. The current trends and challenges to which governments have to respond and to which there are no bounda-ries include: long-term fiscal imbalance, national security, global interdependence, changing economy, demographics, science and technology, quality of life and environment, and last but not least governance. Consequently, the challenges facing the audit profession are also constantly evolving.

The United Nations, together with international financial institutions and development agencies, have for the last two decades expressed concern with the lack of governance and accountability in developing countries and have endeavoured to find responses and solutions. Although structures and mechanisms exist in all countries for ensuring public accountability, these have in many cases not been successful in resolving issues of governance.

Therefore, the ability of the traditional accountability mechanisms to effect change on the functioning, performance and transparency of governments are increasingly being openly debated. International efforts are focusing on issues of governance and accountability, and interventions dealing with government reform range from administrative reforms to the redesign of judicial and audit institutions. In addition, the donor community is increasingly initiating projects aimed at building the capacity of civil society and citizens at large to demand accountability from the State. The focus is on strengthening public accountability through pres-sure from outside of governments, especially through civil society institutions.

Indeed, donors are targeting for key reform the strengthening of parliaments, protecting the autonomy of the judiciary, improving the performance of the pub-lic sector, supporting the development of professional media, encouraging private investment, and decentralizing delivery of services. While in this context, the strengthening of Supreme Audit Institutions (SAIs) in developing countries

has received some degree of attention by the donor community, not enough attention has been paid to these institutions as potential tools for promoting socio-economic and pro-poor governance. Few reform processes of SAIs have zeroed in on how the audit function could become a tool to empower citizens in furthering transparency and accountability for public spending.

The United Nations Department of Economic and Social Affairs (UNDESA) proposes that SAIs and the audit community at large improve their impact by taking into account the growing voices of what have become known as "alternate watchdogs," including civil society organizations and the media, with special reference to the implementation of the Millennium Development Goals (MDGs). The question is whether the audit function, both external and internal, can be made more open, proactive and participatory, moving the function from being a tech-nocratic and a reclusive tool of expenditure control to a more engaging tool for social change and citizen empowerment.

It is UNDESAs belief that the way audit is currently conducted and the institutional framework within which audit activities are conducted provide opportu-nities that can make a meaningful contribution both to the accountability aspect of the public expenditure and to the core of what government initiatives are expected to achieve—reduce poverty, guarantee social justice and empower people.

One of UNDESA's newest initiatives is to make the audit function more central to pro-poor governance, with the results-based audit of MDGs as a focus area. The objective is to extend the role of civil society from participation in the design of pro-poor strategies and service delivery to include in contributing to the accountability processes of the government to ensure full, timely and quality implementation government commitments.

It is to explore this potential that UNDESA organized the Expert Group Meet-ing/Workshop on "Auditing for Social Change". The workshop, among other things included the examination of successful case studies involving participatory audit and monitoring in order:

(i) first, to facilitate evolution of institutions and institutional processes that are conducive to support pro-poor policies and decision-making; and

(ii) secondly, to assist public sector institutions and management systems to become more results oriented, and accountable.

With regard to the first, UNDESA has launched a program on "engaged gov-ernance" examining, promoting and advocating the concept of citizen/govern-ment dialoguing for pro-poor policies including pro-poor budgeting, more as a norm rather than as an ad hoc arrangement. In this endeavour, we see sets of par-allel and yet complementary movements, namely, public institutions adopting a more engaging behaviour in its decision-making and the civil society organizations becoming more collegial and supportive in its dialoguing role, aiming at inter-linking issues of engagement, social justice and pro-poor development. UNDESA recently held an Expert Group Meeting on Pro-Poor Budgeting.

With regard to the issue of results orientation of the public sector institutions, DESA has taken initiatives to promote systems, procedures and methodologies for results based monitoring and evaluation. In recent times, UNDESAhas supported the government of Sri Lanka to develop MDG based results-indicators and to assist oversight of MDG related programs in a more transparent and accountable manner. UNDESA also held an Expert Group Meeting on aid management and explored monitoring aid within the results framework.

The focus of the Expert Group Meeting/Workshop is on participatory audit experiences and methodology.

Participatory Audit is different from Social Audit in that it refers to audit processes where stakeholders are directly or indirectly involved through a variety of audit and monitoring methods and public hearings.

Social Audit refers to a process that enables an organization to assess and dem-onstrate its social, economic, and environmental benefits and limitations. It is a way of measuring the extent to which an organization lives up to the shared values and objectives it has committed itself to.[2]

Audit and the Climate of Change

With the changes brought on by globalization and liberalization, access to informa-tion and indeed, the rising expectations of the citizens brought on by the increased democratization of countries and societies, impetus for change in all aspects of life including the public sector management systems have become imminent, if not already a matter of reality.

In this climate of change, audit is not lagging behind. Already, state of the art auditing has started to go beyond the examination of expenditure and beginning to look into the processes and procedures that influence the decisions on expenditure. For quite some time now, auditors have started to look at management processes and systems to determine the cost-effectiveness of public expenditure. The results of such examinations often lead to recommendations for improvement and change that are systemic in nature. In that context, the modern auditor is indeed becoming a catalyst for change. For example, since over a decade the concepts of "managing for results", "auditing for results" have taken roots in many countries, making it evident that the functions of audit have undergone significant changes and the lines between audit, evaluation and monitoring are becoming less rigid. There are now a lot of complementa-rities among these three tools of expenditure management.

In Results-based audit, "the emphasis is placed on identifying the critical results or products to be achieved by

a program or a process. These results may take form of outputs produced in relation to those intended, products delivered, or immediate goals that must be achieved for the program or process to be a success./.../".

Furthermore, the audit function has also taken an interest in governance as an integral indicator of the managerial health of an organization, whether private or public. In that respect, audit standards regarding the structure, composition, role and impact of Audit Committees have already started to experience significant change. More research is needed to explore to what degree Audit Committees are currently being utilized to ensure proper scrutiny of pro-poor programs and projects, and how both governments and civil society could exploit this mecha-nism for greater transparency.

UNDESA believes that the evolving role of audit can be taken one step further without disregarding its traditional boundaries to focus on issues that are of vital importance to a country and its citizens such as the Millennium Development Goals. It is hoped that some forms of synergic relationships between the citizens and the audit can be forged to empower the former to guide the public sector initiatives to implement the agreed goals, both national as well as international. In other words, the overall thrust is to explore innovative ways of engaging the audit community more pro-actively in ensuring that impact is achieved for the public good not only as a result of audit recommendations, but also as a result of broader engagement in the audit process, thereby creating a better environment of ownership to and compliance of these recommendations.

With the advent of performance audit that blurred the boundaries between financial and compliance audit disciplines, the auditors have already moved in a way that seek for more accountability in the auditing process. Performance audits analysis of a policy, program or project implementation almost always makes reference to policy issues.

The next step, linking the beneficiaries of the public policies and programs — the citizens — to the audit process, holds the promise to create a much stronger climate of compliance and therefore, positive social change.

The efficiency and effectiveness with which governments are using resources are in many cases not showing improvements as major public expenditures and investments turn out to be of low impact and return. There are reportedly also issues of sys-tematic failure to collect revenues. Common causes cited are widespread corruption linked with a lack of rule of law and transparency. Poverty reduction continues to be the major development hurdle for many countries, despite decades of sustained aid.

Both citizens and development experts have argued for the need to restructure the State and its functions as a response to governance and development failures. Supreme Audit Institutions (SAIs), also referred to as national audit offices, exist in most countries, as do provisions for internal audit and other control mecha-nisms within state institutions, but their effectiveness and independence have been at issue in many developing countries. Indeed, most SAIs receive constitutional recognition, and as watchdogs of public finances, act as critical links in providing independent oversight and thereby enforcing the accountability of executive agen-cies to national and state legislatures and through them to the general public.

The effectiveness and efficiency of SAIs — even in performing traditional functions — has however been fairly limited in many countries as a result of several factors including: lack of independence from the executive; limited access to information; financial and legal constraints; capacity and skills constraints; lack of timeliness and relevance; weak political clout to enable follow up; and poor communication between the SAI and the legislature hampering corrective actions; and lack of contact with citizens and civil society organizations thus hampering efforts to treat audit as an instrument of citizen empowerment.

Many of these problems stem from the fact that Supreme Audit Institutions (SAIs) are made to abide by stringent legislative mandates, international and national standards, and remain confined within tradition-bound bureaucracies. In exceptional cases where complaints of massive fraud or irregularities are received, auditors may engage the citizens through some forms of surveys. But these are more exceptions than norms.

Another area where audits seldom get involved is the audit of the international commitments of the governments, though thanks to the initiatives of the Inter-national Organization of Supreme Audit Institutions (INTOSAI) some countries have taken up audits of implementation of these commitments, especially in the area of environment.

Efforts such as the above and other forward looking innovations are underway, even within the limits of existing standards and constraints, to make audit more useful to legislators, decision-makers and the citizenry. For example, the success of "joint, concurrent, parallel or coordinated" audits whereby SAIs of two or more countries , the national and one or more sub-national legislative offices scrutinize a particular area or sector of common interest, reporting through their respective reporting mechanisms. Also, reporting has gone a long way both for external and internal audit, where increasingly reports are not only issued on a timelier basis, but have also become highly visible by making them public. Lately, in its quest for contributing to accountability, transparency and good governance, media is also taking increasing interest in audit.

Making Audit a Tool for Social Change

The challenge facing the audit community is how to strengthen audit to make it a tool for social change. In this endeavour, the following questions need to be addressed:

- By linking expenditure with results, can audit contribute more effectively to guide actions to results?

- Should audit go beyond post-facto expenditure analysis and get involved more pro-actively during the planning and the budgeting phase?
- Since public expenditure is very much about the public, are there opportunities to involve citizens into the auditing process? If so, how can this be achieved? In this, what role can the media play? What role can the civil societies play?
- Finally, by making audit more participatory, can it be made to function as an empowering tool for the citizens to hold the state accountable more directly — but at the same time not compromising the parliamentary process of check and balance?

The EGM/workshop, "Auditing for Social Change" aims to discuss some of these issues insightfully. Seen within the context of the concept of "engaged gover-nance" UNDESA believes that there are real opportunities to broaden the both the operational space as well as the process of audit. It is in this context that UNDESA has recently taken an interest in the role that the audit institutions could play through partnerships and involvement of civil society in furthering the conven-tions and treaties adhered to by its Member States, encapsulated in the 2000 Mil-lennium Development Goals (MDGs).

The emerging issues for public administrations were presented and deliber-ated at the Fourth Session of the United Nations Committee of Experts in Public Administration (CEPA) from 4 to 8 April 2005 at the United Nations headquar-ters. One of the main themes discussed pertains to Integrity, Transparency, and Accountability (ITA), a theme which has been at the core of SAIs' objectives for decades. The overarching framework for the discussions was the achievement of the 2000 Millennium Development Goals (MDGs) by 2015 endorsed by all UN Member states, with focus on poverty reduction and social orientation to development (7 out of 8 goals), and on partnership for development between the private and public sectors and between Government and the citizen.

The following points deliberated by CEPA are directly linked to the theme of the EGM/Workshop :

- Citizen demands for better delivery of services and more equity has increased, as has the demand for strong, open, and participatory monitoring, evaluation, audit, and information sharing;
- Many of the existing standards and norms pertaining to ITA are either out-dated or not institutionalized. The flurry of recent national, regional and international commitments, conventions, and treaties related to ethics, corruption, and money laundering and integrity demonstrate trie urgency of addressing ITA issues — in many countries trie adopted conventions remain to be ratified, implemented, monitored, and enforced; and
- Information and communication technology (ICT) has created opportunities for information sharing and wider stakeholder response and participation/ input in public policy and decision-making.

  Against this backdrop, it becomes clear that the role of an independent and responsive SAI has to evolve towards the following roles:

- Assist the legislature to carry out its constitutional responsibilities and legislative oversight;
- Assist in improving the performance of government; and
- Ensure accountability and transparency of government for the benefit of the citizens.

Adopting such roles necessarily implies that SAIs cannot hide behind the past and must use their audits of past performance and activities to draw lessons for today and tomorrow. It also implies that in addition to preventing and detecting fraud, waste, and abuse, and assisting the government to become more efficient and effective, SAIs

must examine the role of government, albeit within the bound-aries of their mandate. Some newly created SAIs have already enshrined the latter focus in their legislation, specifying as one of their main objectives the evaluation of government policy.

A modern outlook on SAIs' roles would also imply that they lead by example and promote best practices by observing protocols, employ a constructive engagement approach with audited entities, and partner with fellow oversight and accountability organizations as well as with selected "good governance" institutions. Most importantly, to achieve real impact for the benefit of the citizens would imply some degree of engagement of the citizens and their perspectives in the audit processes. However, in the same way that most public administration systems remain introverted and lack inclusiveness in decision-making processes, many audit offices and their operations have remained a mystery and are shielded from the public eye and scrutiny. The time may be ripe for SAIs to pro-actively engage citizens through participatory auditing.

Workshop"Auditingfor Social Change"

In order to discuss in depth the implications for SAIs of moving towards participatory audit processes, UNDESA has structured the workshop "auditing for social change" around the following themes.

Audit and Planning and Budgeting

It is important to explore how audit can contribute to better planning and budgeting to achieve results in social programs, particularly the UN Millennium Development Goals.

The following questions need to be addressed:

- Is there a role for people participation in the audit of budget formulation and implementation?
- What is the potential role of civil society organizations in demanding and fostering fiscal transparency?

- To what degree do government financial systems and fiscal data support a comprehensive oversight and risk-based scrutiny of public spending in the social areas, and can these be linked back to the budget?

Audit and Civil Society

A number of experiences in participatory audit around the world indicate that audit can become a tool to empower citizens at the grassroots level, through part-nering with civil society in the audit process.

It is essential to discuss

- how participatory auditing could be mainstreamed in the audit function while adhering to the principle of independence and other professional audit standards; and
- to what degree civil society has had an impact on fiscal transparency and good governance, and the role that audit could play in this respect.

Audit and Legislative Oversight

The increasing importance of legislative oversight of the executive branch reflects the growing complexity of government activities and program delivery mechanisms. Parliaments are getting more engaged in overseeing the budget and its execution. Parliamentarians are also key actors in supporting propoor spending and programs and in furthering democracy. The oversight function of legislatures is essential in ensuring that governments develop and implement programs which are in the public interest, and in holding the state to account for its spending.

Legislative governance systems for financial accountability and oversight vary substantially according to the country's constitution. However, common challenges point to the need to consolidate and share best practices and lessons learned in effective legislative financial oversight with regard to areas of governance, man-date and committee functioning.

The following issues need to be addressed :

- How can audit become a more effective tool for promoting legislative oversight and accountability for budget decisions, public spending, and government programs?
- How can legislative oversight committees open up to public opinion and input, media reporting and other stakeholders to establish a common understanding of public interest issues?
- Is there scope to engage public interest and citizen dialogue in parliamentary financial oversight, especially in areas of pro-poor spending and taxation?
- Can parliamentarians be sensitized to focus on the quality of audits; and to examine the impacts achieved through audits rather than to analyze specific cases of irregularities?

Audit and the Media

In the last decade, the world has seen the mushrooming of "alternate watchdogs" that often get more public attention than the audit community. Alternate watch-dogs include the media, transparency and anti-corruption bodies and think tanks.

Legislatures and Oversight, World Bank Institute, Edited by Riccardo Pelizzo and Rick Stapen-hurst, 2004

Auditing for Social Change

The media are interested in "horror stories" uncovered through audit — which have great "media value" — as opposed to reviewing impacts achieved through quality audits. It is timely to discuss what the impact of "alternate watchdogs" has been on fiscal transparency.

Other questions that merit debate include:

- What role can the media play in publicizing results of audits and advocating for citizens right to information?

- What are the advantages and disadvantages of the audit community to adopt a media-shy attitude?
- How can the audit community effectively use the media through strategic communication to steer them away from mere horror stories towards the underlying causes and the impacts that can be achieved through audits?
- What are the opportunities to empower the citizens through media involvement in publicizing audit results?

Audit and Pro-Poor Governance

The audit, evaluation and monitoring of pro-poor governance and the United Nations Millennium Development Goals (MDGs) with a focus on outcomes present unique challenges. Special attention needs to be given to the issues of national priorities *vis-a-vis* the MDGs and the institutional framework that drive the planning, budgeting, implementation and monitoring of MDGs, as well as the role that audit can or has the potential to play in the process.

In that regard, the following questions need to be deliberated:

- Can coordination of audit efforts amongst national, regional, local and self-governing bodies be achieved for comprehensive oversight of results achieved?
- Can audit become more engaging and an empowerment tool for the citizens to hold the state to account for the achievements of pro-poor programs and service delivery?
- How can audit methodology become complementary to evaluation and monitoring techniques in order to better measure results and progress towards achieving pro-poor programs, including the MDGs?
- What resultant legal and administrative changes are necessary to evaluate and audit MDG progress and impact for and by the citizens?

Audit and the Millennium Development Goals (MDGs)

UNDESA is in the process of exploring how results-based audit techniques could be applied to areas of socio-economic development and pro-poor governance such as the achievement of commitments to which UN member states have over the years subscribed to, and which are encapsulated in the Millennium Development Goals. In this context, it would also be useful to see how public sector policies and programs have been aligned to achieve these commitments. Currently, most audits examine public sector expenditure based on some accountability standards that are at most only regulatory and results oriented, and furthermore, very few are oriented to Millennium Declaration goals and targets.

Making Audit an Integral Part of the MDG Processes

Following the 2002 Monterrey Consensus, the UN and its partners have insisted on national ownership of the Goals, especially for countries with most pressing needs and low human development, without which national programs will neither be appropriate to local conditions nor politically sustainable. National strategies for poverty reduction need to be based on specific needs, solid evidence, good data, corresponding budgeting and monitoring and auditing.

To that end, over fifty developing countries have prepared Poverty Reduction Strategy Papers, (PRSPs) which provide frameworks for financing, implementing, and monitoring the strategies. Some countries are also taking initiatives to main-stream PRSP within the MDGs. These are prepared by governments but emerge from broad-based participatory processes. However, many of these participatory processes continue to remain limited to planning and to some extent budgeting, but not in monitoring and auditing, leaving an important gap in the account-ability process.

In a 17 January 2005 report released by the Millennium

Project, a strategy for cutting extreme poverty and disease in the poorest countries was spelled out. It is based on existing development processes, tools, and policy vehicles, but emphasize that all these should be MDG oriented. The report reinforces the PRSP approach, but proposes a planning horizon leading up to 2015 to align with the MDG timetable. The strategy calls for the preparation of 10-year detailed and practical investment plans for meeting the goals. The report argues that this will only be possible where the national government is committed to meet the goals; and that only governments willing to sign on to a rigorous compliance regime will receive increased aid levels. It calls for results-based management of foreign assist-ance against the quantitative targets set for 2015, with aid to be delivered in each sector against measurable interim benchmarks on a clear calendar basis. The report calls for specific compliance guidelines that include spot audits, evaluation, and publication of achievement of performance indicators.

In this regard, it is safe to say that as far as the audit function is concerned, few initiatives exist to link public expenditure with MDGs targets; additionally mini-mal effort has been made to make these initiatives participatory, to assist tracking related financial flows, assess utilization of resources, adequacy of decision-making and implementation processes, or ascertain results achieved on the ground. Where donor contributions are involved, auditing, like financial reporting, usually con-forms to the specific donor requirements for audited financial statements. Where government resources are used, audits seem to be planned according to existing institutional audit regimes and are usually sector or project based, without special regard for the targets and indicators of the MDGs. This situation is a clear indi-cation that national ownership of the MDGs is still not entrenched in all of the government management and oversight processes.

Taking HIV/AIDS programs as a case study, UNDESA has found that legislative auditors at national and sub-

national levels, as well as internal auditors of ministries and institutions, have in fact performed audits related to various aspects of HIV/AIDS as part of their mandate and regular cycle of audits of public expenditure items. Those audits varied widely in approach, objectives, scope, and type of audit. Similarly, donor countries and institutions have performed or requested financial audits from recipi-ent institutions — be it a ministry or implementing agency — according to their own specific requirements. In general, the audits dealt with financial and material matters and rarely focused on performance or results achieved; more importantly, trie absence of trie citizenry—trie actual beneficiaries of public expenditure into trie auditing proc-esses—equally weakened trie capacity to make audit more results oriented.

The EGM highlights several citizen-based approaches in audit such as India's report Card System where citizens are called upon to rate various public services. The practice has gone on for several years and is seen to be creating highly positive impacts in reforming both expenditure planning and its utilization. In South Africa, civil society organizations have published existing audit reports to encourage greater compliance. These and other examples indicate that there are real opportunities to collaborate with civil society organizations to make audit more results oriented and effective. However, to make audit more MDGs oriented and participatory several changes both at the methodological as well as at institu-tional level are warranted.

Capacity Building

As part of UNDESAs program to make the audit function central to the MDG roadmap, it has engaged in technical cooperation ventures and partnerships with audit institutions interested in exploring MDG related independent and results-based auditing from a national, local, regional, or interregional perspective. These technical cooperation ventures are not intended to limit SAIs in

servicing the financial and other reporting requirements of multilateral donors as well as the government but rather to become an important stakeholder in realizing the MDGs. The objective is for SAIs, through the independence they enjoy, to assess to what degree their governments and target beneficiaries have the ownership of the policies and processes involved, to ensure transparency and accountability in the use of resources, and to ascertain key successes through evidence.

Another possible area of interest to SAIs is auditing the extent the govern-ment policies reflect international agreements and treaties and their achievements.

One of the immediate impacts of the Seoul EGM on Auditing for Social Change has been that the editor of a daily in Bangladesh, *the Daily Star,* who participated in the EGM as the media representative, found India's Citizens Report Card System that upon his return to his country, he started serialized publication of Score Cards of different Ministries comparing the pre-election commitments and current achievements.

Experts agree, however, that international agreements are not always couched in clear enough language, therefore presenting difficulties in formulating objectives and clear results expectations. However, the MDGs, while general in language, have established a set of measures and benchmarks to allow for measuring progress.

Conclusions

The audit of MDGs provides enormous opportunity and scope to discuss and develop innovative ways — including participatory auditing —of making the auditors partners for social change in putting the audit profession at the heart of citizens' interests, especially in the effort to overcome poverty, diseases, and other social and economic deficiencies by 2015-Auditing, as is evidenced could benefit much from a more participatory proc-ess that includes civil society and media. In addition, legislative oversight is also possible to be

strengthened to such citizen engagement. These are complex process-related issues that will necessitate careful examination and capacity building.

Participatory audit highlights the importance of complementary forms of oversight and scrutiny, such as results based monitoring and evaluation. It also highlights the importance of alternate, if not complementing watchdogs/reporter besides the professional audit community and the legislative oversight forum, such as the Public Accounts Committee of the Parliament.

The audit community needs to carefully examine how the traditional bounda-ries of audit can be respected while the function adopts a more pro-active stance in examining national commitments to international conventions and treaties including pro-poor and socio-economic programs; and in what manner some forms of empowerment of and participation by civil society including media in the audit of public expenditures could be initiated.

4

The Role of Auditing and Public Finance Management

The etymology dictionary explains that the term audit originates from the Latin word *atidire,* which means "to hear." *Audire* in ancient Rome referred to the "hearing of accounts," a process in which one official compared his records with those of another official. As many of the parties interested in the audit findings were illiterate, audits were presented orally. In modern times, auditing has evolved into a technical discipline practiced by professional auditors who provide opinions on whether or not the annual financial statements of an entity comply with set accounting standards.

Over the years, auditing has retained its significance in public finance and, as such, Supreme Audit Institutions[17] (SAI) receive constitutional recognition in many countries around the world. As watchdogs of public finances, the public auditors act as critical links in enforcing the accountability of executive agencies to national and state legislatures and through them to the general public. The public sector auditor reviews financial management of public sector entities to ensure that transactions have been undertaken with due regard to propriety and regular-ity. Recently, several public auditors have also assumed responsibility for assessing value for money considerations in public projects and programs in recent years.

However, the role of SAIs as public finance watchdogs is still limited in many developing countries around the world. This state of affairs is the result of several factors, including financial and skill constraints, SAIs' lack of independence from the executive, and poor communication between the SAI and the legislature and civil society organizations.

Although, public budgeting processes have traditionally excluded civil society organizations, in the last 10 years or so, civil society organizations in many developing countries have built effective capacities to analyze and influence public budgets. Generally, however, civil society engagement in public budgeting has focused on examin-ing the executive budget presented to the legislature and monitoring the subsequent implementation of the budget. There has been much less civil society engagement with the auditing of expenditures after a budget has been implemented and there has thus been limited interaction between civil society organizations and SAIs.

This paper argues that greater collaboration between SAIs and civil society organizations can assist SAIs[18] in overcoming some of the challenges that they face. An enhanced partnership between SAIs and civil society organizations will also help to insert the practice of *audire* — the public 'hearing' (meaning examination) of government accounts — into public auditing. The intention is not to suggest that civil society organizations can replace formal audit institutions. Instead, the authors propose that greater interaction between SAIs and civil society organizations is likely to lead to stronger budgetary oversight by both sets of institutions — and that this interaction will strengthen a country's governance framework and the effectiveness and efficiency of its anti-poverty programs. Our argument is sup-ported by a set of case studies which highlight the innovative work of civil society organizations around the world in complementing the work of SAIs.

The examples presented in this paper cover pioneering civil society work in India, South Africa, and the Philippines. In India, the Mazdoor Kisan Shakti Sangathan (MKSS)—a peasant and worker union—uses innovative public hearing forums to conduct social audits of local government expenditures in village com-

This paper focuses on the potential for civil society organizations to contribute to the work of the SAI. Similar opportunities exist for civil society organizations to contribute to the work of Government agency internal auditors. However, such collaboration will need to be discussed in another paper.

This chapter will consist of three subsequent sections. Section two outlines the role of auditing in public finance management and examines the challenges fac-ing SAIs in developing countries. Section three presents the four case studies that show how civil society engagement has worked effectively to inform and complement the public auditing process. The final section provides recommendations for strengthening the relationship between SAIs and civil society organizations and thereby improving governance and reducing poverty.

Institutional Setting

This section outlines the current institutional framework of auditing in public finance management in developing countries. The first part highlights the signifi-cance of auditing and the manner in which it builds good governance. The second part identifies the challenges and institutional weaknesses facing SAIs in develop-ing countries. The analysis draws on the results of two research surveys, including one conducted by the International Organization of Supreme Audit Institutions (INTOSAI) and one conducted by the International Budget Project (IBP).

Role of Auditing in Public Finance Management

Auditing is an integral part of an institutional framework supporting good gover-nance and the realization

of a country's welfare measures and poverty eradication goals. Social welfare programs and other targeted poverty eradication programs in developing countries are characterized by their access to limited resources. To achieve their goals, therefore, these programs depend greatly on the efficient and effective utilization of these limited resources. Within this framework, the role of the pub-lic auditor in monitoring the utilization of program resources is critical. A vigilant auditor can contribute greatly to the achievement of social development programs by limiting corruption and strengthening the accountability of responsible agencies.

Enforcing the Executive's Accountability toward the Legislature and Citizens

In most democratic countries, legislative oversight of public financial manage-ment takes one of two forms—*ex ante* scrutiny and *ex post* scrutiny. Under *ex ante* scrutiny, the legislature examines the budget prior to enacting it into law. Strong legislatures, such as those in the United States and Germany, have the power to alter the budget at this stage to ensure that budgetary allocations reflect national priorities. Weak legislatures, such as those in many of the Commonwealth coun-tries, generally do not have the power to substantially alter the budget submitted to them by the executive prior to enacting it.

Under *ex post* scrutiny, the legislature utilizes the audit findings presented to it by the nations SAI to examine whether the executive has implemented the budget according to the provisions of the law. Most parliamentary democracies, such as the United Kingdom, India, and South Africa, provide *ex post* scrutiny functions to the legislature or parliament. Under such a system, the SAI (which may also be called the Office of the Comptroller and Auditor General) reports its audit find-ings to the Parliamentary Public Accounts Committee, which is then responsible for considering and acting upon these findings. In many countries, audit reports are made available to the public and the media, which can then utilize the findings to demand accountability from the government.

Combating Corruption

Corruption is a plague that is present in all countries in varying degrees. However, it is in low-income countries that corruption is most wide spread and where it can become a major obstacle to socio-economic development. While trie causes and impact of corruption are beyond trie purview of this paper, it is sufficient to say that corruption can be controlled—and its debilitating impact on an economy minimized—by the development of strong institutions of governance. An SAI that retains a clear mandate, possesses independence from the other agencies of government, employs a skilled staff, and has access to adequate resources is uniquely placed within any governance framework to combat corruption. In fact, it is interesting to note that SAIs in some countries have explicit mandates to report on corruption and criminal activity to law enforcement agencies.

Facilitating Good Governance

According to the United Nations Development Program (UNDP), good governance is classified as being participatory, transparent, accountable, effective, compliant with the rule of law, and responsive to the needs of the people. An effective SAI can play an important role in ensuring that some of these key attributes of good governance are maintained by the government. By auditing public finances, SAIs not only demand accountability of the government but in turn add credibility to the governments public financial policies and practices. By making their audit findings available to the public, SAIs provide a critical window on transpar-ency in public finance management and assess whether government agencies have complied with national and/or local laws, regulations, and their annual budgets.

Aiding Financial Management

Modern day public auditors perform a variety of audits aimed at satisfying different financial management goals.

Financial audits assess the accuracy and fairness of both the accounting procedures utilized by a government agency and the financial statements reported by the agency. Compliance audits assess whether funds were used for the purposes for which they were appropriated and in compliance with relevant laws and regulations. Performance audits analyze cost-effectiveness (economy), operational efficiency, and the general effectiveness of government programs in achieving their objectives. There has been a trend in recent years among SAIs toward increasing the number of performance audits as these audits are seen as revealing more about the effectiveness of government operations. However, a comprehensive audit framework requires that all three types of audits (financial, compliance, and performance) be combined to provide a complete overview of public financial management.

Institutional Weaknesses in SAIs

Despite its critical role in enforcing accountability, SAIs are beset by severe institutional and operational limitations. In some countries, SAIs are not created by legisla-tion that provides adequate independence and freedom from executive interference. Even in cases in which SAIs have sufficient auditing mandates, they may lack additional investigative powers to enable them to follow-up on apparent violations and ensure the prosecution of relevant agencies or individuals. Similarly, SAIs in many countries do not have adequate powers to decide what should be audited or how the audit findings should be presented. In many developing countries, SAIs lack skilled staff to perform the tasks expected of a modern auditor, such as detecting fraud using information technology. Similarly, financial constraints on SAIs often mean that they lack adequate infrastructure (office space, computers, and vehicles for transport), which further hampers the effective conduct of their work.

In many countries, SAIs report their findings to legislatures and particularly the public accounts committee

(PAC) within legislatures. Due to time constraints, the PACisable to consider only some of the audit reports and audit findings—and poor coordination with the SAI may prevent the PAC from taking up the most critical findings. The audit reports in these cases are then shelved and no action is taken against agencies or individuals that have broken the law or committed fraud.

While substantial anecdotal evidence of these problems is widely known and cited, two recent surveys provide concrete evidence of the challenges SAIs face.

International Organization of Supreme Audit Institution Survey

The Lima Declaration of Guidelines on Auditing Precepts was adopted at the Ninth International Conference of SAIs in Peru in 1977- This declaration sets out the internationally accepted basic tenets of public sector auditing, including emphasizing the need for SAIs to have independence from the executive, defining the audit powers that should be granted to SAIs, detailing the relationship that SAIs should have with the executive and with the legislature, and explaining the nature of the reporting that should be carried out.

In 2001, more than two decades after the adoption of the Lima Declaration, the International Organization of Supreme Audit Institutions (INTOSAI) published the results of a survey conducted in 113 member countries (excluding the European Organization of SAIs, which had previously been surveyed). Using the parameters set out in the Lima Declaration, the survey examined the independence (or lack thereof) of SAIs in each country.[28] The INTOSAI Task Force report sum-marizes its findings by stating, "... *it can be concluded that a considerable number of the SAIs surveyed are not really in a position to fulfil their mandates in a manner consistent with the requirements of the Lima Declaration of Guidelines on Auditing Precepts*." Some of the major limitations in the independence of SAIs cited in the report include:

- In 41 countries, SAIs felt that there was significant room for improvement in their constitutional autonomy.
- In 73 countries, SAIs felt that there was significant room for improvement in their financial autonomy.
- In 63 countries, SAIs felt that there was significant room for improvement in their managerial and administrative autonomy.
- In 33 countries, SAIs felt that there was significant room for improvement in their freedom to report findings.

The International Budget Project Survey

In 2004, the IBP conducted a survey in 36 developing countries (drawn largely from Africa, Eastern Europe, Asia, and Latin America) to assess transparency in national budgetary processes. The survey focused in part on key issues concerning public disclosures of audit findings. Respondents in each of the countries covered in the survey were experts drawn from civil society organizations.

The results of the IBP survey reinforce the concerns that the earlier INTO-SAI survey highlighted regarding the institutional and other weaknesses of SAIs in many countries. As the responses to the survey cited below show, public audit systems can often exclude civil society organizations—and, in some cases, even national legislatures — from effectively discussing major audit findings.

- Accessibility: The results of the IBP survey show that not all the annual audit reports are made public. In 12 of the countries surveyed, citizens did not have access to the auditor's reports *even though the reports were produced in 11 of these countries.* In 19 of the countries surveyed, trie year-end audit reports of departmental expenditures that are released to the public do not include an executive summary.

- Timing: Only 6 of the 36 countries included in the IBP survey reported that the SAI produced its attestation report within six months of the end of the fiscal year as recommended by *The OECD Best Practices for Budget Transparency*. In 15 countries, final audited accounts of national departments are either not completed within two years after the end of the fiscal year or are not released to the public; in 8 countries, final audit accounts are released more than a year after the end of the fiscal year.
- Comprehensiveness: In 19 of the countries surveyed by IBP, the SAI either does not release to the public reports of audits of extra-budgetary funds or it does not audit such funds. No audit report is viewed or scrutinized by a committee of the legislature in 4 countries, while in 11 countries only some of the reports are viewed and scrutinized.
- Follow-up: In 7 of the countries surveyed by IBP, the executive does not report (either to the legislature or publicly) on the steps it has taken to address audit recommendations nor does it release findings that indicate a need for remedial action. In 23 of the countries surveyed by IBP, neither the SAI nor the legislature release to the public a report that tracks actions taken by the executive to address audit recommendations.

Summary

In the first part of this section, we demonstrated that SAIs play a critical role in strengthening a country's governance and the administration of anti-poverty and other social-development programs. For example, SAIs assist legislatures inenforcing accountability from executive agencies by producing audit reports; they conduct audit tests to detect fraud and misappropriation of public funds; and they make recommendations to public agencies on how to strengthen their financial management systems.

In the second part of this section, we reviewed two surveys that identified weaknesses in many national SAIs that prevent them from meeting the require-ments of the Lima Declaration and therefore from enforcing their primary man-date of holding the executive accountable for its use of public funds. The INTO-SAI survey suggested that the SAIs' weaknesses arise from lack of autonomy (legal, administrative, and financial). The IBP survey suggested that the SAIs' weaknesses include ineffective dissemination and late reporting of audit reports, lack of comprehensiveness in audit reports, and weak follow-up on audit reports.

The next section explores the skills and experiences that civil society organizations bring to the conduct of public audits that can help SAIs to overcome some of their weaknesses.

Role of Civil Society Organizations in Audits

Over the last 10 years, the capacity of civil society organizations to understand, analyze, and influence public budgeting has grown dramatically. In more than 60 developing countries in Africa, Asia, and Latin America, non-governmental organizations (NGO), think tanks (research organizations), community and grass-roots organizations have been involved in the growing movement to make public budgeting more transparent and accountable.

Civil society organizations engaged in budget-focused work contribute to public expenditure management and oversight in several ways. First, they provide one of the few sources of critical and independent information on the impact of the budget on poor and low-income citizens. Second, they can help build budget literacy among citizens and facilitate discussions and debates on budgetary issues within civil society. Third, by collating, synthesizing, and disseminating information on public finances, budget groups add new data into the budget process. Finally, civil

society budget groups provide training on public finances to citizen groups, the media, and legisla-tures, thereby strengthening the capacity of all of these groups to exercise oversight over budget process and to demand accountability from government agencies.

Although civil society is a relatively new actor in public budgeting, evidence that they are having a positive impact on budget decision-making and implementation is beginning to emerge. For example, in Mexico, a local NGO, Fundar, has worked with a coalition of civil society organizations to monitor and increase the govern-ment's commitment to reducing maternal mortality. In South Africa, the Institute for Democracy in South Africa played a substantial role in strengthening the new financial management act by insisting on the inclusion of stronger *firemen* ^[3] rules and of a provision requiring direct departmental responsibility for overspending. Similarly, the expenditure tracking work of the Uganda Debt Network has helped to curb corrup-tion in the intergovernmental fiscal relations system in that country and to generate new information on the quality of expenditures in health and education.

To date, most civil society budget-focused activity has concentrated on examin-ing the passage of the budget through the legislature and the subsequent implementation of the budget by the executive. There has been much less civil society engagement with the auditing process and the office of the SAL Nevertheless, as the case studies presented in this section demonstrate, there are important opportuni-ties for civil society engagement in the auditing stage of the budget process that can strengthen the oversight function of both civil society organizations and the SAL Audit reports tabled in the legislature often contain vital information on pub-lic financial practices of executive agencies. Unfortunately, these findings do nct always lead to sanctions and appropriate corrections. Shortcomings in public audit processes are detailed in Section 2 of the paper.

Evidence is provided for these assertions through four case studies of pioneering work undertaken by civil society organizations. While illustrating the role that civil society organizations can play in strengthening auditing in each of our case studies, we wish to acknowledge that we have not done justice to the extensive non-audit related initiatives undertaken by these organizations.

Social Audits-Tracking Expenditures with Communities: The Mazdoor Kisan Shakti Sangathan in India

Against the backdrop of rural Rajasthan, the largest state in India, an organization called the Mazdoor Kisan Shakti Sangathan (MKSS) has, in a little over a decade, developed into one of India's most potent social justice movements. The organization is a union of peasants and workers and has successfully demonstrated the power of information as an effective tool to enable citizens to participate in governance. The MKSS uses innovative forums called public hearings—also called social audits—to facilitate structured and focused discussions among residents on government expenditures of public development funds in their communities.

MKSS-sponsored public hearings have had a significant impact in limiting corruption in public works projects in rural Rajasthan. The success of MKSS social audits has even influenced the state government of Rajasthan to introduce aspects of social auditing within local governance processes. The state government now requires that a social audit be held annually within each village; as part of this process, all village residents must be given an opportunity to vote on a resolution verifying that the projects in their village have been successfully completed. While this process has its limitations, it represents a radical change in the institutional space provided to citizens to *audit* public funds.

Typically, a social audit conducted by the MKSS includes five stages:

Gathering Information: MKSS members start by gathering all documents that are maintained by the public agencies on development projects. These include some relatively easy-to-understand documents, such as cash books, muster (pay) rolls, and expenditure voucher files with bills showing materials purchased for project work. MKSS also gathers records that a layperson seldom encounters, such as project engineer measurement books and utilization certificates providing com-plete details of the projects expenditure. In the initial public hearings, the MKSS depended upon sympathetic officials who provided them with the information they sought. Later, after a right to information law was enacted in the state of Rajasthan, the MKSS uses the provisions of the law to request documents.

Collating Information: Initially, MKSS members faced a major challenge in deciphering and categorizing the details contained in the records that they had obtained. Over a period of time, they became familiar with the management sys-tems in public agencies and the project documents maintained by them. MKSS members developed a simple methodology for collating the information into matrices that summarized the different kinds of information obtained from the project records. Thus, one matrix was prepared from pay rolls that detailed for each worker the days in a year that he/she had received employment in a particular project site. This matrix was very useful as it identified cases of fraud in which a single worker was shown to have been working on two different project sites on the same day. Similarly, a matrix summarizing and re-classifying materials used in a project was developed. Volume measurements presented in official records as 'metric tons' were translated into camel or bullock cartloads.

Distributing Information: MKSS members and other volunteers involved in the social audit make several copies of the project documents and the matrices developed. Teams of volunteers then go from house to house in the villages in which public hearings are to be held and distribute and

explain this information to the residents. Residents who have worked on project sites become valuable resources for verifying the accuracy of project documents. The copies of the pay rolls, for example, become sources of enormous excitement as residents identify names of dead or ficti-tious people in the rolls. This verification process also helps to identify workers who have received smaller sums than those shown to have been given to them in the pay rolls. Bills drawn in the name of camel cart owners are shown to be false when the person in question verifies that he has never owned a camel all his life.

This information distribution process can take from one week to a couple of months and provides an opportunity for MKSS members to build momentum within communities prior to the day on which the actual public hearing is held. Using creative media like songs, street plays, banners and posters, MKSS members and community volunteers encourage residents to scrutinize project information and to attend the forthcoming public hearing.

As the villagers are more familiar with measurements expressed in terms of bullock cartloads they are able to comment on whether the material had been delivered to the project site or not. Many instances of corruption in billing by over-charging materials supplied to project sites are disclosed by villagers and workers during the public hearing.

The public hearing: Public hearings sponsored by MKSS have a very festive atmosphere around them. There is a lot of anticipation among residents of the vil-lage in which the public hearing is being held about the possible outcomes of the day's events. The hearing is normally held on an open field in the village. Special efforts are made to ensure that the location of the public hearing is in a place that is conveniently accessible by all residents, such as an open field in the village. The hearings are attended by public agency officials, local elected representatives, the media, and residents of the area. Apanel comprised of eminent citizens of the area is set up to administer proceedings.

MKSS members control the flow of discussions so as to enable residents and public officials to systematically provide their opinions on the project/program under discussion. Often, discussions in the public hearings bring out explosive findings in the conduct of public projects. Instances of corruption and inefficiency in the utilization of public funds, and poor planning within public agencies may be uncovered in the testimonies provided by speaker after speaker. Workers and residents may identify false information contained in public records. Discussions become especially animated when the public officials try to defend the projects that they supervised and village residents point out lies in their statements. The process is so effective that in some public hearings, family members of corrupt officials have testified against them. In some instances, public officials have even confessed their wrongdoings. In front of an audience of 200-300 village residents, officials have handed over cash — the proceeds obtained through the corrupt use of project funds — to the panel adjudicating the public hearing.

Follow-up to the public hearing: A formal report is prepared by the MKSS following each public hearing. Copies of this report are sent to senior state govern-ment officials, the media, and other groups engaged in anti-corruption campaigns. The report contains details of the proceedings and the findings resulting from the public hearing. These findings include recommendations to the state government regarding action that should be taken against errant officials, as well as changes that should be implemented in official programs and policies to make them more effective and more responsive to public demands.

Realizing that its dependence on the intervention of sympathetic officials to obtain records remained a significant barrier to broader engagement in public dis-cussions of official programs, the MKSS launched a massive state-wide campaign in 1995 demanding a law on right to information for all citizens. The campaign achieved

success when in 2000 the state government of Rajasthan passed a right to information law. Spurred by its success, the campaign was replicated in other Indian states too and led to the formation of the National Campaign for People's Right to Information (NCPRI). The NCPRI demand for a national law on right to information is currently being considered by the Indian Parliament.

Monitoring Follow-up to the Auditor General's Report : The Public Service Accountability Monitor in South Africa

"Accountability Lacking in Eastern Cape" proclaimed a June 18, 2004, headline in Grocott's Mail, South Africa's oldest surviving independent newspaper. This provocative finding headed an article quoting researchers from the Public Service Accountability Monitor (PSAM) on the poor monitoring of public service delivery agencies in the Eastern Cape Province. The article noted that PSAM had long argued for the need for effective oversight of public agencies, which was *'"woefully lack-ing'* and cited a statement made in 2002 by the Auditor-General (the SAI in South Africa) noting that *"not a single one of the Standing Committee on Public Accounts recommendations had ever been implemented by any provincial department."*

PSAM was established as an independent research project at Rhodes University in 1999. It initially took on the task of tracking actions taken by the provincial administration in response to reported cases of corruption. A number of these cases had originally been identified in Auditor-General's reports. PSAM collected this information in a database that was made available to the public on its website. The database shows that effective corrective action had been taken in response to less than 10% of reported cases. The database became a source of information that citizens and civil society organizations could use to gauge the commitment of government agencies to take combat corruption involving agency members.

Over time, PSAM began to shift its focus to the structural context of weak finan-cial management that was responsible for many of these acts of corruption and malad-ministration. It began to systematically monitor the compliance of provincial admin-istrative agencies with public finance regulations and administrative directives. This included creating a database of information on the coherence of strategic planning within agencies and their annual and audit reports. In particular, PSAM monitored whether recommendations to improve financial controls made to agencies by the Auditor-General and the legislatures oversight committees were being implemented.

PSAM utilizes a wide variety of means to obtain documents pertaining to finan-cial management, maladministration and corruption including, when necessary, using freedom of information provisions. It publicizes its findings on a regular basis, including by producing a weekly column (the "Accountability Monitor") in a pro-vincial newspaper. PSAM produces analyses that are geared to public understanding and specifically designed to engender and support public involvement in governance processes. It endeavours to produce and distribute its analyses of public expenditure management in a manner timed to coincide with the budgeting and oversight cycle in order to influence budget and spending priorities and improve service delivery.

PSAM has achieved encouraging results in the Eastern Cape Province in spite of working in a hostile political environment. Its research and advocacy efforts have contributed to the improvement of financial reporting standards in provincial government agencies, which in turn has led to a dramatic decrease in the number of *audit disclaimers* issued by the Auditor-General to these agencies since 1996.

PSAM documented that audit disclaimers were issued to 10 of the 13 major public agencies in the province from 1996 to 2000. However, while the auditors Due to the very

nature of its work—holding government accountable—PSAM is often seen as a threat by many government agency personnel. While this has been a challenge for the organiza-tion, over the years they have managed to earn the respect—begrudging as it might be—of government officials, who now acknowledge the value of PSAM's interventions and extend regular invitations to the organization's researchers to participate in the strategic planning and budgeting processes (Source: Interview with Colm Allan, PSAM, March 2005).

Audit disclaimers are issued when the public auditor's office is unable to form an opinion on the accuracy of the financial statements reported by an agency due to omissions or insufficient documentation.

Faced with increasing pressure as a result of the media scrutiny, several major agencies improved their financial reporting processes. As a result, in 2002-2003, audit disclaimers were issued by the Auditor-General to expenditures that comprised only 41 % of the total provincial budget — a reduction of more than half.[42]

PSAM's advocacy efforts highlighting the lack of corrective action on corrup-tion contributed to a decision taken by the South African national cabinet to insti-tute a specialized Joint Anti-Corruption Task Team (JACTT) in January 2003-The JACTT consisted of members from various anti-corruption and oversight agencies including the Auditor-General and was given a mandate to investigate and prosecute the huge backlog of corruption cases in the Eastern Cape Province. PSAM shared with the JACTT its extensive database, documenting cases of cor-ruption in various provincial agencies. Preliminary reports seem to indicate that the JACTT has achieved significant success in its task.

The PSAM has also continued to highlight the failure of government agencies to improve their financial control systems in response to the Auditor-General's audit findings.

In April 2005, the provincial Premier established a judicial com-mission of inquiry to investigate the finances and expenditures of the Eastern Cape administration from 1994. The terms of reference of this commission included establishing "the reasons why the Auditor-General's recommendations and foren-sic audit report to Provincial departments were not acted on." The PSAM believes that the establishment of the judicial commission illustrates the potential for civil society organizations to conduct research and advocacy and thereby strengthen the oversight of public agencies. The potential for such civil society action is par-ticularly relevant in cases where executive agencies ignore the findings of their oversight agencies.

Participatory Audits: The Concerned Citizens of Abra for Good Governance in the Philippines

The Concerned Citizens of Abra for Good Governance (CCAGG) is a non-governmental organization that monitors government projects in the Abra region of the northern Philippines. CCAGG was formed in 1986 when new opportunities were created for civil society organizations to participate in development programs by President Corizon Aquino. Under the new community participation policy, CCAGG members signed a memorandum of understanding with the National Economic Development Authority and received training from the agency in project monitoring. CCAGG members used the local media (radio, newspapers) and organized community meetings to inform residents about public infrastructure projects.

While monitoring community employment and development projects, CCAGG members were shocked to see a newspaper advertisement by the Ministry of Public Works and Highways (MPWH) declaring that it had successfully completed 27 projects in Abra province. Knowing that this declaration was untrue, CCAGG members decided to take action against the agency's misinformation. To make a strong case against the agency, the members of CCAGG developed detailed documentation

of the actual state of projects that had been declared as completed— but in fact were only just beginning or were mid-way through the construction stage—including affidavits composed by residents of project areas and photographs of the project sites. CCAGG submitted these findings to the national government and demanded that the Department of Public Works be investigated.

Notice 12 of 2005, Eastern Cape Provincial Gazette, Appointment of Commission of Inquiry into finances of Eastern Cape provincial administration, 8 April 2005.

An official government audit concurred with CCAGG's findings and several officials were charged with corruption. While several officials were convicted, the prosecuting lawyers argued for leniency on behalf of the government officials and asked that they receive only official reprimands as punishment. Outraged by this development, CCAGG members mobilized public opinion and the Office of the Secretary of MPWH was bombarded with telegrams from concerned citizens demanding that the convicted officials receive more severe punishment.

The Secretary finally relented and 11 government officials found guilty of dishonesty and misconduct were suspended. In addition, the Chief and the Deputy Chief Engineer of MPWH in Abra were not only suspended without pay but were also debarred from serving in the province in the future. This was probably the first case in the history of the Philippines in which a civil society organizations vigilance had resulted in the conviction and punishment of government officials on charges of corruption. Further, as a result of this case, the Regional Director of the MPWH issued a directive requiring that projects in Abra province be funded only after they had obtained clearances from CCAGG.

Subsequently, CCAGG consolidated its activities and its members developed a unique technique for monitoring government projects. Members of CCAGG— primarily house-wives, students, and other youth members — observe

road con-struction projects and report their findings to specialist colleagues, such as engi-neers and accountants. These staff members in turn conduct detailed investiga-tions on project sites.

CCAGG investigations monitor a variety of corruption in government projects, especially road construction projects, including the use of sub-standard materials (cement mixtures) and/or poor construction techniques, and fraud in contract-ing procedures (such as rigged contracts). In one road construction project, for example, CCAGG members found that contractors had embezzled project funds. In response to these findings, the government forced the contractor to pay from its own resources to expand a road.

Recognizing the critical role the organization plays in preventing corruption, as well as the expertise it has developed in monitoring public works projects, the national Commission on Audit (COA) — the SAI of the Philippines — entered into a partnership with CCAGG to conduct participatory audit exercises in the Abra region. The exercises focused on assessing the impact of the audited government pro-gram/project to determine whether the program/project achieved its desired results. This exercise was sponsored by the UNDP and was described as successful by all the concerned parties. The chairman of the COA described the results of the exercise as "very focused and efficient." The lessons from the audit process were later incorpo-rated into a manual on the Conduct of Participatory Audit published by the COA.

While successful, the experience of the COA-CCAGG participatory audit highlights several challenges that need to be addressed for future cooperation between civil society organizations and public auditors.

Audit Methodology : The COA staff objected to demands made by the CCAGG staff to discuss preliminary audit findings with community members. In turn, CCAGG staff were concerned that restricting official audits to the

post-project period increased the likelihoods of losing potentially valuable findings.

Sustainability: Even though the participatory audit exercise was declared a success by all participating organizations, it was discontinued with a change in the COA administration. The new COA commissioner had other priorities and shelved participatory audit exercises. This raises serious questions on the sustain-ability of participatory audits.

Advocating for Transparency in Public Procurement: Procurement Watch, Inc., in the Philippines

During the late 1990s, there was a growing feeling among concerned govern-ment officials in the Philippines that official procurement practices needed to be reformed. The appointment of a sympathetic Secretary as head of the Depart-ment of Budget and Management provided an opportunity for this process.

The new Secretary appointed a task force comprised of experts from within government agencies as well as private consultants to examine the problems affecting procurement practices and to suggest revisions to procurement laws. The task force met and eventually recommended a new law, however, the law failed to pass in the legislature. In response, the task force members decided they needed to involve civil society groups to build public opinion in favour of the law and thereby bring pressure for its adoption in the legislature.

Two private consultants from the task force joined two concerned citizens in 2001 to form a non-governmental organization called Procurement Watch, Inc. (PWI). PWI was formed with the express mandate to advocate for the new procurement law and to monitor enforcement of the law after it was enacted. The gov-ernment task force invited PWI to become a member of the task force and to help it in redrafting the law and in analyzing regulations promulgated after enactment of the law. PWI staff members used their

proximity to the technical experts that comprised the task force to develop their own understanding of the nations procurement practices and eventually became regarded as experts in their own right.

Over the next two years, PWI staff took on the task of contacting other civil society organizations—primarily groups working on anti-corruption—and mobiliz-ing public opinion in support of procurement reforms. PWI found a key ally in the Catholic Church, widely perceived to be the most influential non-governmen-tal institution in the country, during its efforts to mobilize public opinion on this issue. The media (newspapers, radio, and television) too became part of a strategic and well-planned awareness campaign.

In January 2003, PWI's efforts paid off when the legislature passed a new procurement law—the Government Procurement Reform Act (GPRA). This was a unique victory for PWI. For the first time in the history of the Philippines, a civil society organization was successful in advocating for a law to be enacted on a subject that required a high degree of technical expertise normally not associated with civil society initiatives.

Now widely recognized for its expertise on procurement law and practices, PWI conducts a wide variety of activities with different groups including the Ombudsman, government agencies involved in large procurements, and civil soci-ety organizations and citizens. PWI has developed very close relationships with the national Ombudsman in particular and even conducts training sessions on the Government Procurement Reform Act for officials in the office of the Ombuds-man. As a partner of the Ombudsman, PWI has also established a "Feedback and Complaint-handling Mechanism" to process and respond to reports and other information provided by procurement observers.

In many developing countries, citizens prefer not to contact government officials with complaints (due to the fear of harassment from corrupt officials) and are more

comfortable dealing with non-governmental organizations to address such issues. The presence of PWI as an intermediate organization that can serve as citizens' link to the Ombudsman helps make citizens comfortable in registering complaints on procurement irregularities that they have observed.

PWI has also developed partnerships with government agencies to observe and study the systems in place for soliciting proposals and evaluating bids and awards. As part of this process, PWI conducts diagnostic exercises on procurements man-aged by the Bids and Awards Committee (BAC) of various agencies, including the health and defence agencies. Similarly, PWI has assisted the Philippine Ports Authority in preparing the terms of reference for the bidding of its port security services. PWI also develops research papers and press releases on the subject of best practices in procurement procedures.

A new partnership is now being planned between the Ombudsman and PWI to take advantage of a law in the Philippines that requires all college graduates to participate in 3-4 weeks of mandatory community service. The Ombudsman is advocating with the authorities concerned that they recognize time spent by col-lege graduates as observers in government bids and award decisions as community service. If allowed, this initiative would produce a steady stream of citizens who are familiar with contract bid and award procedures. The Ombudsman has asked PWI to assist in this initiative by training the trainers in the Ombudsman's office to imple-ment this program.

Recommendations

The argument was made in section 2 that SAIs are essential institutions for ensuring that governments are held accountable for their utilization of public funds. In our case studies, we have seen how civil society organizations utilize innovative methodologies to complement and strengthen the role that external auditors play in enforcing government accountability. In Box 1, we illustrate how SAIs

and civil society organizations can partner each other to improve good governance.

Box 1: The Audit-Governance

Civil Society Organizations

When a government is accountable, it means that it is answerable to its citizens and is therefore also responding to their needs. Audits (in their expanded mod-ern versions, which include performance audits) provide citizens with concrete measures of how governments have performed against accepted standards. Civil society organizations can use the information gathered through audits to pressure governments to respond to audit recommendations and improve governance. In turn, civil society organizations, through social audits and other such processes can provide information to the SAI that can complement and augment the work of the SAI. As such, each institution can complement the others work in promoting good governance.

The case studies illustrate how SAIs can cooperate with civil society organiza-tions to strengthen the role of audits in promoting good governance and poverty reduction.

1. *Civil society organizations build citizen literacy on*

public financial management. To facilitate the creation ofia cadre of activist citizens, SAIs should develop acces-sible and understandable reports that arefieely available and widely distributed to the public in a timely manner.

- PWI provides training courses for civil society organizations and individuals on procurement law. They have been successful in building a cadre of citizens who have the capacity to monitor public agency procurement practices and to demand changes when corruption occurs.
- PSAM maintains a scorecard of public agency performance. This database is used to educate the media, other civil society organizations and individuals on specific problems with public finance management in agencies through reports released by the public auditor.

2. Civil society organizations have the networks and expertise to detect potential cases of corruption and to report these to SAIs. To take advantage of these networks and expertise, SAIs should create communication channels that civil society organizations can access to report these cases as potential subjects for formal audits.
   - Social audits conducted by the MKSS have yielded a wealth of informa-tion and documentation on corruption in public projects. Ironically, many of these projects had been previously cleared by the public auditors.
   - CCAGG extensively monitors public projects even as they are being undertaken by government agencies. They have documented numerous instances of corruption in public projects.
3. Civil society organizations can augment limited SAI capacity to undertake performance and procurement audits.

- PWI's specialization in procurement systems and its advocacy on improving procurement law make it a potentially critical ally for auditors in strengthening their own capacity to perform specialized procurement audits.
- MKSS sponsored public hearings provide platforms for citizen-beneficiaries to comment on the effectiveness (or lack thereof) of government programs that can be then fed into the findings of official performance audits.

4. Civil society organizations, (together with legislatures /parliaments) can monitor and fressureon the executive to implement auditrecommendations. WhileSAIs are Prevented from engaging; in policy processes, civil society organizations can use their networks to add political weight to SAIs recommendations.
   - PSAM tracks and documents — in its databases — public agency responses to cases of corruption and mismanagement, and on corrective action (if any) taken by the agencies in response to the findings of the Auditor-General. As shown in the case study, PSAM research and advocacy on audit disclaimers enable it to advocate for improvements in financial reporting systems and in the presentation of financial statements.
5. Civil society organizations have pioneered innovative audit methodologies to mon-itor public projects/ programs. SAIs should adapt and adopt these methodologies, where appropriate, to augment their own audit procedures.
   - Public hearings of the kind sponsored by the MKSS can provide the public auditor with critical evidence on the propriety of funds spent on public projects/programs. In addition, the auditor can engage beneficiaries and residents of public

projects/programs in the course of conducting performance audits.[53]

- The participatory audit experience of CCAGG in the Philippines establishes that civil society organizations can develop the skills needed to perform auditing tasks traditionally undertaken by the public auditors butthat they also bring skills and information that can improve the practice of performance audits.

The Future of Public Auditing: the Need for Audit Activism

Democratic governments derive their legitimacy from the constitutions that cre-ate them. Furthermore, constitutions provide framework of checks and balances among the government institutions that derive their mandates from the constitu-tions (e.g., the legislature, executive, and judiciary).

In modern times, the term 'judicial activism' is used to describe instances in which jurists may seemingly exceed their constitutional mandates in ruling on the cases before them. Controversial as it may be, there are many proponents who defend the need for judicial activism — especially in the face of corrupt and negligent executives on the one hand and poor and ineffective legislatures on the other.

Perhaps, SAIs also need to incorporate elements of activism while conducting their duties. In many constitutional democracies, the SAI derives its legitimacy from the constitution. As watchdogs of the public purse, the SAI is given consti-tutional authority to report on the use (and misuse) of public funds. Experiences in many developing countries have shown that while SAIs have been successful, in many instances, in carrying out the technical requirements of their office — i.e. in conducting competent audits — they have been less successful in ensuring that action is taken on their findings.

Perhaps, to be effective, SAIs need to reach out not only to legislative oversight committees but also to civil society.

In doing so, they might be accused of violat-ing a strict interpretation of their constitutional audit mandates, which frequently restrict SAIs to reporting to the legislature. The examples cited in the case stud-ies amply illustrate the point that civil society organizations have the capacity to monitor public agencies and the expenditure of public funds. Strategic partner-ships between civil society groups and SAIs can assist both entities in creating the political capital needed to push legislatures and trie executive to take corrective action to protect public funds.

In their current form, audits do not always provide a direct measure of gov-ernment performance in those specific areas in which citizens have the greatest interest. For example, the citizen might be interested in measuring the perform-ance of the government on health policy. The usual methodology employed by the government auditor when auditing the health department will comment on the veracity of the funds expended for health programs but will rarely comment on the appropriateness of the government s health policy. How then can a citizen measure whether health programs reflect health policy — and whether the underlying health policy responds adequately to the nations health needs?

There are two ways to increase the ability of audits to provide information on government performance that is directly relevant to citizens. First, the scope of audit mandates can be increased and audit methodologies developed that will enable auditors to offer some comments on the government policies that underpin agency performance. SAIs in Germany, Vietnam, and the U.S., for example, now comment on the appropriateness of government budgets in addition to exam-ining government expenditures. But these SAIs are the exception to a norm which holds that audits should be limited to examining the performance of government agencies in implementing policies. The expansion of the scope of audits require that the mandate of SAIs be expanded and that sufficient funds be allocated to these audits.

A second way to improve the ability of audits to provide information directly relevant to citizens is by allowing citizens to participate in the conduct of audits. As citizens will look for specific measures of performance, they will use their access to (and participation in) audit institutions to obtain information on those measures that they are interested in reviewing. Allowing citizen participation in audits will require that audit institutions create spaces in which citizens can meaningfully participate in audit programs and thereby obtain specific measures of government performance.

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5

Audit and Legislative Oversight: Developing Country Perspective

The countries of the Commonwealth share a common framework of public financial management and accountability rooted in the Westminster form of government for over a hundred and fifty year — a system which has played a major role in the socio-economic development of countries rich and poor. The paper details the working mechanism and recent experiences of this system, particularly: critical relationships involved in the process of holding the executive arm of government to account in pursuit of democratic governance—the role of "the three men in the boat"; first principles that underlie the legislative oversight function; factors that legislators believe are most important for the effectiveness of public scrutiny; constraints and challenges ahead and suggestions for further improvements that have been based upon research on the system. In doing so the author draws heavily from his work with the Commonwealth Parliamentary Association (CPA) and the World Bank Institute (WBI).

Background

The system of legislative control of the public purse goes back to the nineteenth century. In the United States, the system of congressional "appropriations" along with audit

was introduced in the early part of that century. In the U.K., the system was built on the principle of parliamentary control of all finance transactions incurred by the executive with Gladstone induced reforms for "closing the loop" by the Public Accounts Committee going as far back as 1861. In France too, the system worked with expenditure controls introduced by law and powers provided to the "Court of Accounts" to independently scrutinize the expenditure incurred by the executive.

Budget: Over the last three centuries, the process of the annual budget and supplementary grants evolved from pure control over every item of expenditure, to groups of expenditures sorted out by function, to appropriations and report-ing arrangements on aggregates of transactions. The other features of the "system" worth mentioning at this time are the secrecy behind budget formulation and the ceremonial nature of the budget presentation in the legislature. The budget is the big event of the year; it sets the direction for public expenditure. Economists dominate this aspect of public finance.

Does this "System" serve the citizenry well? Is this the model of the future? Is it sufficient in the context of developing countries? Does the system scrutinize right things at the right time? Such questions are being raised in several countries.

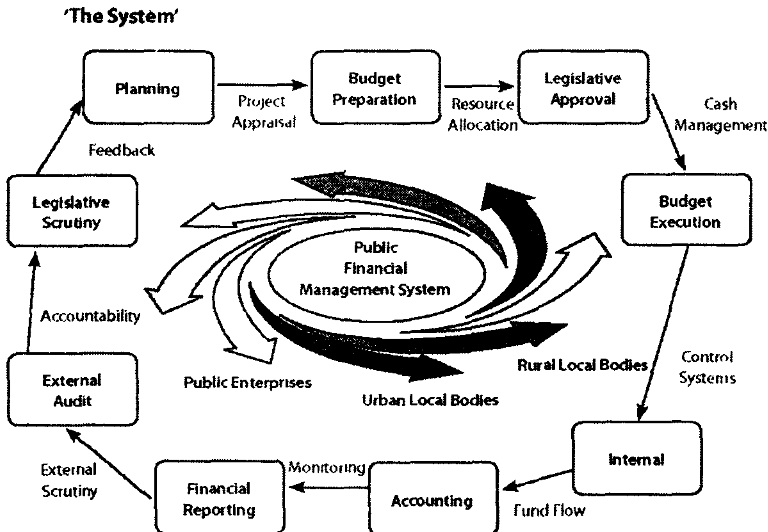
The System of Public Financial Management and Accountability

So what is the "System" that is being referred to? There are nine key components.

Main Components : *(i)* Planning; *(ii)* Budget Preparation; *(iii)* Legislative Approval; *(iv)* Public/ Legislative Scrutiny, *(v)* Budget Execution; *(vi)* External Audit; *(vii)* Financial Reporting; *(viii)* Accounting; *(xi)* Internal Controls & Internal Audit. These are all interconnected. The health of one affects the others. Underlying the system are the accountability relationships

between the executive and the legislature and between the external auditor and the legislature.

Accountability Assessments: In India, a State Financial Accountability Assessment was undertaken in Orissa. One of the features of this study was a report of the CAG of India pointing to a large amount of irregularities in the case of a poverty related program for rural employment. The external auditor reported that only 38% of funds provided by the government were used for the purposes intended without any financial irregularity.



Risk: Funds are not being fully used for purposes intended

Scrutiny: The example below is one of a result of the scrutiny provided by the audit and legislative oversight function. This function is dominated by the account-ing profession. Audit has done its share by reporting the irregularities; however what the legislative oversight function does with the Report in most developing countries is not normally as transparent. The Public Accounts Committee (PAC) often meets in *"camera"*. What happens at the Committees can only be learned from second hand

information. Press briefings are rare. The audit reports, year after year point to key similar deficiencies. Whether this lack of transparency of the PAC has contributed materially to the limited impact of the public audit function is becoming more evident. Public interest is limited unless there is a major scam with political implications.

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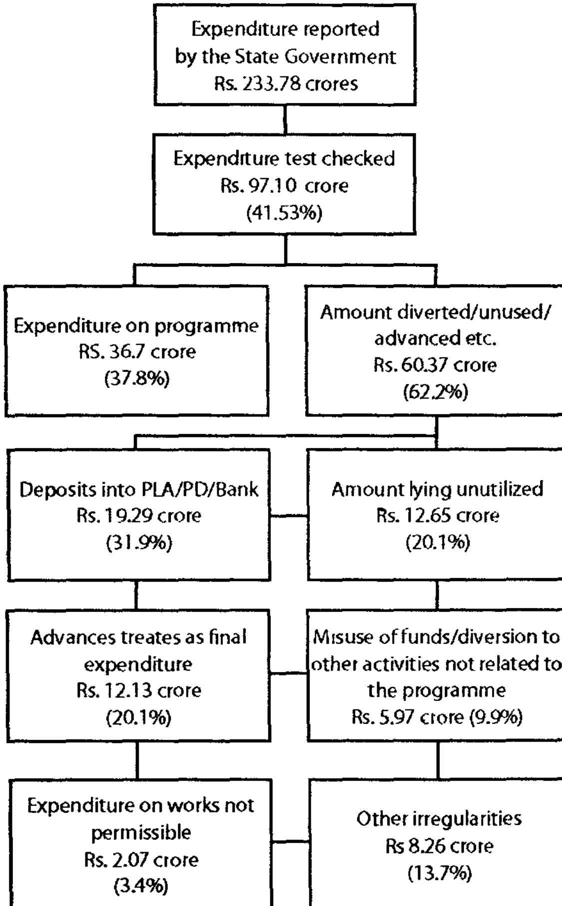


Values based System Re-examination: The underlying values associated with good governance and public scrutiny are widely accepted : economy and effi-ciency, effectiveness,

accountability, responsibility, less bureaucracy, transparency, participation and equity. Perhaps the time has come to re-examine the system from the perspective of a focus on regularity of cash in-flows and out-flows to a broader set of parameters that incorporate a variety of inputs from a development perspective such as cash and other assets—financial and physical, as well as human resources and a host of outputs, outturns and development outcomes. This raises the question of good governance and accountability for the management and con-trol of public resources where *information* — financial and non-financial, is in the drivers seat, and governance is value based.

Holding the Executive to Account—The Role of the Public Accounts Committee

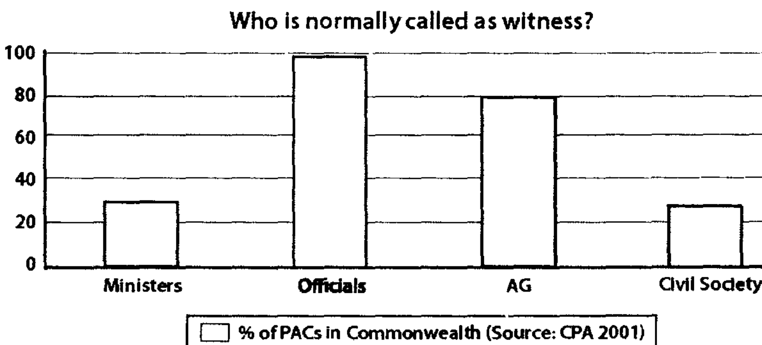
Compliance to Value for Money: The main emphasis of audit and oversight has so far been on "Moneys *spent* for the purposes intended" as recorded in the books of accounts. And the scrutiny has been primarily on cash transactions. Whether money was *usediot* the purposes intended has been a more difficult task for devel-oping country auditors. The impact of audit has become a burning issue in parts of the world where modernization has been constrained. Here lies the problem. Auditors tend to rely overly on documentary evidence which is increasingly limit-ing in the digital age. They often do not look at other sources of evidence such as electronic transfers, physical inspection and rational argumentation to form their conclusions. Additionally, they do not provide examples of excellence for others to follow. Furthermore, at times the materiality of their findings has been ques-tioned. The emphasis today is changing to look beyond mere "compliance" with financial rules and books of accounts to questions of "value for money" and best practice related performance.

Fair Presentation of Financials: Another aspect of holding the executive to account is one of fair presentation of financial statements prepared by the executive for tabling

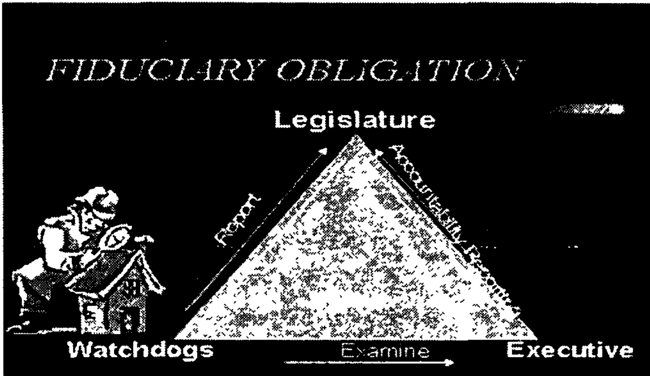
in the legislature. There are generally accepted international standards for accounting and for auditing being formulated. But here again most develop-ing countries are not sufficiently advanced on this front. Many SAIs are *de facto* insufficiently independent to provide third party assurance. Executive control can be bothersome. Often they lack institutional capacity to perform auditing in line with standards set by IFAC.

Modernization: A more modern system of public financial management and accountability would encourage the executive to develop ongoing monitoring and evaluation procedures as well as carefully structured risk management and reporting on the performance of schemes funded by tax payers and citizens. These performance oriented aspects of holding the executive to account are at the embryonic stage in most of the developing world. The focus has been on the nature and extent of compliance by officials to the financial rules which are too often set by the executive.

Witnesses at RVC hearings: It is interesting to note the results of a recent sur-vey (CPA 2001) revealing that while officials and the SAI are almost always called upon as witnesses at hearings, it is not so for Ministers and the Civil Society.



Critical Relationships



First, there is the accountability relationship between the legislature and the executive—the paramount relationship. This is where the rule of the game should be set. The rule inform the budget planning the preparation process to the external audit and -scrutiny process, This "bargain between the legislature and the executive" can be one of the most critical aspects of good public financial man-agement and accountability. This matter is unfortunately least understood. Often the bargain is struck within the executive without any visibility to the public, and over the years many developing countries have been unable to make the debate on setting the "rules of the game public"; the scope for light at the end of the tunnel one observer pointed out the relationship should be "cordial not "cosy, This issue is also complex. In many cases, the executive does not see value added from the work of the auditor and accordingly does not participate in the audit process, in the process. It has been argued that the time to start a dialogue with the auditee is towards the beginning of the audit and not towards the end, A course correction is advisable. Modern auditing standards are attempting to fill this gap. And we are seeing movement in this area in India and Sri Lanka. Here, auditors are being encouraged to meet with the executive regularly during the conduct of the audit.

Third, there is the relationship between the auditor and the legislature. This too is a strong relationship. Does the oversight committee of the legislature depend primarily on the AGs Report? 85% responded "yes" to this question posed by the CPA in 2001. The auditor operates in a proactive manner and in most cases the report is tabled in the legislature. The report is almost always a public document. OECD sought the answer to yet another question.

Are the findings of the national audit body available to the public?

	Number of countries	*percentage of total*
Always	20	50%
Generally, but some exceptions	18	45%
Never or rarely	2	5%
Total	40	100%

Note: * For example audits of the military.

Timeliness and quality: The main issues of continuing concern are of timeli-ness and quality. There is a debate going on whether the focus should be on indi-vidual transactions, management systems or program results and so on. There is no clear cut answer. Most developing countries' auditors tend to report on individual transactions. The emphasis is on "accidents" (deliberate or inadvertent) rather than on "road conditions. There are hosts of related issues in this area, some techni-cal others cultural and some that could be dealt with by greater clarity of need expressed by the legislature. The difficulty is getting consensus on what the ideal "mix" should be between reporting on transactions, systems and program results.

Competing Institutions of Accountability: While the struggle to develop these relationships continues, a number of competing accountability institutions have sprung up to

fill the gap. Public access to information is one such institution. The rise of the institution of the Ombudsman being another. The media is playing a critical role in scrutiny and the proposal of expanding the ambit of the social audit by community groups and concerned NGOs is very much alive. The traditional Westminster model of governance and audit in the context of colonial times did not emphasize social development as much as financial compliance.

Contract Appointments: Another interesting reform on the plate is the increas-ing number of appointments of top civil servants on contract basis. This is a new feature for developing countries. Sri Lanka is a case in point. This relatively recent move is significant in that the "CEO Concept" is emerging with greater clarity vis-a-vis performance expectations. There is convergence taking place between public and private sector management. There is an emerging consensus on the need for a common set of accounting and audit standards to govern the accountability regime associated with public financial accountability. An issue is the role of the "Audit Committee" of the legislature. Should this evolve on the lines of the private sector (corporate world) where the Committee plays a pivotal role in the oversight function and is subject to legal liability associated with members of the Board of Directors? Perhaps this is too far into the future.

Speed of Modernization: In most developing countries the evolution of audit and legislative oversight from financial compliance towards more effective system of oversight of executive performance, based on strengthening of the above noted critical accountability relationships, has been relatively slow.

First Principles

The success of the audit and legislative process rests very much on the principles on which the process is embodied.

Policy Neutrality

The Westminster model of governance calls for a bipartisan approach (to over-sight) and the expectation is to audit policy implementation rather than *policy* per se. The U.K. legislation, for instance, specifically refers to avoid deliberations on "the merits of policy". Not so in the U.S. or India and other countries where the lines between audit and evaluation are blurred. The increasing emphasis on auditing of results and more performance audit orientation suggests that it will be increasingly difficult to draw the lines in a traditional manner. Some audit institutions have already begun the process of examining the nature and extant to which intended beneficiaries do in fact derive the benefits of the program funded from public money. India is one such country. I think this is a commendable move that needs to be expanded in line with the more modern risk based approach to audit advocated by professionals in the world of both public and private audit.

Performance of the Bureaucracy

The focus of legislative oversight is mainly on the performance of the bureaucracy. Officials are almost always the main witness at a PAC hearing. Ministers are called in less than 40% of cases and civil society witnesses are called in less than 25% of cases surveyed by the CPA.

There is less going on in developing countries byway of self-evaluation on the part of legislative auditors on their own performance or their combined effort with legislative committees responsible for oversight, than in more advanced countries. The effectiveness of the traditional audit system has been questioned in one country by way of a Public Interest Litigation. The impact of the audit function would be greatly enhanced if greater attention was paid on the need for a more holistic approach; one where the contribution of audit and the legislature oversight function taken together was also subject to some form of measurement and public reporting.

While the author is not aware of Public Accounts Committees in develop-ing countries providing annual performance reports to the public, nonetheless, he gives due credit to the SAP community, where the development of auditing norms now incorporate the need for members to meet the standards of management and performance in line with those of the executive subjected to audit scrutiny. In another words, there is recognition that what applies to the 'goose should apply to the gander'. Unfortunately PACs in developing countries do not have an equivalent forum for their professional growth and development. For example there is no web site to locate PAC recommendations or action taken notes. PACs are generally far behind the legislative auditor in this regard; additionally, there is no concept of Peer Review among developing country PACs.

Inter party co-operation

The need for a bipartisan approach to legislative oversight has already been men-tioned. While many PACs are chaired by members of the opposition—the key rests in the manner in which the committee is able to develop a consensus on what issues need priority, the manner in which committee hearings are organized and recommendations formulated. The PACs stature is greatly enhanced by strong inter-party cooperation; additionally, whether the chair is from the opposition or the ruling government is not half as important as the strength with which the chair can induce a common front to promote answerable, honest and productive government operations. The tenure of the committee, regularity of its meetings, timely actions and rigorous follow-up are equally important areas for promoting the effectiveness of the oversight function.

Unanimity in Decisions

Following through on the question of inter party cooperation is the requirement for unanimity in decisions of the oversight committee. This approach adds to the clout of the committee. Most importantly, the likelihood of timely

remedial action on the part of the executive is enhanced. Without question a case can be made for retaining a dedicated committee for dealing with the reports of the SAI. This is however presently open to debate given the evolution from "financial compliance" audit to "performance" audit. In countries where there are proactive subject matter committees in the house, the call has arisen for audit reports to be dealt with by the relevant subject matter committee. This reform should be seen as a step forward. The need for effective co-ordination by the PAC goes without saying. A dedicated committee for follow through of the audit reports issued by the SAI regardless of where the "hearing" takes place needs to be preserved. And the Public Accounts Committee would the preferred choice in this regard.

RECENT EXPERIENCE

CPA Study Group

The CPA Study: The "Overseers" is a landmark study on the working of Public Accounts Committees across the Commonwealth. It was held in Toronto in 2001 where the author served as a technical adviser and was impressed by the dedicated effort made by the members from around the globe to evaluate the role and functions of the committee (PAC) as well suggest ways to move forward. Many common issues emerged and also the challenges ahead. For instance, the need for public oversight in relation to international transactions and cross border funds flow was raised well before September 11, 2001.

Openness: Of special interest was the discussion on openness with which the Committees work across the Commonwealth. It became clear at the meeting that most developing countries lagged in terms of the speed of evolution towards greater transparency of their hearings and deliberations. The split between committees—those that are open to the public and those that are not was about 55:45. This needs to change. Pakistan and Nepal have

already moved in this direction and to the best of the authors knowledge, no committee has regretted the move from "closed door" meetings to "open" public hearings.

Functioning of Committees: The Toronto meeting raised important ques-tions on a host of issues such as the nature and extent of research undertaken by committees, the tenure of its members, access to information on developments internationally, the independence of auditors *(de jure and de facto),* the relevance of global development goals to legislators and the distinct challenges facing small countries such as Botswana and Nepal where resources available to the committee are extremely limited.

Selected results from survey of Public Accounts Committees in the Commonwealth

	Yes	*No*
Is the chairperson from an opposition party?	67%	33%
Are departmental officials normally summoned?	97%	3%
Is the auditor general normally summoned?	79%	21%
Are ministers normally summoned?	31%	69%
Are committee reports freely available to the public?	87%	13%
Are hearings open to the press and the public?	55%	45%
Committee depends primarily on audit report?	85%	15%
Is the committee report debated in the legislature?	57%	43%
Executive required to respond to recommendations?	80%	20%

Main Conclusions and Recommendations: The Toronto meeting of the study group came to the conclusion that there were three main areas for serious consideration.

(a) ***Capacity building:*** A constant theme was the need to improve institutional capability, that is, the ability of parliaments, PACs and auditors-general's offices to carry

out their functions by being provided with sufficient resources and having adequate training and access to the expertise that they require. The audit of central banks, for instance requires special expertise.

(b) Independence: Particularly for the auditors-general, it is essential that they be free from political or legal constraints that could inhibit them carrying out their duties diligently and impartially. Administrative constraints too need to be watched.

(c) Information exchange: PACs in particular need to have the means to exchange information and ideas so as to keep them up-to-date with important developments, changing standards and best-practices as they emerge. The World Wide Web provides an opportunity to overcome this difficulty.

The following are the main individual recommendations of the study group :

(i) The International Dimension:

- There should be greater direct contact between parliaments, especially PACs, and international financial institutions.
- The CPA should include good government as a subject of the theme or sub-theme of its conferences

(ii) Auditors Generals

- The auditor general should be an officer of parliament independent of the executive.
- The appointment process for an auditor general should involve consultation with a wide range of stakeholders.
- An auditor general should only be removed from office on limited grounds that are specified in advance by law.

- Central banks should be subject to the auditor generals audit mandate in the same way as other public sector agencies.
- The auditor general should take account of the views of PACs in framing their work programs.
- Parliaments should be involved at trie pre-budget stage in determining the resources to be allocated to the auditor general.
- Auditors general and their staff must have appropriate legal protections conferred on them to enable them to carry out their duties.
- PACs should keep under review any proposals to change the auditor generals audit mandate.
- Any company receiving public funding to deliver public services should be subject to the auditor generals audit mandate in respect of those services.
- Auditors general should present their reports in an attractive form and devise active communications strategies.
- Auditors general should take steps to measure their own performance.
- The main of PACs work should be guided by the work of the auditor general.
- Auditors general should actively participate in international auditors general associations.
- Auditors general should actively introduce themselves and their services to all parliamentary committees, not just PACs.
- Auditors general have a role in approving internal audit standards .

(iii) Public Accounts Committees:

- Parliaments should regard the PAC as their pre-eminent committee.

- Senior opposition figures must be associated with the PACs work.
- There should always be sufficient experience and seniority among the membership of the PAC.
- Specially structured training be provided to PAC members.
- It is crucial that the chairperson of the PAC has the qualities to ensure that the PAC works effectively.
- PACs must be adequately resourced to carry out their functions.
- PACs, while not being bound to act unanimously, should strive for some consensus in their reports.
- PACs should promote greater public awareness of their role.
- PACs should consider using subcommittees for specific inquiries.

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should be used to disseminate information on PACs.

- Procedures for follow-up action in recommendations in PAC reports are critical.
- Parliament should hold an annual debate on the work of the PAC.
- PACs in smaller and developing parliaments need improved access to information technology.
- A rational local method of allocating funding to PACs needs to be put in place to ensure that they have adequate resources.
- Smaller parliaments need to take innovative steps to expand the pool of personnel available to serve on the PAC.
- Special attendance allowances, rather than a special salary, should be con-sidered for PAC attendance.
- Links between PAC websites should be developed.
- The CPA should explore the potential for the use of a news group to encourage information exchange on PAC matters.
- The CPA should examine what options exist for conferences of associations of PACs
- A compendium of Commonwealth PAC practice be established to be managed by a CPA branch or parliament
- Research should be undertaken into establishing a basis for making international comparisons of PAC performance

World Bank Institute Survey

The CPA study outlines how the PACs work. A survey conducted by the WBI subsequently explored the reasons

behind the practices employed by PACs. What are the critical success factors? And what are the main constraints?

(a) Success Factors :

The success factors that PACs themselves consider most important included:

- Having a broad scope of enquiry.
- Power to select issues without government direction.
- Power to report conclusions, suggest improvements and follow-up on these.
- Strong support from the legislative auditor, members and research staff that creates a unity of purpose about PAC work.
- Having a bi-partisan relationship among committee members.
- Involving the public and encouraging media coverage.

There are other factors that were rated highly, many of which support these listed above. The survey results support the view, for example, that a PAC will be more effective if it meets regularly, keeps up to date with the progress of public business, members are well prepared for committee hearings and detailed records are kept of committee meetings for the public record.

As regards results achieved by the PAC: How frequently has the PAC achieved the following results in percentage terms:

Result achieved	*Frequently (%)*	*Rarely (%)*	*Often (%)*
Recommendations accepted	78.8	15.2	33
Recommendations implemented	63.6	27.3	33
Better information	60.8	18.2	33

Disciplinary action	27.3	15.2	33
Modification of legislation	15.2	54.5	33

(b) Major constraints — cultural and technical

Some of the most significant constraints that hamper progress included:

Cultural

- Partisan climate
- Executive dislike for legislators
- Weak civil society/media
- Lack of ediical base
- Belief: audit reporting is die end of die responsibility
- Unduly adversarial approach to politics
- Ministers on die oversight committees

Technical

- "System" design: performance reporting?
- Dated and/or immaterial audit findings
- Audit reports diat focus on "accidents" radier dian "road conditions"
- Executive non response
- Capacity for research and follow through
- Communications capacity at die SAI
- By convention: team work discouraged by adversarial environment

(c) Suggestions for enhancing the impact of the Legislative Oversight Function

(i) Chair of the Committee: A strong chair widi leadership qualities and desire to forge a consensus among members was referred to earlier as a key ingredient of success. Next, experience shows that smaller committees

(5-11 members) are likely to be more effective than very large committees (over 12 members). A senior parliamentarian who is well respected by all parties, fair minded, visionary and subscribes to openness as an important value makes for an ideal chair.

(ii) Tenure: Tenure of members is also important. Ideally the tenure of the committee should be the life of the legislature. A PAC system where there is con-stant turnover with change of members on an annual basis may not provide for adequate continuity and therefore, could lack effectiveness. Sri Lanka and India tend to have this kind of difficulty.

(iii) Selection of Topics: Providing *Suo Motu* powers to investigate is another suggestion for enhancing the scope and clout of the oversight function. A number of committees are able to select topics of their choice for investigation over and above those pointed out by audit. But most do not. An example of one that does is the Public Undertakings Committee of Sri Lanka.

(iv) Research Support from SAL: In many developing countries, the contri-bution of the SAI at Public Accounts Committee hearings is limited to "a friend, philosopher and guide" to the chair of the committee. This convention has led to a situation whereby the SAI is highly subordinate to the committee; the SAI representative sits "behind" the chair rather than in front of the chair and the com-mittee. The SAI is rarely questioned on the validity of the report or cross-exam-ined by the members for his/her analysis and views supporting the "cause" of the problems reported by the auditor. Some believe that this practice needs to evolve towards more open debate on issues of public interest raised by audit, whereby the SAI is also a witness and subject to public scrutiny as in the case of more advanced countries such as the UK and Canada. This reform would likely lead to a more level playing field for officials hauled in for scrutiny. It would also allow for a more informed discussion on the auditors findings and

recommendations. This, together with the presence of other witnesses that could provide subject matter expertise would encourage a higher quality of discussion. At the same time, some believe that the auditor would be even more conscious of the importance of quality of audit work and the need to defend, if necessary, the basis of his/her judgments.

(v) Relevant Topics: Other suggestions include greater attention to the selec-tion of relevant topics for discussion at the PAC. Topics that are current, relate to areas of high fiduciary risk and those that are of greatest interest to the public tend to invite the best debate. Canada provides a good example in this regard. The quality of strategic thinking and planning that goes on at the Audit Office has had a salutary effect. The recent issue of what appear to be highly "irregular" disburse-ments to individuals recently uncovered by the Gomery Commission is a follow through of a previous audit report on this matter.

(vi) Performance Report: The annual performance report on the workings of the PAC and its tabling in the legislature is another area of importance. A question was posed by the CPA—is there any mechanism in place for the measurement of PAC performance? The response was instructive. 33% responded 'Yes' and 67% 'No'.

(vii) Evaluation of Performance: Common mechanisms in place for mea-suring the performance of PACs are annual reports and corporate/business plans that provide performance indicators and targets. In this regard, it was found that PACs are far more likely to have their performance measured in Africa (47%) and Canada (50%) than in Asia. And when the question was posed — has there been any recent study or comment on the strengths and weaknesses of the operations of the committee? 8% responded 'Yes' and 92% 'No'.

(viii) The working of the PAC was considered at a conference of chairmen of central and state Public Accounts Committees at Parliament House, New Delhi on 17 and 18 January 2001. The need to improve performance was

widely accepted, the need for regular meetings stressed and methods to reduce backlogs explored. Consideration to open PAC hearings to the public was deferred. This event is a good example of a self evaluation process.

(ix) Other comments on the subject of performance generally derive from the media. It was reported in the media of one Caribbean country, for example, that the PAC was not as effective as it should be. Information tabled was often dated.

(x) Media Coverage: The overall suggestion remains to encourage public and media coverage of the oversight function. Given the increasing role of other insti-tutions of public accountability such as social audit, ombudsmen, vigilance, media and civil society interventions—there is a strong signal emerging to harmonize efforts among the various institutions of public accountability.

(d) An Ideal PAC: In the light of the findings of the CPA and the WBI work, presented below (with certain caution) are some aspects of an ideal PAC.

An "Ideal PAC Committee"

- The committee is small; committees seem to work well with 5-11 members, none of whom should be government ministers;
- Senior opposition figures are associated with the PAC's work, and probably chair the committee;
- The chair is a senior parliamentarian, fair minded and respected by parliament;
- The committee is appointed for the full term of the parliament;
- The committee is adequately resourced, with an experienced clerk and a competent researcher(s)
- There is clarity on the committee's role and responsibilities;

- The committee meets frequently and regularly;
- Hearings are open to the public; a full verbatim transcript and summary minutes are quickly available for public distribution;
- A steering committee plans the committee's work in advance and prepares an agenda for each meeting to the full committee;
- The typical witness is a senior public servant (the "accounting officer") accompanied by the officials that have a detailed understanding of the issues under examination;
- The auditor's report is automatically referred to the committee and the auditor meets with the committee to go over the highlights of the report;
- In addition to issues raised by the auditor, the committee occasionally decides to investigate other matters;
- Committee strives for some consensus in their reports;
- The committee issues formal substantive reports to parliament at least annually;
- The committee has established a procedure with the government for following up its recommendations and is informed about what, if any, action has been taken;
- In all its deliberations, the committee uses the auditor as an expert advisor;
- Parliaments hold an annual debate on the work of the committee.

Conclusion

Audit and legislature oversight are crucial links in the chain of public financial management and accountability. The system of public financial management and

accountability cannot function effectively without a strong audit and legislative oversight function. The Public Accounts Committee acts as the crucial agent among the "Three Men in the Boat"—the Legislator, the Executive and the Auditor. There is a call for both the public and private sectors of the economy in developing countries to strengthen public governance & accountability.

The success of a PAC depends, to a large extent, on how it is institutionalized and the institutional features and characteristics that it has—its power and mandate. In this respect, recent research points towards: first, PACs should focus on governments' financial activity (implementation and service delivery) and accountability for perfor-mance rather than evaluating or assessing the content of the governments' policies. Second, PACs should have the power to investigate all past and present government transactions regardless of when they were made. Third, PACs should be given the power to verify whether the executive actually undertakes concrete steps to implement the recommendations of the PAC itself. And finally, PACs must have a close working relationship with the auditors general. The relationship is truly symbiotic.

The success of a PAC does not depend exclusively on institutional design; equally importantly, it depends on the behaviour of its members and in the functioning of the committee itself. Here, some obvious best practices can be identified: PACs' members must act in a non partisan fashion and should try to have a good working relationship with other committee members in spite of possible partisan differences. In its functioning the PAC should always strive for consensus. The WBI Study has revealed that the effectiveness in the PACs' activity increases whenever the PACs members study the documentation and prepare themselves before the PAC meetings. The PACs should keep the transcripts of their meetings, they should publish their conclusions and recommendations, and they should involve the public and the media. Public opinion can in fact

be a strong incentive for governments to improve their financial accountability and avoid possible alle-gations of ineffective management of public resources.

Many developing countries need to catch up with their counterparts in more advanced democracies. The traditional "compliance" based regime needs to be broadened to a more "performance" based regime. For audit and legislative over-sight to remain effective there is an urgent need to modernize the system of pub-lic financial management and accountability in many developing countries. One way is to change the focus of audit and legislative oversight from "cash outlays" to "development outcomes" and of audit from reporting on "accidents" to "road conditions". There are many common issues to tackle, good practices to follow, ways to support the harmonization agenda and building capacity by sharing and learning.

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6

Learning from Civil Society Initiatives

Recent years have witnessed a growing concern in development circles about issues of governance and accountability in developing countries. There are several reasons behind this trend. First of all, there is mounting dissatisfaction with the manner in which the state has performed its functions in these countries. Both citizens and outside observers have questioned the efficiency and effectiveness of resource use by governments. Public investments have resulted in meagre returns and low pro-ductivity in many cases. Failures in terms of lack of transparency, rule of law, and corruption are often highlighted as the key contributory factors underlying this phenomenon. The plea for a restructuring of the state and its functions has been greatly influenced by these perceptions. Second, the failure of many developing countries to achieve significant poverty reduction and the consequent inequity and injustice suffered by millions of marginalized people is yet another reason for this global concern about governance. The weak bargaining power and organizational capabilities of the poor have no doubt contributed to this outcome. The global campaign under UN auspices in support of the Millennium Development Goals (MDGs) is a response to this reality. Third, there is a growing realization that existing mechanisms for ensuring

public accountability have not been able to resolve these problems. Supreme audit institutions (SAIs) exist in almost all countries. But the efficacy of traditional accountability mechanisms and their impact on the functioning of governments have come in for serious questioning.

International development agencies and donors have given increasing attention to the issues of governance and accountability referred to above. Their responses can be divided into two categories. The first consists of international efforts to reform and restructure government systems and practices so as to strengthen their performance and accountability. It covers a mix of interventions that range from administrative reforms to the redesign of judicial and audit institutions. Many foreign aid projects include reform programs of this nature. The second focuses on strengthening public accountability through pressure from outside of governments, especially through civil society institutions. The endeavour here has been to experiment with different types of pressure that civil society or citizens at large can bring to bear on their governments to be more accountable to the people. Some donors have begun to invest in the creation of civil society capabilities to play this role in specific country contexts.

Since the purpose of this paper is to discuss ways and means for SAIs to enhance the relevance and impact of the audit function by drawing upon civil society perspectives and feedback, it aims to focus primarily on the current think-ing on this approach to strengthen public accountability. This is not to deny the importance of restructuring governments. A lot of good work is going on in this regard, and it should continue to receive high priority. But, as noted above, in the context of this paper, linking the audit function to the potential of civil society pressure as an aid to accountability has greater relevance.

This paper is divided into three sections. The first section presents some basic concepts and approaches that may help us to understand how civil society pressure can act

as an influence on accountability. A narration of recent civil society initia-tives to strengthen public accountability is provided in the second section. A case study of one of these initiatives, namely, citizen report cards on public services, in which this author was personally involved, is also presented here. The third section offers some ideas on how SAIs might draw upon these concepts and experiences to make their audit of social change more focused and effective.

Accountability and Citizens'Voice

In a democracy, the State is the servant of the people. It performs many functions essential for the welfare and development of its citizens and provides an array of essential services many of which are "public goods." The State collects taxes from the people to discharge its functions and is accountable to society for proper use of the resources entrusted to it. Periodic elections are seen as the ultimate lever that citizens can use to hold those wielding power in the name of the state account-able for their performance. But the dilemma is that while much happens between elections in terms of transactions between the state and its citizens, there is little an individual citizen can do in the short run if things go wrong in the discharge of functions or services by the states agencies. Waiting for the next election is of little help to a citizen who needs immediate corrective action. The problem arises because the citizens have no "exit" unlike in the market place where they can exit from one supplier of a good or service to another. When citizens have no exit option, they can only vent their feelings through "voice." Voice may take the form of protest, non-cooperation or the rejection of political representatives through the ballot process.[93] Collective action in any of these forms can act as an instrument of accountability, signalling the authorities that they must listen to the peoples voice and take remedial action. Of these different forms of voice, the ballot process is the most difficult to access because of the long time gap between elections. Other forms of collective

action (a form of voice) are more easily resorted to when people face problems continually with the functioning of governments, especially with the delivery of services.

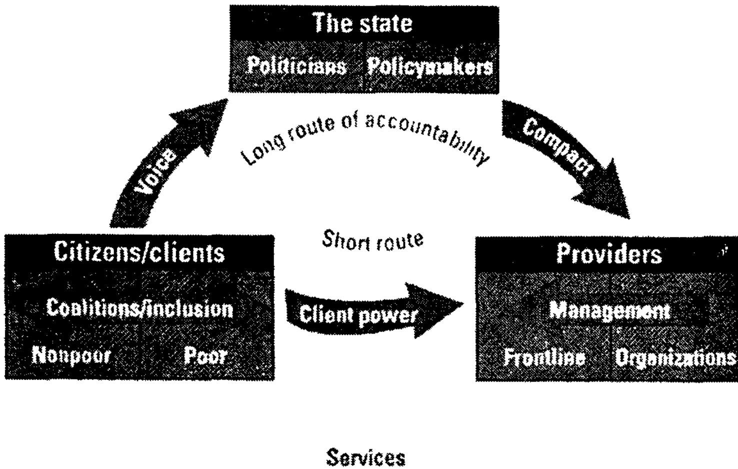
There is a growing literature on the use of voice as an aid to accountability and on the evidence from numerous experiments based on this approach. Illustrative of this trend is the framework for accountability presented in the World Devel-opment Report (WDR) 2004. WDR uses the term "client power" to denote the voice of the users of public services. It is true that as customers of a service, citizens are clients. Nevertheless, it is important to note that their role as citizens is larger and has more power that what a mere client can command. Citizens, for example, have rights and avenues for action that may not always be available to mere clients. The preference of this papers author, therefore, is to use the term "citizens' voice."

Diagram 1 below presents a graphical representation ofWDR's framework for accountability. Its focus is on accountability with respect to the services for the poor. But its implications are by no means limited only to the services or functions that matter only to the poor. This framework brings together four sets of players, namely, citizens/clients, political leaders/policy makers, public service providers, and frontline professionals. Citizens participate in the political process both indi-vidually and in groups. But they are also clients of the public agencies that provide different services. Their interests and goals need not always be the same and hence, conflicts between groups cannot be ruled out. Elected leaders and policy makers have the power to formulate policies and laws, and allocate and supervise resources and their use. Service providers are line departments and agencies charged with the responsibility for the design and delivery of public services. Providers may also be from the private sector, but are required to function under the regulation of public authorities. Frontline delivery personnel such as teachers and doctors work under the supervision of service providers. But their goals and

incentives need not always be in tune with those of their service providers or policymakers.

Diagram 1: Key Linkages in Accountability

The WDR framework refers to the long route and the



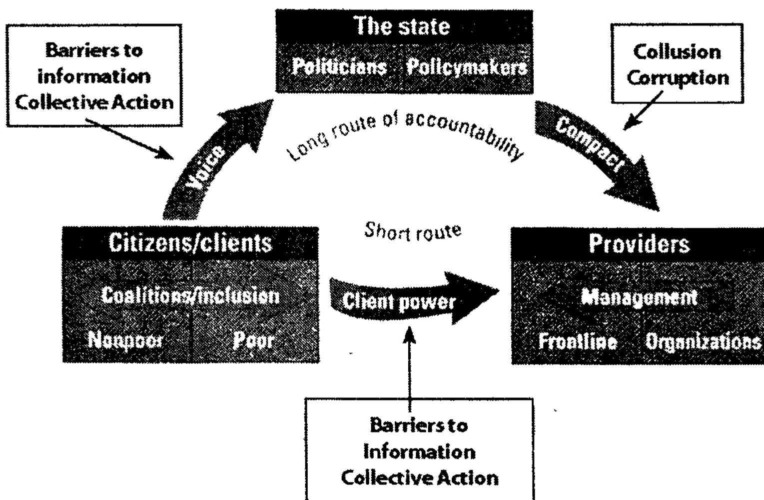
short route of acco ability. Both operate in acircular fashion (see Diagram 1). Citizens/clients car voice to signal policymakers/leaders on their needs and problems. The latR turn can hold service providers accountable for the delivery of services throu compact, much as a contract with explicit terms and obligations or a mutual kind. Service providers then deliver services through their frontline workers and units that directly interface with citizens. Accountability here is enforced through the use of voice that works through the political process. In the short route, the linkage between citizens and providers is more direct. Here, client voice directly impacts on the provider and accountability is achieved through this direct pressure.

It is not our objective here to delve deep into this framework and its merits, urtice it to note tnat it is a departure rrom tne traditional notions or vertical accountability mechanisms. Trie latter have not been assumed away in this diagram. The traditional audit

function is presumably built into the right side of the diagram. The operation of the compact and the resources deployed for services are subject to audits of various kinds.

But the new feature here is the mechanism of voice and the manner in which it acts as an aid to accountability. But the big question is whether this framework can actually be made to work. The logic is appealing. In a democratic setting, listening to the people or responding to their collective voice seems desirabfe and feasible. Are there barriers that can derail or weaken these linkages?

Diagram 2: Barriers to Accountability



The diagram on the previous page illustrates the kinds of barriers that can break the neat relationships and influences implied in Diagram 1. It highlights two sets of barriers, one that could weaken the power of voice and the other that can render the compact ineffective. Voice, for example, will not work when citizens/clients do not have the necessary information or knowledge to make it effective. This can happen when people have limited knowledge in a specific area and are therefore unable to digest new

information and make use of it. Even if they are educated, but have no access to information, then again the outcome will be no different. Thus, governments can create barriers to voice by denying people knowledge about their rights and entitlements, and standards and norms pertaining to services. Even when such information is available, if citizens do not have a sufficient background for understanding this information, it can potentially act as a barrier to voice. The poor often tend to suffer from this handicap.

There are equally important barriers to collective action as a form of voice. Col-lective action calls for time, organizational skills, and resources. It requires capacity to identify key issues and knowledge about possible remedies. The poor typically are weak in terms of these capabilities. When they are struggling to survive, they may neither have the ability nor the incentive to invest in collective action. It is the reason why intermediary organizations (such as NGOs) enter the scene and organize the poor and marginalized communities. Collective action is easier to organize for the better off sections of society. Nevertheless, it is an uphill task even for them because of the "free rider" problem and the indifferent characteristic of many middle class citizens who seek easy exits. It is not uncommon, for example, for people to pay a bribe to get their work done.

There is a similar set of barriers on the right hand side of the diagram that can turn the compact between policy makers and providers into a hollow ritual. There may be a nominal compact, but in reality, both parties may agree to ignore its provisions and collude to follow their own interests rather than the public good. When those who are meant to enforce the compact dilute or ignore it, there is no one left to demand accountability, and the casualty is the service providers performance. In a country where citizens' access to information is limited, the latter will be unable to challenge collusive conduct. More often than not, corruption and political patronage are at the heart of this phenomenon.

Extreme cases of this kind signal the existence of a predatory state that citizens are unable to break.

What is described above applies to both the long and short routes of account-ability depicted in the diagram. Barriers to information and collective action could render voice ineffective when citizens try to influence service providers directly (the short route). Delivery of services to the poor and the accountability of the providers to the people will not improve under these conditions. To conclude, unless the barriers to information and collective action are somehow eliminated, and citizens' voice is strengthened enough to weaken the grip of collusion and corruption in the machinery of government, it is unrealistic to expect that public accountability will improve.

Accountability Initiatives by Citizens

Despite the barriers discussed above, there have been numerous efforts by indi-vidual citizens, civil society groups and NGOs in several countries to improve the accountability of governments and service providers. Their interventions have taken different forms, depending on the context, the problems involved, and the skills and resources of the participants in these movements. Whether they have made any lasting impact or led to systemic changes within governments is difficult to say. Some of the interventions have been documented and assessed, and their lessons have been widely disseminated. In all cases, they have exerted pressure from outside the system. And some of them have resulted in models and approaches that have been replicated or adapted in other settings and even countries.

The civil society initiatives for accountability presented below fall into five categories: (1) community management of local services, (2) independent budget analysis and tracking, (3) public hearings, (4) public interest litigation, and (5) citizen report cards on services. A brief description of each follows.

Community Management of Local Services

There are many public services that lend themselves to direct monitoring and supervision by local communities. In many cases, citizens and users of the services could participate in aspects of managing and monitoring such services. A good example is the local school where the parent-teacher association could actively participate in planning and supervising the school programs. Similarly, the main-tenance of drinking water facilities and community toilets has benefited from the participation of user groups. A recent case from the slums of Mumbai, India has shown how local communities have pitched in to manage and maintain the newly built toilet facilities. NGOs and local communities have played a lead role in this project and the government has funded it through a World Bank project.

The initiative for community management has come largely from NGOs working in the field in local communities. Their primary interest is in promoting community participation in local development programs and services so as to make them more relevant to the people and more sustainable. But it turns out that such participation is also a powerful means to hold the government or service provider accountable to the people. When the latter influence the design of a service and monitor its delivery or contribute to the maintenance of public facilities, they have a strong interest in ensuring that the agencies involved are responsive to their problems and needs. Being closer to the scene and with a seat at the table, they can observe and challenge abuses and poor performance. Community management of local services can thus act as an aid to accountability, and to a large extent, compensate for the inherent problems in monitoring local activities that higher level officials encounter. In several countries, governments and international donors are now encouraging and facilitating community management of public services and facilities.

Independent Budget Analysis and Tracking

Budgets are the basic instrument of governments to mobilize, allocate and monitor scarce resources (money and personnel). By bringing government budgets under public scrutiny, civil society groups are able to raise important questions about taxation, public expenditure, and the distribution of benefits to different groups of people. This initiative, of course, calls for special skills in terms of analysis and evaluation. Examples of civil society groups engaging in budget analysis and using the findings for advocacy are therefore not many. But wherever it has been attempted, the process has resulted in informing and educating both the people and the authorities (legislators and officials) on the implications of the allocations and on the need to modify them to achieve the stated policy objectives. Budget analysis can also be used to advocate reforms, especially with reference to the poor, as their interests are seldom adequately addressed in the complex bargaining pro-cesses behind the budgetary allocations.

A classic case of such budget analysis where citizens are actively involved comes from Porto Alegre, Brazil. Here communities participate by articulating their needs and priorities. This is an open process that helps the government to listen to the peoples voice and arrive at allocations that take into account public concerns. Needless to say, the process presupposes a government that is inclined to listen and seek ideas from the people. It is also a time consuming process that calls for a great deal of involvement by community groups. Broad based budget analysis has been carried out in South Africa under the auspices of a local NGO. The International Centre on Budget and Policy Priorities in Washington DC is engaged in strengthening civil society capabilities to undertake budget analysis in developing countries.

A more limited form of budget analysis has been attempted by DISHA, an NGO in the Indian state of Gujarat. The focus here has been on analysis of the budget

from the standpoint of the poor, especially the tribal population. The find-ings are used by the NGO to engage in dialogues with elected representatives and officials. The findings are publicized through the media in order to create public support for the proposals made by the NGO.

A third example is from Africa where public expenditure tracking has been attempted to monitor the effectiveness of public spending on services for the poor. The World Bank has led this effort in Uganda and other countries, but the approach lends itself to be used as an initiative to increase accountability. Budget analysis, of course, is primarily a means to improve the process of resource allo-cation by governments and to nudge them to be effective. But when civil society groups engage governments in this exercise, it can act as a force for greater public accountability.

Public Hearings

Public hearings are a well known mechanism for eliciting the views and concerns of the people on a variety of issues. Regulatory agencies use this approach in the determination of tariff rates and other policies. In recent years, NGOs and other civil society groups have organized public hearings as a means to demand increased public accountability towards the poor and marginalized communities. Being an open process, it attracts the attention of the media and lends itself to being used as an aid to advocacy to improve the conditions of the poor. NGOs act as intermediaries in the process as the poor are not equipped with the skills and organization necessary to make a success of public hearings. When people face highly localized problems, it is possible to stimulate the poor to participate in public hearings.

A documented case from India narrates how MKSS, an NGO based in Rajasthan, India used public hearings in rural areas to publicize the abuses in public employment programs. This adverse publicity led to the authorities taking corrective action that benefited the local communities. It also gave a strong push to the right to

information movement that was gaining momentum in the country in the early 1990s. Public hearings were used in this case to demand accountability in the programs that are supposed to benefit the poor. In the absence of the resultant pressure, abuses in the employment program might have continued unabated.

Public Interest Litigation (PIL)

Public interest litigation refers to legal action taken in a court of law for enforc-ing the public interest or to protect the legal rights and liabilities of the public or a community of people. The term, PIL, was first used in the USA in the 1960s to describe a legal development that sought to widen civic participation in gover-nance. In some developing countries like India, PIL has been widely used to get the courts to direct governments to take corrective steps to restore the rights and entitlements of the poor. An independent judiciary and a democratic constitu-tion are essential prerequisites for PIL to succeed. PIL is a potent accountability mechanism when the executive and legislative branches of government are unable or unwilling to protect the rights and entitlements of the poor. Individual citizens, especially the poor, will find it difficult to resort to PIL to hold the government accountable for the denial of their rights simply because of the time and costs involved. As in public hearings, it is NGOs and organized civic groups that make use of PIL in most countries.

Citizen Report Cards -An Accountability Tool

A citizen report card (CRC) is a new way to rate different service providers from a user perspective and to utilize this information to make the providers more accountable to the people. User feedback is a cost effective way for a government to find out whether its services are reaching the people, especially the poor. Users of a public service can tell the government a lot about the quality and value of a service. Surprisingly, this is not a method that is known to or used by most developing country governments. The continuing neglect of the quality of services is in part

a consequence of this gap. This is in sharp contrast to the practice of seeking "customer feedback" that is common in the competitive market place.

A CRC on public services is not just one more opinion poll. Report cards reflect the actual experience of people with a wide range of public services. The survey on which a report card is based covers only those who have had experiences in the use of specific services and interactions with the relevant public agencies or other aspects of public services. Users possess fairly accurate information, for example, on whether a public agency actually solved their problems or whether they had to pay bribes to officials. Of course, errors of recall cannot be ruled out. But the large numbers of responses that sample surveys generate lend credibility to the findings.

Stratified random sample surveys using well structured questionnaires are the basis on which report cards are prepared. It is generally assumed that people from similar backgrounds in terms of education, culture, etc., are likely to use compa-rable standards in their assessments. But these standards may be higher for higher income groups than for the poor whose expectations about public services tend to be much lower. Dividing households into relatively homogenous categories is one way to minimize the biases that differing expectations can cause.

Since the author of this paper played a modest role in launching the first CRC in Bangalore, India, a briefcase study of this experiment will be presented. Public Affairs Centre (PAC), founded in Bangalore, has taken this initiative much further over the past decade. The first report card on Bangalore's public agencies in 1994 covered municipal services, water supply, electricity, telecom, and transport. Since then, PAC has brought out report cards on several other cities, rural services and also on specific sectoral services such as health care. But since it has tracked ser-vices for a longer period in Bangalore, this experiment shall be referred to in detail below.

The findings of the first CRC on Bangalore were most striking. Almost all of the public service providers received low ratings from the people. Agencies were rated and compared in terms of public satisfaction, corruption, and responsive-ness. The media publicity that the findings received and the public discussions that followed brought the issue of public services out in the open. Civil society groups began to organize themselves to voice their demands for better performance. Some of the public agencies responded to these demands and took steps to improve their services. The inter-agency comparisons and the associated public glare seem to have contributed to this outcome. When the second report card on Bangalore came out in 1999, these improvements were reflected in the somewhat better rat-ings that the agencies received. Still several agencies remained indifferent and cor-ruption levels continued to be high.

The third CRC on Bangalore in 2003 has shown a surprising turnaround in the city's services. It noted a remarkable rise in the citizen ratings of almost all the agencies." Not only did public satisfaction improve across the board, but problem incidence and corruption seem to have declined perceptibly in the routine transac-tions between the public and the agencies (See the charts below). It is clear that more decisive steps have been taken by the agencies to improve services between 1999 and 2003.

What accounts for this distinct turnaround in Bangalore's public services? What lessons can we learn from this experiment? Needless to say, without deliber-ate interventions by the government and the service providers, improvement in services would not have taken place. But trie key question is—what made them act? A whole complex of factors seems to have been at work. The new Chief Minister of the State who took over in 1999 was very much concerned about the public dissatisfaction with the city's services. He set in motion new mechanisms such as the "Bangalore Agenda Task Force," a forum for public-private

partnership that helped energize the agencies and assist in the upgrading of services. Civil society groups and the media supported and monitored these efforts. What is significant is that the initial trigger for these actions came largely from the civil society initiative called "citizen report cards."

What are the pre-conditions for such civil society initiatives to work? It is obvious that these initiatives are more likely to succeed in a democratic and open society. Without adequate space for participation, CRCs are unlikely to make an impact. A tradition of activism within the civil society can also help. People should be willing to organize themselves to engage in advocacy and seek reforms sup-ported by credible information. Political and bureaucratic leaders must have the will and resources to respond to such information and the call for improved gov-ernance by the people. Last, but not least, the credibility of those who craft CRCs is equally important. The initiators of the exercise should be seen as non-partisan and independent. They need to maintain high professional standards. The conduct of the survey and the interpretation of the findings should be done with utmost professional integrity.

When service providers and governments on their own improve their services and accountability, initiatives such as CRCs may not be necessary. Even under these conditions, a report card can be an effective means for civil society groups to monitor the performance of government and its service providers. Public agen-cies can on their own initiate report cards on their performance as indeed some in Bangalore have done. But when a government is indifferent to these concerns, advocacy based on a CRC can act as an accountability tool to challenge the gov-ernment to perform better.

Policy Implications for Supreme Audit Institutions (SAIs)

The range of accountability initiatives described above

Agencies Covered by CRC 3

BMP	The City Municipal Corporation
BESCOM	The Electricity Authority
BWSSB	The Water & Sanitation Board
BDA	Land Development Authority
BSNL	Telecom Department
BMTC	City Transport Company
POLICE	City Police
RTO	Motor Vehicle Office
Gov. Hospital	Government Hospital

Chart 1: Decline in Problem Incidence

Problem Incidence across Report Cards

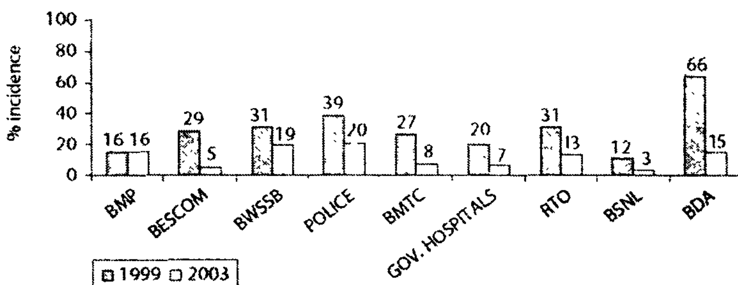
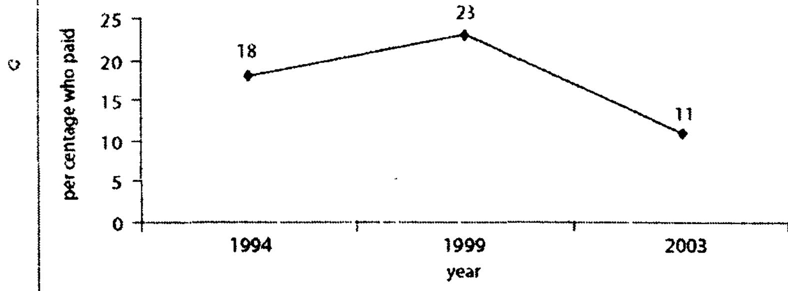
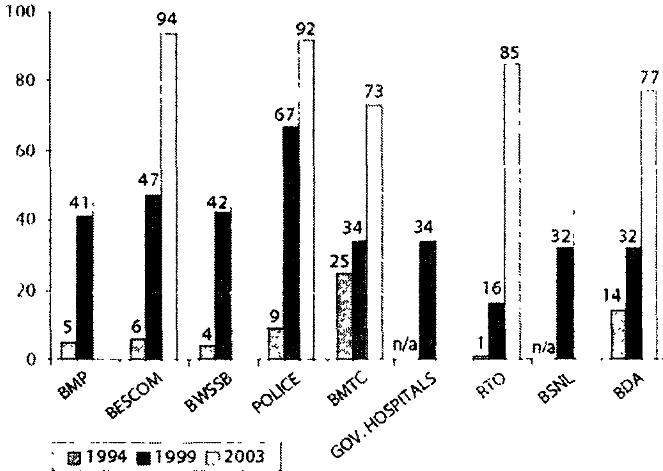


Chart 2: Decline in Corruption Levels (routine transactions)

Speed Money Incidence across Report Cards





tells us the story of how civil society has responded to the weak public accountability that prevails in many developing countries. In a real sense, they represent a form of audit by the people on the effectiveness and outcomes of what government does. Note that it does not focus on the internal processes of government. A common thread that runs through these diverse experiments is the manner in which they have empowered citizens with new information and knowledge that could be used to hold a gov-ernment or service provider accountable. These initiatives emerged in different countries and contexts and in response to different problems. That some of these concepts and tools are being replicated in other countries and sectors testify to their wide applicability.

Despite the potential power and impact of these civil society initiatives, it is difficult to imagine that they are the answer to the accountability deficit in developing countries. They do inspire and provide models for others to follow. In critical situations, their pressure may make service providers

and public agencies more accountable. And such initiatives will continue to emerge in different places. But they cannot assume the role of the institutions of government that have been assigned the responsibility of making accountability mechanisms work. In the final analysis, it is the governments and their supreme audit institutions (SAIs) that have a duty to make public accountability a reality.

What are the policy implications of the civil society initiatives for SAIs? Do they offer new ideas or practices that can be incorporated into the agenda of SAIs? Are there ways to tap into the energies and insights of civil society that can be an aid to the work of SAIs? Admittedly, all of the civil society initiatives discussed above are not equally relevant to SAIs. PIL is clearly not an approach an audit institution can adopt. It cannot get involved in community management. Nor can it be in the business of budget analysis. But there are several other things that SAIs can do. What follows are some tentative ideas for consideration.

Incorporate Citizen Feedback into Performance Audits

The audit function in developing countries is, for the most part, compliance ori-ented. Compliance is certainly a legitimate concern. But in the context of MDG goals and poverty reduction, concern for effectiveness needs to receive far more attention from auditors than at present. Performance audits and value for money audits represent moves in this direction. These practices are beginning to be adopted by developing countries. But the methodology used in these new types of audits may benefit greatly by incorporating the findings of user feedback. Perfor-mance audits should go beyond output measures to get an assessment of the qual-ity and effectiveness dimensions of services. This is what user feedback can provide to the auditor. Performance audits that focus only on physical outputs and costs may miss this insight. In a drinking water supply program, a performance audit may count the number of water taps installed or the volume of water supplied. But

the regularity of water supply or the maintenance of the facility that matter a lot to citizens may still leave much to be desired. Corruption may add to users' costs, but do not get reported anywhere. These aspects of effectiveness can be captured only through systematic user feedback.

The diagram below shows the value added that user feedback can offer when taken together with compliance audit.

Diagram 3: Compliance vs. User Feedback

Compliance	User Feedback: Negative	User Feedback: Positive
Low	Weak Internal Systems/Controls Poor Service Delivery	Weak Internal Systems/Controls Effective Service Delivery
High	Strong Internal Systems/Controls Poor Service Delivery	Strong Internal Systems/Controls Effective Service Delivery

In this 2x2 matrix, the findings of compliance audit are graded vertically, while the user feedback results are graded horizontally. The quality of compliance in a program or department may be rated low or high. Similarly, user feedback may turn out to be negative or positive.[100] Four combinations of these two variables can be seen in the diagram (A, B, C, and D). Insights from user feedback will now enable the SAI to see that some departments/programs may be weak in compliance and yet are more effective in their services (cell B). Cell A refers to departments/programs that are weak on both counts. Cell C shows that a department/program may be high on compliance, yet fails to deliver services effectively. Cell D is the only case where the performance is good on both counts. It is clear from this analysis that a more complete picture of how well a department/program is managed can be generated when information on both variables is taken together. This approach may help SAIs to make more balanced and well focused recommendations to the government.

CRC for Monitoring MDGs

Using the CRC approach to assess the effectiveness of all government functions and programs may be unrealistic. CRCs do call for extensive field surveys and the time and cost involved can entail a heavy burden on SAIs. But it should not be difficult for SAIs to use this approach in programs and departments that provide essential services for the people. MDGs are a case in point. The long term targets implied by MDGs will be achieved only through the interventions and service delivery over the years for which the state is responsible. If the delivery is not reach-ing the people as planned, it is unlikely that MDGs will be achieved. SAIs will be able to give advanced warnings to governments on whether they are on track with MDGs if they can tap into the power of user feedback. The message may stimulate governments to take midcourse corrections.

User feedback is already a component in the performance audits being done by SAIs in some of the more developed countries. USA, UK, and Canada have shown that this approach has merit. India's SAI has sought user feedback in its audit of the public distribution of food program. CRC's feasibility is thus not in doubt. But it is not known or widely used by SAIs. The challenge is to deploy it on a scale that can make a difference.

Audit of Government's Information Disclosure

A key lesson from the civil society initiatives for accountability discussed in this paper is that empowerment through new knowledge and information can moti-vate citizens to demand accountability. Governments are not always proactive in informing and educating citizens on their rights, entitlements, and what they should know in order to access public services and programs. This is an aspect of government that needs a systematic audit. Just as SAIs audit public expenditure, they should also assess the adequacy and quality of the information being provided to citizens to access services. There is much talk of citizen

charters, the right to information, e-governance, etc. They lend themselves to be audited in terms of their relevance, implementation, and effectiveness. If citizens can be empowered through information, they will complement and reinforce the efforts of SAI.

Educate Citizens on SAI Audits

In many countries, SAIs reports and recommendations are not widely known to the public. Audit reports may go to the government and legislature, but may or may not get much attention in the press or other public fora. It is also possible that governments and SAIs restrict their public dissemination. Some of trie reports that pertain to the inner workings of the government may not in any case interest the average citizen. If these reports do not get acted on by governments, nothing more will be heard of them. But this is not the case with reports and recommendations on programs that directly impact on citizens. If SAIs can increase citizen access to such reports, it is possible to generate public support for the changes and reforms being proposed. In many countries there are public interest groups and NGOs that may help initiate public debates on their implications. Stimulating informed debates on audit findings can be a powerful way to facilitate increased participa-tion by citizens in governance processes and to strengthen the constituency for accountability.

7
Media and Audit

The function of audit has progressed beyond a mere exercise in accounting to a medium for social planning. The successful advent of this evolution owes in part to the remarkable commonality that exists between the media and the audit profession — likened to two family members separated at birth that are only now discovering that they belong to the same family. Thorough examination of the relationship between media and auditing reveal a mutually beneficial partnership leading to transparent, accountable, progressive, and democratic societies.

The paper examines the challenges to good governance that have led to an evolution of the context within which the media currently functions, and outlines the expansion of the media's vision as a result of this evolution. It discusses how the partnership between the traditional 'watchdog' role of media and audit institutions produce greater government accountability leading to good governance. It categorizes the relationship of Audit with Legislative Oversight, Planning and Budgeting as supply side initiatives, while categorizing the relationship of Audit with Civil Society and Media as demand side initiatives, to bring about good governance and accountability. The ultimate struggle lies in establishing the right to information as a fundamental right, a demand side initiative to be advocated by the media and civil society. The paper goes on to highlight specific advocacy roles played by

the news media in Bangladesh as well as the challenges that lie ahead-**Challenges to Good Governance: Corruption**

The demand for participatory and transparent governance swelled simulta-neously with the demise of state-cantered command economies. Democracy has become the most universally accepted political system, with elected representa-tive government as its institutional expression. An increase in public demand for

The original paper presented by Mr. Anam has been revised and updated by Numayr Chowd-hury of Policy Analysis & Coordination Unit (PACU) of UNDESA and augmented with seg-ments of Mr. Anam's verbal presentation from the workshop on "Auditing for Social Change"

9Q Auditing for Social Change

greater involvement in state management and greater knowledge of the use of national resources has led to rising intolerance for corruption, which hinders over-all progress as scarce resources are devoured by powerful vested groups. Conse-quently, public service institutions today face stricter scrutiny and greater pressure to deliver 'good governance.'

Good governance is lacking in most developing countries due to a variety of reasons which include corruption, poor planning, lack of transparency in budget-ing, ineffective public policies and failure to establish a pro-poor focus. In Bang-ladesh, the principal hindrance to good governance is corruption which perme-ates all levels of socio-economic life. In 2005, Transparency Internationals (TI) Corruption Perception Index ranked the perception of the level of corruption in Bangladesh the highest among 159 nations (along with Chad) for the fifth year running. The nation scored a measly 1.7 out of a scale of 10 with 10 being highly clean and 0 being highly corrupt. Corruption in Bangladesh has gradually cor-roded and debilitated the basic institutions that have the task of upholding the states administrative

structure, leading to the destruction of public confidence upon which democratic governance must necessarily rest. Consequently, there is an urgent need to eliminate corruption in order for democracy to deliver. *Ifiekhar Zaman, Executive Director of Transparency International Bangladesh* identifies cor-ruption as the most formidable challenge to governance, development and poverty reduction and goes on to state that:

"One of the early lessons we learnt inTI Bangladesh is that when political will is absent or not strong enough at the highest level to fight corruption without fear or favour; when the key institutions like the parliament, the executive, the law enforcement agencies, the judiciary and the anti-corruption commission are not independent and effective enough; and when people are denied access to informa-tion; the ultimate source of strength in anti-corruption movement is the awareness and participation of the people at large."

The malaise of corruption as a hindrance to good governance is not only lim-ited to Bangladesh, and TI concludes that corruption is still rampant in more than 70 countries, most of them being developing economies. According to David Nussbaum, TI's Chief Executive. "Leaders must go beyond lip service and make good on their promises to provide the commitment and resources to improve gov-ernance, transparency and accountability." TI states that for low-income coun-tries to combat corruption effectively they must "enable greater public access to information about budgets, revenue and expenditure". Supreme Audit Insti-tutions (SAIs)[105], parliamentary oversight committees and other institutions of accountability must be strengthened.

Supply and Demand Side Initiatives for Good Governance and Accountability

Supply side initiatives for enhancing accountability and good governance incor-porate existing audit mechanisms created by the government in their own "good judgment",

with the stated intent of monitoring spending and improving gov-ernance. These include oversight bodies, parliamentary bodies and SAIs among others. Demand side initiatives create greater expectation in the public mindset with regards to knowing how their resources are being spent and whether they are getting the right "bang for the buck". Civil society and media are essential tools for creating such demand, whereby the public clamours for greater moni-toring and supervision. In order to place demand side initiatives on a theoretical context, they should be looked at as a part of democracy, which thus far has been narrowly viewed as a set of political and civic rights confined to constitutionality, the right to vote, elect and reject one's own government, as well as the freedom of speech, expression, movement and so on. Subsequently, democracy has been sub-consciously confined to political and civic freedoms in the popular mindset.

The aforementioned notion of democracy has now evolved to incorporate the right of the citizenry to govern their own resources. The citizenry is increas-ingly less willing to be a passive spectator in the administration of his/her coun-try and the allocation of its scare resources, as evidenced from uprisings in Geor-gia, Ukraine, Kyrgyzstan and Lebanon that have effectively altered the status quo. Democracy now incorporates ones right to know how public resources are being utilized, creating the notion of "I want to know for I am the owner of my country's resource".

In several countries, the 'Right to Know' has progressed from a distant concept to a practical demand with the passage of "Freedom of Information Acts", establishing the citizenry's right to access information pertaining to resource management by the state and the private sector. This includes keeping close tabs on the utilization of taxes, revenues, investments, and external aid, and necessitates the compulsory 'disclosure' of assets of elected officials.

Nevertheless, in many countries, it is still not an uncommon feature for people to consciously demand their

rights as citizens and voters, while disregarding their right to know how their national resources are being managed. While this demand has emerged from time to time in public discourse, it needs to be established as a right—in the same vein as voting and citizenry, given the fact that the ultimate ownership of national resources rest with the people.

Owners have a singular mindset and such a mindset is what society should be striving for. Once people begin to believe that the national budget is public money which the government has been entrusted with to utilize for their ben-efit, the scenario shifts. It is at this point that the media steps in, advocating to implant a sense of resource ownership in the popular consciousness. While this sounds relatively simple, almost like a truism, those living in evolving democra-cies recognize that the reality is quite different, for they are not empowered to demand information as a right. Information comes at the whim of the govern-ment where the quantity and quality of information received depends entirely upon the goodwill and cooperation of government leaders. It is the right to information as a fundamental right where the battle for accountability and good governance must be fought.

Evolving Role of Media: Gender and Environmental Advocacy

To date, the ethos of the media profession has been to refrain from advocacy which is seen as another form of propaganda commonplace in command econo-mies & socialist states. Consequently the media in the "free world" considered their role to be confined to simply informing their audience and leaving the judgment up to them. Thus, the fundamental ethos of media was just to inform, not to advocate or suggest.

However, in the past two decades, emboldened by the spread of democracy, by the irrepressible demand for the 'Right to Information', by greater public awareness of the need for government transparency and accountability,

media as an institution was no longer satisfied with its limited role to simply inform; the time was now ripe to advocate.

The coverage of social issues such as environmental degradation and gender inequality have played a pivotal role in bringing about a change in the media's approach from 'information dissemination' to public education'. Greater scien-tific findings regarding 'limits to growth', reckless use of natural resources, negative impact of technologies that damage the environment, global warming and the depletion of resources in the ocean bed were all concerns that needed to be addressed in order to allay irreversible damage to societal existence. Consequently, in covering environmental issues, the media realized that it was not only necessary to inform, but also to advocate for the preservation of forests, water and clean air. In doing so, the media unconsciously and inadvertently shifted from pure infor-mation dissemination to an "advocacy mindset".

Gender inequality was another platform for media advocacy. Gender discrimina-tion was so ubiquitous that it cut across all cultural lines as well as the north-south divide; consequently it was necessary not only to uphold women's rights but also to advocate for them consciously and actively. This agenda gradually and inadvertently expanded to include advocating for democracy and fundamental freedoms, such as the freedom of expression and freedom of the press, in order to resist their erosion at the hands of the government or extremist groups. The global anti-terrorism campaign has further contributed to the media's advocacy mind set.

The media's advocacy role coupled with the expanding notion of democracy incorporating peoples right to govern their own resources, has created the scope for a mutually beneficial partnership between Supreme Audit Institutions and the media to come together for the purpose of protecting public resources. The paper is accordingly titled "Media and Audit: Strengthening Peoples' Right to Public Resource Management".

OBSTACLES TO MEDIA ADVOCACY OF PEOPLES'RIGHT TO PUBLIC RESOURCE MANAGEMENT

The media's current challenge involves realigning its advocacy role to focus on the management and expenditure of scarce resources by state and corporate policy-makers. In addition to reporting on corruption, wastage, misappropriation, and other financial irregularities, the media should also advocate their demise through encouraging the citizenry to pressurize the government to respond to these ills. The media must collaborate with SAIs and other 'watchdogs' to publicize alterna-tive policy options. Major obstacles that the media need to overcome to attain the aforementioned objectives include:

Tradition of Secrecy

A tradition of secrecy permeates most developing societies characterized by the legacy of feudalism (with its social hierarchy) and the Asian obsession for 'saving face' (where the truth must be concealed to preserve ones social standing). This contradicts the prerogatives of democratic society where openness is highly valued. Democracy's core premise is founded on an informed public opinion that guaran-tees judicious decision-making in the day to day operations of a society. Informed public consent, often unpalatable in the short run, provides wider benefits in the longer term. The spirit of taking the public into confidence' imposes on govern-ments, private corporations and NGOs, the duty to share information with the public; this in turn brings with it a sense of accountability on the part of institu-tions entrusted with managing public funds.

Openness generates self-confidence given the knowledge that the power to make changes ultimately lies with the people. Public opinion consequently becomes a key factor in the decision making process, subjecting all government actions to public scrutiny. The media is informed of governmental activities in most western democratic societies because the idea that the public has a

'right to know' has been accepted. The challenge faced by the media in the developing world pertains to the fact that information is considered to be the ruler's prerogative rather than a right. Consequently, in the absence of a tradition of openness, in the absence of a freedom of information act, the media often runs into a 'wall' when attempting to inform the public on the activities of the state, particularly when these activities pertain to wastage, misallocation or outright corruption.

In Bangladesh, neither the government nor the bureaucracy has an obligation to share information with the media. There seems to be a continued adherence to Articles 123 and 124 of the Evidence Act of 1872 dating back to the colonial British administration. Article 123 clearly states that "no one shall be permitted to give any evidence derived from unpublished official records relating to any affairs of State except with the permission of the officer at the head of the department concerned, who shall give or withhold such permission as he thinks fit." Consequently any information available to the media depends upon the benevolence of the concerned official. Furthermore, Section 124 of the Act states that "no public officer shall be compelled to disclose communications made to him in official confidence when he considers that public interest would suffer by the disclosure." Given that no clear guidelines or parameters exist to define the "public interest", any and all information can be potentially withheld under this premise of protecting the greater good.

Access to information was further restricted by the "Official Secrets Act" of 1923, where section 2: sub-section 8 of the Act defined "prohibited areas" very broadly, further limiting the scope of information collection. The post-independence government incorporated the spirit of the aforementioned acts into the "Government Servant (Conduct) Rules" of 1979, where Rule 19 affirmed that a sitting government official cannot disclose any information "to other Ministries, Divisions or Departments, or to non-

official persons or Press". While the "Rules of Business 1996" assigned the Ministry of Information with the responsibility of interpreting the policies and activities of the Government of Bangladesh to the press, this has not been put in practice.

This results in a situation where the media is committed to the peoples right to know, but institutions and public representatives, whose main job is to inform the public, have no obligation to disseminate the requisite information. In this scenario disgruntled government officials become the primary source of information. Other occasional sources of information include apologist debates in parliament as well as the budget. Consequently, the media in Bangladesh has taken to cultivating disgruntled civil servants and like groups, "going to town" with whatever informa-tion they can gather, and facing litigations as a consequence.

Archaic Legal Systems

Colonial administrations offered minimal scope of popular participation in man-aging the affairs of the state. They made no pretence of popular accountability and maintained strict secrecy in financial matters. Accounting and auditing existed purely for the benefit of those in charge. Post-colonial administrations in a number of developing countries adopted the mindset of their predecessors, consequently retaining the same command and control psychology, similar rules and regulations to govern auditing, and the same ambience of secrecy when it came to making expenditures public. In Bangladesh, the budget is made public not as a demonstration of the governments commitment to accountability, but rather a tool to justify the governments point of view.

In recent decades, many developing countries have enacted amendments to their legal framework, allowing for public reporting and parliamentary hearings open to the public and the media. Unfortunately, the vast majority of the changes that have taken place in Bangladesh are not in

Obstacles to Media Advocacy of Peoples'Right to Public Resource Management

The media's current challenge involves realigning its advocacy role to focus on the management and expenditure of scarce resources by state and corporate policy-makers. In addition to reporting on corruption, wastage, misappropriation, and other financial irregularities, the media should also advocate their demise through encouraging the citizenry to pressurize the government to respond to these ills. The media must collaborate with SAIs and other 'watchdogs' to publicize alterna-tive policy options. Major obstacles that the media need to overcome to attain the aforementioned objectives include:

1) Tradition of Secrecy

A tradition of secrecy permeates most developing societies characterized by the legacy of feudalism (with its social hierarchy) and the Asian obsession for 'saving face' (where the truth must be concealed to preserve ones social standing). This contradicts the prerogatives of democratic society where openness is highly valued. Democracy's core premise is founded on an informed public opinion that guaran-tees judicious decision-making in the day to day operations of a society. Informed public consent, often unpalatable in the short run, provides wider benefits in the longer term. The spirit of'taking the public into confidence' imposes on govern-ments, private corporations and NGOs, the duty to share information with the public; this in turn brings with it a sense of accountability on the part of institu-tions entrusted with managing public funds.

Openness generates self-confidence given the knowledge that the power to make changes ultimately lies with the people. Public opinion consequently becomes a key factor in the decision making process, subjecting all government actions to public scrutiny. The media is informed of governmental activities in most western democratic societies because the idea that the public has a

line with modern auditing proce-dures. While parliamentary oversight bodies (ex. standing committees on pub-lic expenditures) and the Office of the Comptroller and Auditor General (CAG) are entrusted with monitoring government expenditures (and do so with varying degrees of effectiveness), there exists no binding law to ensure that the public has access to the findings of audit institutions. The CAG's reports are sent to parliamentary committees whose discussions on the findings are not disclosed to the public. Media coverage is totally dependent upon the willingness of informed officials to speak to them at their own discretion.

Corruption as a Consequence of Freedom without Accountability

The pressure to globalize has forced many countries to abruptly lift control mech-anisms before they could create an adequate legal framework that allows for a healthy free market environment. Consequently, businesses enjoy the freedoms of the open market without the demands of transparency and accountability that are necessary hallmarks of western free market economies. Corruption, malpractice and a wrecked economy has resulted from this freedom without accountability.

Absence of Bureaucratic Performance Orientation

Economic growth is highly dependent upon the bureaucracy in countries where the private sector relies heavily upon government contracts for their survival. Since the bureaucracy is not performance-oriented, the speedy or accurate execution of devel-opment projects is ignored, and a nexus develops between businessmen, bureaucrats and elected officials who drain scarce national resources and operate beyond the law.

Lack of Transparency in the Business Community

Business communities in most developing countries are not transparent, paying only a fraction of the taxes that are legally due and accumulating the remainder as undeclared

wealth. The accumulated wealth is then preserved through a network of bribery incorporating anyone and everyone who has any role to play in the tax collection process.

Criminalization of Politics

The exponential growth in the cost of competing in elections has led to elected offices being viewed as "investments" which need to be "recovered" through exploiting the privileges of the post. Consequently, corrupt members of the busi-ness community have muscled their way into elected office, at the expense of traditional politicians, through heavy initial investment. Traditional politicians and even established political parties that try to survive must now increasingly turn to corrupt business elites to underwrite their campaign expenses. Consequently, the result has been to legitimize criminals who earn 'respectability' through the acquisition of elected office.

Functions that the Media can Undertake to Strengthen the Role of SAIs

Wealth creation and utilization takes centre-stage as more countries enter the glo-balization process. Resource management has become a far greater concern than ever before, given mounting scientific evidence that resources are limited and in some cases non-renewable. Consequently, the manner in which a government spends its resources is central to the public discourse on governance. Accordingly, institutions that monitor the usage of financial resources, like SAIs, are increas-ingly in the public spotlight. The media can undertake a number of important functions to strengthen the role of SAIs:

Media as a Mindset Changer

Media can become a very powerful instrument of inculcating the notion of public ownership of resources. The submissive mind-set of the general public needs to be transformed and made far more demanding about how national resources are spent. This involves instilling in the

minds of the general public that it is their wealth, that they have a right to know about it, monitor it, and supervise it. The mass media can play a vital role in this transformation process by regularly carrying news articles to reinforce the point that the people—as citizens, voters, and taxpay-ers, have a right to know how their resources are being used. The casual acceptance that government can keep information away from citizens has to be vigorously challenged. The media has to work towards raising public demand about their basic right to know.

Media as a Resource Protector

In as much as the popular conception of democracy needs to be expanded to include peoples right to resource management, the media must also probe deeper into resource-related issues such as corruption, waste, inefficiency, politicization, and cronyism. Just as it acts as a "watchdog" of fundamental freedoms, the media must also see its role as the guardian of public wealth with equal vigour. In other words, by becoming a powerful instrument for monitoring the waste of public resources, the media automatically become a protector of the public resource.

Media to Ensure Transparency and Accountability in the Workings of the Government

Just as justice must not only be done, but it must also be seen to have been done, similarly a government must not only obey all laws, but the public must see that it is obeying all laws. The people must have the right to ask questions at any time and demand any relevant information, and trie government must be obliged to provide it. Only then can accountability and transparency be established. History has shown that the fear of public knowledge of one's actions automatically improve the quality of governance. The "Freedom of Information Act" must be enacted to ensure transparency and guarantee peoples right to be informed of their government's actions. The media must raise public awareness of its necessity and benefits, and support civil society initiatives in favour of this act.

Media as the Upholder of the Law

The legal framework within which society operates constitutes a vital part of'intellectual infrastructure'. The legal environment has a gravitational effect in that it influences our every action even though we are not generally aware of its omni-present company. Given their status as institutions responsible for upholding the legal framework, governments are cognizant of the ways and means of manipulating the law, bending it without breaking it or even sidetracking it without bending it. Consequently, in many parts of the world, governments have become the prin-cipal violator of the law. Given their unremitting violations, it has now become the full time job of the media to hold the government to the law. The media has three very distinct functions in this regard.

The first is to inform the public of their rights as citizens, taxpayers and vot-ers, as delineated in the constitution and statute books. It is often the case that people are not fully informed of the freedoms encompassed in their rights, and consequently, do not realize it when they have been denied or violated. The second is to play a watchdog role by maintaining a constant vigil on coercive government agencies (secret services, police) and reporting consistently and aggressively all incidents pertaining to the abuse of rights. The third is to collaborate with specialists in examining existing laws, and assess their effectiveness in serving the citizens of modern society. Constant examinations of existing laws are necessary to make them better serve the needs of the citizenry in a modern democracy.

Media as an Instrument for holding Political Parties to their Election Pledges

Populist political parties in developing countries promise the world to the electorate in order to attain their votes. Once an election is won, the pledges are forgotten and the voters are marginalized. Elected officials go about acting

according to their own self-interest which amounts to nothing more than siphoning the nations resources. Unfortunately, in most developing countries, there are no petitions' or 'recall' mechanisms, either to bring something to the government's attention, or reprimand it for having broken a promise. Voters are helpless between elections, being totally at the mercy of their elected representatives. The media is the only medium through which the citizenry can pressurize elected representatives and the ruling party to fulfil their election pledges.

The Daily Star and Media Advocacy in Bangladesh

The role of the media has become "larger than life" as a result of the deterioration of the government's oversight institutions (parliament, judiciary) and manipula-tive capacity. Within this context The Daily Star was first published in January 1991 with the slogan(s) "Journalism without Fear or Favour" and "Committed to Peoples' Right to Know". The Daily Star firmly believes that a major part of its work is accomplished if it can uphold this one single right.

The Daily Star blends straight reporting, news, commentary, and editorials with advocating environmental conservation, gender equality, human rights and democracy. It is a staunch believer in media independence and advocacy, a position prompted by several bouts of military rule and a consequent desire to negate the possibility of a similar eventuality through the indoctrination of democratic val-ues. The social and developmental challenges faced by Bangladesh necessitates The Daily Star to be socially responsible in their journalistic endeavours, and whole-heartedly committed to pertinent issues like poverty alleviation, human resource development, education & public health.

Conscious Citizens Committees (CCCs)

The fight against corruption has become the principal focus of The Daily Star, with all the major institutions in the

country being afflicted by this 'disease', stymieing overall growth and performance. The Daily Star regularly carries out investigative reports on corruption, abuse of power, cronyism, and other related subjects. It interviews people from all walks of life to build an atmosphere of public outcry against corruption. Additionally, in close cooperation with the Bangladesh chapter of Transparency International, The Daily Star has created Conscious Citizens Committees (CCCs) in seven district towns outside the capital. The CCCs exist primarily to discuss corruption in public institutions.

Environmental Conservation: "Save Dhaka, Save Buriganga"

The Daily Star's environmental advocacy role is clearly evident in its opposition to the encroachment upon the river banks of the capital city (Dhaka) by real estate agents, who take advantage of the fact that these banks are not properly demar-cated. Encroachment has proceeded to such an advanced stage that the river bed, upon which the capital city is located, is essentially dying. The river might well have been reduced to a stream had it not been for the medias constant reporting on the issue. The Daily Star carried out special reports on the illegal occupation of land by unscrupulous developers as well as reports on the 'disappearance' of parks, lakes, and open spaces in the city centre. The paper went a step further and created a campaign titled "Save Dhaka, Save Buriganga" in a joint collaboration with all the environmental groups fighting for the survival of the river. The Daily Star's reportage has made significant inroads into safeguarding the urban landscape.

Urban Planning

Another example of media advocacy deals with the reporting on irregularities in urban planning. Shopping centres are illegally receiving construction permits in zones where they are officially prohibited, as even a single deal

can be highly lucra-tive for the parties involved. Protecting the city, the environment and the rivers have become a full-time job for the media, and The Daily Star has made a note-worthy contribution in this endeavour.

Round Tables

The Daily Star has further expanded its advocacy role through organizing round tables on a regular basis. These roundtables bring together decision makers, politi-cal leaders, professionals, researchers, stake holders, civil society members, and representatives from NGOs under one roof and they are made to answer questions from the public. While some participate for the sake of publicity, the principal achievement of this event lies in all sides getting the opportunity to debate, something which has not happened in the Bangladeshi parliament for many years due to its perpetual boycott by the major opposition party. A sense of dialogue is realized among the participating groups as a consequence of the open and democratic nature of the discussion. What results is a series of recommendations where all the participants can feel a certain level of ownership. The discussions are taped, transcribed, edited and subsequently published as a four page supplement to the daily edition. This supplement allows the general reader to inform him/herself about the substantive ideas discussed by the participants within the confines of the conference room. Following the publication, the editorial page is opened up to the general public to commentate on the discussions, covering issues ranging from the independence of the judiciary, the role and independence of the Auditor Generals Office, election of clean public representatives and means to ensure their adequate performance.

Children in Jails

One such round table focused on the Daily Star's discovery of children in jails, who were there because of the lack of any judicial assistance. The newspaper established that there were more than 710 adolescents languishing in

jails alongside adult criminals. As a result of the roundtable process and a subsequent campaign, more than 570 adolescents have been released while another 110 still remain in jail.

The roundtable mechanism has been effective in bringing together all the opposing parties in a controversy and encouraging them to work out their differ-ences in order to move towards a solution. The Daily Star's successful experimenta-tion with round tables has popularized the concept into a standard practice among other newspapers and the NGO community. Round tables on auditing and issues related to monitoring should be organized in order to generate strong public inter-est in this matter.

Comptroller and Auditor General (CAG) Reports

In carrying out reports on corruption and wastage of resources, The Daily Star has made extensive use of the reports published by the Office of the Comptroller and Auditor General (CAG). Established by the constitution in 1973, the CAG audits the accounts of 22,885 administrative units through 10 audit directorates with the purpose of identifying administrative & financial irregularities and corruption. Introduction of performance audits have added a new dimension to the accountability process. Still at its infancy in Bangladesh, performance audit it not fully understood by all and the CAG's office is finding it difficult to make signifi-cant headway.

Two major problems faced by the CAG include: a) the delay in reporting and b) the lack of discussion in Parliament of the reports produced. The utility of audit reports are greatly diminished as a consequence of the 4-8 year time lag in publishing them. While this delay has been somewhat reduced in recent years, the reports are far from being current. The tragedy lies in that even when these delayed reports are submitted to Parliament through the Office of the President, they are not adequately discussed.

According to CAG's office, as of August 2002, a total of 770 reports were submitted to the parliament of which 690 were annual reports, 75 special reports, and five performance reports. Of them only 120 annual reports, 20 special reports, and one performance report were discussed. This means that only 141 of a total of 770 reports were actually discussed. This is a good example of how the account-ability process stands subverted by Parliament not doing its job on time. These reports, not officially accessible to the media, were obtained as a result of an inter-nal leak and subsequently published by The Daily Star. Efforts by the CAG's office come to naught when concerned legislators cannot even bother to review them. Given the aforementioned indifference of the parliamentarians to their oversight responsibilitíes, corrupt officials have little to fear with regards to the auditing process. Consequently existing limited oversight mechanisms are either unused or not effectively utilized to serve the public interest.

The media needs to advocate the strengthening of the Office of the CAG, with regards to its authority, independence, resource, staff, training, and public recognition. The CAG's Office must be made totally independent of all controls, both direct and indirect, from the executive branch of the state. Without this separation, the audit function cannot reach the effectiveness that is required in a 'transparent and accountable' democratic state.

Coverage of Auditing Events

The Daily Star has been dedicated to covering workshops and sessions on audit-ing practices in order to better educate the public of the need for accountability. Coverage of recent sessions includes the Regional Auditors' General Conference on Harmonizing Institutional Efforts for Promoting Accountability in the Public Sector, held in Dhaka in August 2004. Participating experts recommended that partnerships between public and private sector auditors

should be undertaken in order to improve the quality of auditing and promote accountability in government spending. They emphasized the necessity of integrating the private sector into the auditing process in order to ascertain that government spending conforms to financial regulations. An accrual accounting system needed to be implemented through public-private partnerships in order to ensure public finance management accountability.

Failure to Impact on the Government

As a result of the whole-hearted commitment of The Daily Star to the pubic good, they have been able to create a public opinion that favours transparency, account-ability and the peoples right to know. The Daily Star has been a success story in one sense and a major failure on the other. Its failure lies in its inability to impact on the government which simply refuses to accept public criticism and public demand, and continues to act according to its whims. The situation is summed up well in a September 2004 editorial piece of the Financial Express, a leading national newspaper:

> "When one focuses on Bangladesh, it will be found that all these oversight institutions are functional and active. But the fact of their being active notwith-standing, the wild goose of accountability has forever remained a matter of mere chase and well beyond the reach of governance. One of the reasons for such a state of affairs is the repeated failure of the executive to respond to the critiques, sugges-tions and recommendations made by the oversight institutions."

There are many reasons to account for this, all of them being related to the peculiar political situation in Bangladesh. While the media has played its part, the insensitivity of the government hinders them from having much of an impact on public policy and serving peoples' interest.

CONCLUSION

The conception of democracy in the age of globalization must be expanded to incorporate peoples' right over resource management. As the focus increasingly shifts toward resource generation and national economic growth, greater attention must be paid to tackling the issues of corruption, waste, and the inappropriate use of scarce resources. This can be achieved through strengthening SAIs and other institutions of financial management and auditing. It is essential to generate public opinion in favour of new institutions that can produce trained human resources in the field of auditing. Without greater control over how national resources are being spent, without better financial management, and without greater accountability of government spending, society cannot evolve for the better.

To achieve these goals, it is necessary for the media to play a very supportive role. Tremendous scope exists for effective collaboration between SAIs and the media to push forward a genuinely 'accountable and transparent' governance proc-ess without which neither democracy nor economic prosperity can attain their true potential. The media's advocacy role can be greatly strengthened through a network of committed print and audio visual institutions. Additionally, a network of committed media and civil society institutions can become a viable force, both nationally and internationally, in advocating the people's right to know.

Governments have an aversion to oversight institutions and public scrutiny, irrespective of whether they are democracies or not. Consequently there exists an adversarial relationship between the government and oversight institutions, a rela-tionship in which the government is at best a reluctant partner, but most often a totally disinterested party. The stronger the demand for the right to information as a fundamental right, the more effective will be the reluctant supplier, i.e. the government.

8

Audit and Evaluation : Integrating Politics and Public Involvement

Public auditors and evaluators derive their role and mandate, their need for technical competence and credibility, their right to independence, and their duty to publish their findings from the political notion of accountability in government. Account-ability is, of course, the widely accepted democratic principle that governments are responsible to the people for their actions. That is, agencies, legal systems, individual officials, and other government entities are expected to obey the law, to work effi-ciently and effectively, and to act responsively in using the taxpayers' money to carry out their expressed public will. Accountability studies performed by auditors and evaluators therefore have two main components: they measure how a particular part (or member) of government is functioning, and they inform the public of what has been learned. Both of these components are equally important, but the first has gen-erated much more attention from auditors and evaluators than the second.

There are several reasons why this is so. First, performing accountability stud-ies within a political environment has often been so arduous that most of the energy available has been channelled into producing sound

and useful work in an inhospitable atmosphere. Second, although it is clear that the concept of account-ability always involves a judgment by the people about what their government is doing, the role of informing the public has usually fallen to the legislature and the press in most democracies. Auditors and evaluators have not typically gone beyond getting their reports published and into the public record—a heroic enter-prise in some political circumstances—and have dedicated few resources to dis-seminating their findings to the public. Third, the idea of specifically relating the public to a particular audit or evaluation is a relatively new development. There is on-going experimentation, especially in the evaluation community, but experience has been uneven and not very extensive. Only when auditors and evaluators began grasping the importance of public involvement in accountability studies (not for the empowerment of any group, but to improve study quality) has there been increased public participation in audits and evaluations.

This paper will argue that auditors and evaluators should devote more time and attention:

- To the "fit" of their studies within the political framework involving *both* components of accountability;
- To the potential for public participation in improving the soundness and credibility of findings;
- To increased responsibilities in the dissemination of their work.

The paper begins with a closer look at political accountability, particularly its devolution from the governments structure within a democracy.

Accountability and the Architecture of Government

In most modern democracies and certainly in the United States, government functions are split among different branches. Adopting such a structure has the

political goal of keeping too much power from accumulating in any one place or any single pair of hands. In the United States, it is an architecture born of distrust, based on past experience with a coercive central authority, and on fear of "the inevitable corruptions that could result when unseen rulers congregate in distant places" (Ellis, 2002). It is also the fruit of compromise between those most concerned with maintaining a powerful government that functions efficiently, and those most con-cerned with preventing any central authority from becoming abusive or corrupt.

Such a structure is not without its disadvantages. For one thing, it results in a fragile balance that moves continually between different political goals of oppos-ing camps. For another, the walls that are generated by individual branches or agencies trying to protect their independence also generate suspicion and secrecy. Further, fragmentation (and especially extreme fragmentation, as in the United States) carries with it a host of impediments to even the most basic of public functions. Sharing of information across agencies, for example, is rare. Most demo-cracies are far from attaining efficiency in government. The result is residual tension between optimal performance and trie preservation of a nations liberty (Chelimsky, 2006).

In trie United States, trie framers of trie American Constitution produced a divided and cross-divided governmental structure featuring trie distribution of power not only between trie federal and state governments (to preserve a cer-tain degree of sovereignty in trie states), but also separated power at trie federal level (among trie executive, legislative and judicial branches). This architecture of "checks and balances," of functions split across multiple players at different levels and branches of government and across multiple jurisdictions, features both external and internal controls against excessive centralized power. Madison wrote of the "necessary partition of power among the several departments" as being part of an external control structure. He also called for internal

controls to be established "by so contriving the interior structure of the government as that its several consti-tuent parts may, by their mutual relations, be the means of keeping each other in their proper places." This is, of course, nothing less than a clarion call to agency independence, and Madison stated it clearly: "each department should have a will of its own, and consequently should be so constituted that the members of each should have as little agency as possible in the appointment of the members of the others" (Madison, 1788).

Fortunately, the framers had few illusions about the dangers that could accom-pany too much agency independence, so they envisaged a check against it in the form of legislative oversight, that is, the particular "authority to supervise the administration of government" which has led to so many confrontations over the years (and continues to do so today) pertaining to accountability and secrecy in the executive branch (Jewell and Patterson, 1966).

The legislature thus has oversight authority over the judicial branch which it exerts, for example, through approval of judicial appointments, and through the power to establish federal courts and to prescribe their jurisdiction. And it super-vises the executive branch through such mechanisms as the appropriations power, the impeachment authority, approval of nominations to executive office, and, in particular, the investigation of how well past legislation has been implemented and with what integrity, fidelity and effectiveness (Jewell and Patterson, 1966). It is this authority that engenders accountability studies.

In short, the governmental structure builds in democratic protections through exterior and interior controls, agency independence, and legislative oversight. But this structure depends for its authority on the support of a well-informed public: that is, an electorate possessing the willingness and capability to debate, protest and correct problems in government when they become known. This

idea, like the others on structure, independence and control, comes from the framers.

Accountability, the Public, and the Press

Along with the exercise of oversight, "one of the principal functions of a legis-lature is to inform the people about the activities of their government" (Bradshaw and Pring, 1981). Madison recognized that organizational controls and the like were essentially adjuncts to the real power of the citizenry, which lies behind any governmental structure in a democracy: "A dependence on the people," he wrote, "is, no doubt, the primary control on the government" (Madison, 1788).

Jefferson went further than Madison in actually grappling with the issue of how even a vigilant population might become aware of excesses or omissions in a distant government and take steps to correct them. He wrote in 1816: "The func-tionaries of every government have propensities to command at will the liberty and property of their constituents. There is no safe deposit for these but with the people themselves, nor can they be safe with them without information. Where the press is free and every man able to read, all is safe" (Jefferson, 1946). Thus, for Jefferson, the nation could rely on a free press to inform the people.

Today, however, things are less sure. An enormous information industry has grown up since the time of Madison and Jefferson, and this industry, now beset with competition and striving to maintain its profit margins, is less concerned with informing citizens about their government than with featuring stories that sell papers or attract viewers. Although the press and other media are still primary transmitters of accountability study findings, this is more likely to be the case when the study subject has great popular appeal. But when the press views a study as dull, complex, or highly technical, it is very possible that the public will never learn of its findings.

Yet there is no doubt that accountability studies exist to inform the public, no matter who commissioned the study, who asked the policy question, or which branch of government expects to use trie findings. In other words, the ultimate cli-ent or user of these studies is the public. Therefore, with declining ability to count on the press, it becomes incumbent on auditors and evaluators to think of new ways to assure the appropriate dissemination of their work.

Even though the foregoing discussion has focused on structural characteristics of government in the United States, it is also the case that most governments in the world today (especially democracies, but even a fair number of authoritar-ian regimes) have taken at least some steps to implement accountability in dif-ferent guises. These range from the simple establishment of an auditor generals office, through varied sets of control systems (internal and/or external), to the full-bore separation of powers featuring checks and balances whereby one branch of government holds another accountable. Therefore, even though governmental structures may be quite different, accountability studies will have similar goals and raise oppositions that are similar in kind (if not in degree) wherever they are performed.

If the discussion is restricted to democracies, however, the earlier discussion can be summed up by noting that there are five issues which together gener-ate the need — as well as the form and function— of accountability studies. These are:

— Fragmentation in government;

— Independence of individual government units;

— Secrecy and information distortion as potential protections for unit independence;

— Use of oversight authority to investigate government activities; and

— The need to ensure that citizens are informed about the results of these investigations.

This framework of five issues sets up the political principles and context from which the place of accountability studies in government can be inferred. They sit at the heart of the tension between the need for governmental power, and the need to ensure probity and effectiveness in the exercise of that power. Yet, despite their obvious and unique importance for the public interest, it cannot be said that accountability studies are easy to do in any political environment.

Fitting Accountability Studies into a Political Universe: Some Clashes with the Premises of Audit and Evaluation

Public auditors and evaluators are interested, first and foremost, in getting their work right. Evaluation always involves major, scrupulous, iterative struggles to rule out bias: in the data, in the analysis, in the findings, and in the presenta-tion. Audit leans heavily on established criteria (i.e., norms), and/or on general consensus to achieve legitimacy of measurement and correlation. These efforts on both sides to satisfy requirements for technical competence are needed if a study is to be methodologically convincing. They are also a prerequisite for accountability, since flawed or biased studies will not usually be helpful in holding a mirror up to government. But accountability also requires auditors and evaluators: to insist on independence in their study choices and in their planning, performance and reporting to maintain objectivity and political credibility; to routinize the publica-tion of their findings so as to reach the relevant public; and to seek use of their study in oversight or policymaking, so as to accomplish the larger goal of the audit or evaluation process. Unfortunately, these premises are often threatened, separately or in combination, by the everyday push-and-pull of politics.

For example, the independence of evaluators and auditors can be threatened by the political origins of some

accountability questions, especially when negotia-tion of the study's subject and design is difficult. Indeed, when auditors and evalu-ators cannot carefully refine and specify both subject and study design, the con-sequence may be not only loss of independence, but also infeasible, untimely or over-costly studies. In some cases, the political origins of the questions may signal a partisan (potentially ideological) purpose for the study; this engenders expecta-tions among study sponsors for a particular set of findings, thus raising another threat to independence. In a more technical way, political pressures by sponsors—to meet a deadline, say—that intervene in the choice of the most appropriate study design, or prevent the collection of needed data, again strain independence, with likely effects on credibility and future use as well.

Further, no matter how worthy the accountability study being planned, those being held accountable may fear embarrassment and set up roadblocks that both impede the study's performance and eventually weaken its findings. If the "tar-gets" of an accountability study decide to protect themselves by hiding their data, or producing only favourable data, or obscuring their decision-making processes, this obviously affects the validity of the study, and raises the spectre of advocacy. Skewed data reflect the possibility that there is a relationship between someone's presumptive interests and the direction of the audit or evaluation findings. Yet it is to promote objectivity and avoid improper outside influence (among other pur-poses) that auditors and evaluators insist on independence in the first place.

Another way in which data may be distorted can result from the auditors or evaluators inattention to all of the political interests (including the public) that are involved in an accountability study. Some of the relevant voices may not be as loud as others and may therefore fail to obtain a proper hearing within a study. But auditors who omit these voices from their criteria for comparison, for example, or

evaluators who exclude them from their data collection, risk winding up with invalid findings and credibility problems. Audit criteria needs to include repre-sentation of all groups involved in a study—that is, patients as well as physicians, students as well as teachers, welfare recipients as well as program managers — if the normative comparisons are to be persuasive. In evaluation, failure to understand the views of, say, program beneficiaries, may mean entirely invalid conclusions about what is happening in a government program.

Finally, during the reporting, publication or dissemination of a study, advocacy may again become a problem if and when political pressures (by special interests, or study subjects, or sponsors, or a variety of other stakeholders) are applied to make changes in report findings, or language, or presentation, or simply to delay the study's appearance. This is not merely a constraint on independence, of course; it vitiates the ultimate accountability purpose, which is the public's right to know.

These clashes—and there are many more—show how difficult it can be to con-ciliate politics with audit and evaluation in accountability studies; indeed, no one has ever been more than partially successful in this endeavour. Still, the experience of the Program Evaluation and Methodology Division (PEMD) shows that if one can prepare properly for some of the inevitable political contingencies, the auditor or evaluator will be harder to intimidate, better able to avoid or counter political interference, and more likely to emerge with a credible and useful product.

Four PEMD initiatives seem relevant here:

- Getting a clear understanding of the political history and likely stakeholders of an issue to be studied;
- Supporting independence and credibility by negotiating vigorously with sponsors about what study questions will be answered, with what methodologies, and in what timeframe;

— Dealing with data issues such as public involvement in information collection, and governmental denial of access to data; and

— Strengthening the dissemination of study findings.

Understanding the Political History of Study Issues and their Likely Stakeholders

The truth is that public auditors and evaluators are not fond of politics. It is com-mon to hear them lament what they call the "politicization" of their work: that is, the degree to which their studies involve them in the predictably messy political processes discussed above. They would much prefer to envision the political sphere as extraneous to the essentially technical character of their work, which is concerned—as they see it—uniquely with establishing the soundness of their findings, conclusions and recommendations, and with reporting systematically about government activi-ties and their evolution, along with their efficiency and effectiveness.

However, auditors and evaluators practicing in the public service can never escape the world of politics, first, because it is precisely this world which gives their work legitimacy and consequence, and second, because the political struggle to achieve accountability that generated the governments need for public audits and evaluations in the first place, also triggers the political maelstrom in which auditors and evaluators must exercise their craft. After all, it would be surprising if inquiries into the integrity, efficiency, effectiveness and transparency of government entities were not met with challenge and multiple efforts at manipulation by the subjects of the inquiries.

Thus, the conflict of political values inherent in a program or policy to be studied is both entirely normal and, as befits normalcy, full of passionate advoca-cies. As Marris and Rein wrote: "Since every society is informed by a great variety of ideals and interests competing for expression, it compromises them all and can fully satisfy none... This

fundamental incompatibility reappears at every level of discussion. Any policy implies the reasons by which it could be refuted. In appeal-ing to the values which justify it, it must disparage others which are also valid, and whatever balance it strikes enjoys only a grudging and provisional acquiescence" (Marris and Rein, 1973). This means that auditors and evaluators must, at very least, be thoroughly aware of these ideals, interests and political conflicts if they want to be able to predict and parry their likely efforts to influence a study.

While PEMD evaluators had always performed literature reviews, it was decided to extend them to include program histories and values, past and current controversies, and probable stakeholder positions vis-a-vis a projected study. This expanded literature review was the first step taken in PEMD towards knowledge construction in every study, but the larger need it filled was to integrate conflicting values into PEMD's core thinking about the work to be performed.

For example, in beginning a study on the effectiveness of a new program intended to lower infant mortality rates, it became clear that there is not much real knowledge about either causes or solutions, but more than enough ideology to go around. On one side of the spectrum, advocates affirm that the problem is caused by culpable maternal behaviour (i.e., not seeing a physician early enough, becom-ing pregnant at too young an age, using drugs, failing to comply with medical advice, etc), thus leading to premature or low birth weight babies who are at high risk of mortality. But programs seeking to lower infant death rates by concentrat-ing solely on maternal education or compliance, neglect the fact that there are rival hypotheses about why these rates are high (e.g., lack of health insurance and other financial or social supports for low-income mothers, maternal health problems that are unrelated to a pregnancy but affect its outcome, or simply the quality of the obstetrical or neonatal care received in some hospitals).

A contrasting ideological view is that the "fault" is not maternal but societal, insofar as disadvantaged pregnant women are denied adequate health education and insurance. Partisans of this view advocate universal prenatal care as the solu-tion to the problem, but this also fails to deal with many of the related issues and, in addition, ignores a critical fact: that all disadvantaged population subgroups do not have equally high rates of infant mortality. In the United States, for example, Mexican-Americans, who have many of the same health, education, poverty and insurance problems that African-Americans do, present infant death rates that are much lower.

What difference did this kind of review make to the study by PEMD? First, it became obvious that the study area was one of major disagreement; that the disagreement was related to some basic differences in political views about society; and that the effectiveness of prenatal care programs had not been demonstrated. Second, PEMD evaluators realized that they would have to deal with these issues in their study design, either by recognizing explicitly that program effectiveness still needed to be determined, or by using the strongest possible methodology to try to determine it themselves. In either case, opposition from a host of identifiable stakeholders was easily predictable. Given this kind of political debate, and given also the uncertain basis for the program's assumptions, it was evident that study design would be critically important, and that entering this combat armed only with a case study or a couple of focus groups was not a realistic possibility.

Third, and more generally, these reviews changed evaluator thinking about stakeholders. It became clear that mutual accommodation between stakeholders and auditors or evaluators had been rare and that it was unlikely they could all sit down as reasonable people and come to agreement in the name of the public good. Usually, the money involved was just too big. In fact, the PEMD experience over fourteen years showed that little or no

amicable negotiation ever took place with stakeholders concerned that an accountability study could hurt their inter-ests. Negotiations? Sometimes. Amicability? Never.

The bottom line here seems to be that auditors and evaluators should not expect any gifts from stakeholders, big or little, but that there may be nuances in the general relations with them, depending on the kind of stakeholder and the kind of study involved. However, even in accountability studies that are conducted under warlike conditions, a thorough understanding of the political environment will help auditors and evaluators to predict stakeholder attacks, to plan for them adequately, and, if their arguments are credible and they stick to their guns, to win a fair hearing for their study. PEMD had skirmishes with huge stakeholders such as medical device manufacturers, highway and insurance lobbies, military technology corporations and their media, pharmaceutical companies and the alcohol lobby, not to mention agency managers and liberal or conservative think-tanks. Those

skirmishes went on and on, but PEMD evaluators were usually able to make their argument publicly. In some cases, PEMD even won out, not immediately perhaps, but over time.

Negotiating the Study with Sponsors

Abcut eighty per cent of PEMD s work consisted of studies requested by the U.S. Congress, with about twenty per cent being self-initiated. Most of the latter were methodological in nature (e.g., issues in using statistical samples, developing sur-veys, generalizing from case studies, applying the research synthesis method, com-bining data bases and the like). These rarely involved political concerns, except insofar as using new methods may involve some credibility risks. But the legislative study questions PEMD received were often vague, afflicted with underlying

political agendas, not always feasible, and fraught with uncertainties about eventual reporting and use.

Soon there was a realization in PEMD that it was necessary to think through carefully when an accountability study should not be done, if the credibility of PEMD products was to be maintained. The author began by adopting Cronbach's resource allocation criteria: that is, "prior uncertainty about a question; costs of information; anticipated information yield; and leverage of the information on subsequent think-ing and action" (Cronbach et al, 1980). But although these criteria are excellent as far as they go, they are mostly aimed at knowledge acquisition, they presume a rational use of information by policymakers, and they do not take much account of the political forces affecting the success of an accountability study.

Based on PEMD's early experience, the author ended up with a set of twelve questions for making preliminary resource allocation decisions (see Appendix I, Chelimsky, 1982). The author posed these questions to staff immediately after PEMD received a new congressional request, so as to respond quickly to the requester. If the answers to the question were troubling, PEMD would try, together with the would-be sponsor, to revamp the study to everyone's mutual satisfaction. If that failed, the author, as head of PEMD, sometimes had to refuse a request; this could be for a variety of reasons, some infused by political considerations inherent in the work. In general, the author did not turn down study requests because the subject was controversial, or because the program's objectives were not measurable, or because they required special expertise from PEMD's staff, or because policy use might be impeded by program advocates or other stakeholders. But the author did refuse them when: (1) it appeared they could not be done convincingly within rea-sonable funding constraints; (2) there was little or no knowledge base to build on; (3) original data could not be collected and extant data were not available; (4) they could not be finished in time to be

useful; (5) there was no policy fix available for implementing potential recommendations; (6) the public interest was not clearly paramount; and (7) the policy questions were too numerous, or too broad, or too trivial, or too biased, and could not be changed.

PEMD evaluators learned to present their reasons for saying "no" to the Con-gress very carefully, and sometimes their conclusions were accepted, sometimes not. In one case, the author was called "recalcitrant" in a letter to GAO from SenatorTed Kennedy because she had refused a request to estimate the future impacts of a new provision in the immigration legislation without any historical data on which to base the estimates. In another case, the ten-page letter the author had written to a House requester, explaining the reasons for PEMD's refusal, was faxed all over the country by that requester (without the author's knowledge) and accompanied by the query, "Is she right?" The first time the author heard of this was some months later when she received a letter from the requester, enclosed in an enormous packet of mail, saying that, to his surprise, most of his correspondents seemed to agree with the author, and so, where should the requested study go from here?

It will surprise no one to learn that, in both cases, PEMD was eventually obliged to do the studies (USGAO, 1989, and USGAO, 1988c). But the refusals turned out to have been extremely worthwhile because they brought what had not been achievable without them: a serious reconsideration of the requests, major changes in the questions to be answered, appropriate timelines, and agreement for intensive bipartisan committee participation, in the one case, and extensive execu-tive branch consultation, in the other.

Dealing with Data Issues in Accountability Studies: Involving Relevant Public Groups

Many accountability studies are concerned with assessing the effects of government policies and programs

on the behaviour or wellbeing of particular population groups. It goes almost without saying, then, that these groups have informa-tion of the greatest importance for the technical validity and political credibility of those studies. Yet in the 1960s and 1970s, it was common — even typical — to see audits and evaluations of programs for the aged, say, that never interviewed or surveyed a single elderly person. Among the reasons for this apparently strange omission was fear of politicization: the concern that, by involving public groups, auditors and evaluators could lose the very independence and objectivity that make accountability studies persuasive and useful.

On the other hand, specific public groups may have a number of important informational roles to play in data collection for a given accountability study, depending on the particular subject. In an effectiveness inquiry about a public program, for example, auditors and evaluators will always need to know how con-gruent the projects central objectives are with current public and/or participant views on what should be done to resolve a problem, and what would constitute project success in their eyes. Those views figure once again in setting up study crite-ria for normative inquiries where the "general consensus" will be compared against study findings. And detailed experiential information from relevant public groups is needed when:

- Their knowledge is related to the study questions;
- There is stakeholder conflict within a program and the risk exists that some views may be drowned out by others; or
- The program itself is situated at the heart of an ideological conflict within the larger society (as in the program to reduce infant mortality, discussed earlier, or any program or policy seeking to equalize educational or employment opportunity, for example).

The two main reasons for involving the public in these

three ways are, first, to improve the soundness of the study, and second, to strengthen its objectivity: neglecting or ignoring relevant information from specific population groups not only damages the validity of the findings, but opens the study to charges of advocacy. This is especially likely when stakeholder groups collide within a program, or when business interests stand in opposition to the public good.

PEMD's effort to incorporate public views always began with the literature review. In most cases, when there was strong public disagreement with a programs goals—for example, using law enforcement rather than medical treatment in deal-ing with drug addiction -this was usually clear from prior study results. When it was not clear, PEMD evaluators did preliminary work of their own.

In looking at public participation in food stamp programs before starting an accountability evaluation, for example, evaluators noted that participation rates by eligible people seemed surprisingly low, but that the reasons for non-participation were not well understood. So in a preliminary study, using extant data, PEMD first confirmed that participation rates were in fact under fifty percent, and sec-ond, that there was extraordinary confusion in the minds of potential participants about who was or was not eligible for the program; many needy people simply did not bother to apply (USGAO, 1988a).

These findings obviously raised important questions for an accountability study with regard to:

— Whether potential participants were comfortable with the goals and values of the program and were deterred only by confusion in the programs administration;

— Whether agency managers disliked the program and were purposely erecting administrative barriers to full participation, or were merely inefficient; and

— Whether the major study issue for PEMD to examine was not program effectiveness, but rather the appropriateness of the program concept in meeting participant and agency needs.

In accord with the sponsor, PEMD changed the focus of the new study to a detailed examination, by population group, of both participation and non-participation in the program (USGAO, 1990a).

This kind of public participation analysis, then, was critical in determining the right questions for PEMD's study. And it is a worthwhile endeavour whenever project use and sustainability within a community are in question.

A second kind of use evaluators made of data from public groups in PEMD had to do with including their views in the norms, models, or standards typically employed in criteria-referenced studies. It was evident that if these were selectively conceived, or favoured one group over another, this could inadvertently introduce a kind of advocacy (and also invalidity) into the study. In establishing standards for the effectiveness of communications in a health service program, say, were the criteria based on physicians' views alone of what constituted quality, or did they include nurses' and patients' views as well?

PEMD dealt with this problem by incorporating small advisory groups into a study's planning process that would include, for example, a program beneficiary as well as an agency manager, a patient as well as a doctor, a student as well as a teacher, a farmer as well as an agro-businessman. The idea here was, of course, to come up with criteria that reflected, to the degree possible, the views of the major groups relevant to the study. PEMD evaluators did not, however, relinquish con-trol over this part of their work, and remained responsible for the blending of those views into the models they eventually used for comparison.

This process worked quite well when conflicts were not overwhelming, but even when they were, PEMD evaluators

always gained fresh perspectives on their success criteria by better understanding the specifics of the clashes. In one case, they were able to use the views of both farmers and government agricultural program managers to establish criteria allowing them to evaluate the influence of federal farm policies and programs on different aspects of farm practice (USGAO, 1990b).

The third use made of data from public groups (and by far the most important one) in PEMD was as an integral component of a study. PEMD started doing this in 1983, with an assessment of federal centres that provided assistance to runaway and homeless youth, a program that the Reagan Administration was proposing to eliminate. Here PEMD evaluators collected information directly from parents, youth, program staff, aftercare officers, and rival service organization personnel across the nation, and had the extraordinary experience of finding them all in agreement about the excellence of the program (not without some caveats and suggestions, of course), as well as its value to the communities it served (USGAO, 1983b). After a hearing on the Hill featuring PEMD's findings, the program was reauthorized by the Congress with increased funding, based on PEMD's work.

Other studies in which PEMD involved public groups extensively in data col-lection included:

— An effort to determine why fewer American agricultural workers were becoming available for employment on U.S. farms in different crop areas (USGAO, 1988e);

— An investigation of whether tax incentives were sufficient, in and of themselves, to lure new businesses to distressed areas, as expected by enterprise or empowerment zone programs (USGAO, 1988b);

— An examination of the extent to which physicians prescribe drugs "off-label" (i.e., for uses not

designated by the Food and Drug Administration (USGA, 1991b);

— An evaluation of cataract surgery, including information from patients on their own experiences (USGAO, 1993a); and

— A study of ADA (Americans with Disabilities Act) using the opinions and experience of handicapped people to estimate the effects of the law in eliminating physical barriers restricting their access to goods and services (USGAO, 1993b).

In all of these cases, PEMD included public groups as sources of informa-tion, not as designers or conductors of the evaluations themselves. Again, PEMD retained control of all study decisions, as in any evaluation. What PEMD evalu-ators found was that increasing public involvement in appropriate ways brought them notable technical improvements and information that was often unique. With respect to any political cost, such as the potential appearance of advocacy, PEMD's experience was quite the contrary: the inclusion of public groups in a study increased its credibility because of the breadth and balance they brought, countering, in many cases, the voices of other, more powerful stakeholders.

These are, of course, felicitous outcomes. But PEMD evaluators were less successful in improving their data access when it came to overcoming bureau-cratic protections and denials of information.

Confronting Governmental Secrecy

There can be no more critical issue for auditors and evaluators than open access to data, because of the potential to affect the validity, persuasiveness and usefulness of a study. Yet, as noted earlier, agencies or programs or school systems or the military may feel threatened by a study and impose constraints—sometimes going as far as the total restriction or classification of information—on auditors' and evaluators' access to data. Whatever the political climate,

classification of information is a fact of life in an increasing number of agencies, and it constitutes a danger for auditors and evaluators in that, if they ignore the classified literature, they risk coming to manifestly false conclusions. When PEMD evaluators started their work on chem-ical warfare, for example, they found that all the open literature had been written by so-called "doves," or liberals, whereas the classified reports had been signed by "hawks," or conservatives. This meant that doing a synthesis of information in this area forced the inclusion of classified data, with consequent restrictions for report-ing, dissemination, and the public right-to-know (USGAO, 1983a).

Another problem for auditors and evaluators has to do with what is classified. The temptation is, of course, for an agency to hide under a blanket of secrecy what-ever might reveal its warts and foibles. For example, PEMD evaluators found in a review of operational test and evaluation at the Department of Defence that once they had examined all the classified information, it became clear that what had been released to the public on an unclassified basis "resulted in a more favourable presentation to the Congress of test adequacy and system performance than was warranted by the facts" (USGAO, 1988f). In other words, unclassified informa-tion may be favourable to a system for which funding or approval is sought only because the unfavourable data have been classified or suppressed. Classification, then, by its selective release of data, not only threatens accountability, but also puts auditors and evaluators in a difficult position. They can tell the truth and go to jail for revealing classified information; they can tell only truths that are palatable to the agency; or they can take so narrow an approach on such unimportant policy issues that nobody cares, not even the agency.

Of course, no one contests the idea that some information, such as the design of advanced weapon systems, should be classified. But because secrecy makes life

so very much easier for agency managers and officials at every level of govern-ment, auditors and evaluators are now seeing its spread beyond the military into domains like health, education or public assistance—where no national security issue can be reasonably invoked. It is thus imperative for evaluators and auditors to confront this situation when it occurs, because it precludes the examination of all the facts, it makes a mockery of executive accountability to the legislature, and it drastically reduces and distorts the flow of factual information to the public.

Two things were done in PEMD to combat not only specific data restrictions, but also those attitudes prevalent in government that promote and protect secrecy, like fearing to speak out, adhering to "message," acting like a "team player," accept-ing cave-ins to political pressures, and putting loyalty to an agency ahead of the agency's public mission. First, staff members in PEMD were explicitly instructed to speak out (often in situations that included numerous adversaries, all with different viewpoints and interests) and to insist on their right to independence in speaking out. This takes some courage, of course, even in ordinary times when the normal scepticism of the auditor or evaluator is unwelcome amid the ambient fervour for one program or another. But when accountability studies have to be done in an ideological political climate, then doubting the conventional wisdom can become dangerous, and insisting on access to data, career-limiting. Still, these things must be done, and staff should be strongly supported and rewarded for doing so.

Second, PEMD management pursued every possible means for obtaining the data needed: alerting sponsors, negotiating endlessly, and even invoking court action. If and when these actions failed, PEMD always went on to publish a report documenting data problems, and pointedly eschewing conclusions where data constraints did not allow them. While this was hardly a winning strategy, it did bring PEMD some victories in individual studies, and it

sometimes achieved a longer-term deterrent effect. Although many agencies look with irritation on what they see as legislative incursions (also known as oversight) into "their" affairs, most would usually prefer not to see their data-hiding (or -shredding) pro-pensities revealed publicly in an audit or evaluation report, or in the press.

This then leads directly to the accountability issue of dissemination, and whether more should be done by auditors and evaluators generally to increase public awareness of their findings.

Strengthening Dissemination

It is often the case that public officials have a short memory for studies. Indeed, because the political process loses sight of findings almost from one week to another, and because media attention to accountability issues is not guaranteed, auditors and evaluators sometimes need to be persistent to the point of obstinacy in bringing important study findings to the attention of press and public. Thus, the job of auditor or evaluator in a political environment cannot end with the publication of an important report. There is a need to disseminate the findings in such a way as to keep them at the forefront of the public debate.

It is, of course, impossible for auditors and evaluators to take on the entire accountability burden of informing the public. And even if it were possible, it would not necessarily be a good idea, since there is a fine line between dissemina-tion and marketing, and authors of accountability studies should not be perceived as "selling" their work. Also, despite changes in the press and media, there remain many serious press venues and journalists that can be counted on to understand and explain new findings to the public.

On the other hand, there are a number of efforts that can be made to ensure a hearing for the information. In PEMD, the author and the evaluation staff thought a lot about how to write a technical report so that not only

accountants and social scientists, but also policymakers, press and the public might be interested in read-ing it. PEMD's big priority here was the writing itself. That is, if people were in fact interested in PEMD's latest findings, they should not be deterred by a report that was pretentious, obscure, full of jargon, and unnecessarily voluminous. As William Carey once put it, evaluation reports tend to be "over-theologized, spooky, tedious to read, and complicated to understand" (Chelimsky, 1977).

PEMD decided to use the summaries which always preceded full reports to serve as new platforms for displaying clarity, simplicity (at least relative), and plain-speaking. A respected journalist (Robert Pear, of the New York Times) was asked to read through their current summaries, criticize them for structure, limpidity and accessibility, and help them come up with new "rules of the game." The idea was that even if technical complexity could not always be reduced, it was unwise to add to it through the quality of the evaluative prose.

Second, PEMD evaluators used every means at their disposal to bring their findings to public attention. They employed press briefings, press conferences, legislative hearings, trade publications, staff articles in professional journals, and television interviews to get the word out. Testimony at a congressional hearing, in particular, is a remarkably potent, many-sided form of communication; it can disseminate technical information more easily, painlessly, and effectively than can a major written report. Here, not only are the findings aired to a much wider audience (all members of a committee, for example, plus newspaper reporters and/ or television and, through them, the public), but the opportunity also exists for both written state-ments and oral discussions. This was by far the best of all dissemination methods available to PEMD, but it was available only when the sponsor suggested it. In other cases, sponsors might simply decide to issue a press release and, as a result, newspapers would publish articles about one of

PEMD's studies without testimony. This pathway, however, lacked the fuller dialogue and debate of a hearing.

Indeed, sometimes a hearing, because of its comprehensive review of a study, can pave the way for new hearings and hence, expanded dissemination. In this type of situation, the testimony based on a report can take on a slightly different per-spective or emphasis, in harmony with the particular angle taken by the committee on the issue. An example of this experience is the testimony the author gave to the House Budget Committee based on a PEMD report evaluating "smart" highways (USGAO, 1991a). This Committees interest was in transportation planning and procurement, rather than in the new transportation technology *per se*, which had been the sponsoring Senate Committees orientation. This meant a whole new look at PEMD's data, and although the findings didn't change, of course, the pre-sentation of them certainly did. The same thing happened with PEMD's study of enterprise zones, discussed earlier (USGAO, 1988b). PEMD had found, based on their study of the Maryland experience, that the concept did not appear to have been effective either in attracting new business, in employing the disadvantaged, or in raising tax revenues. This was a disappointing finding for the study's sponsors. Although no one tried to intimidate PEMD evaluators or change the findings or suppress the evaluation, still, no interest was expressed and no hearing was called for by the requesting committee. However, instead of the oblivion PEMD fully expected, the published study was widely cited in the research literature and, about a year after its completion, the author was called to testify on the PEMD findings before a different committee. The dissemination experience here was quite instruc-tive by reason of the cross-fertilization involved, with the communication of findings to the research community having been critical in the reconsideration and use of the evaluation by the Congress.

Finally, PEMD evaluators always looked carefully at

their draft study reports to see whether any special targeted dissemination might be necessary. In one case, finishing a study for the House Education and Labour Committee, they found that there were surprising gaps in parents' and students' knowledge of the federal aid available for college education, gaps that could drastically limit families' con-sideration of different school options (USGAO, 1990c). Since information about financial aid possibilities should have been imparted to families when students were still in high school, PEMD decided to target the dissemination of this report to every high school principal in America. The same kind of focused mailing was done for other reports as well, including one detailing different ways of educat-ing hard-to-reach, high-risk populations about the prevention and transmission of AIDS (USGAO, 1988d). Another study, which revealed much higher rates of Hispanic mortality and morbidity with respect to many preventable or treatable diseases than existed for other population groups, received special dissemination to Hispanic centres across the nation, not by PEMD, but by the Office of the Surgeon General (USGAO, 1992).

In short, the first lesson of PEMD's experience in trying to make the public aware of new findings is to take dissemination seriously. It is, after all, the ultimate point in the study process at which evaluators and auditors can hope to influence the use of their work. And although it is true that a good dissemination strategy cannot ensure either public awareness or policy use, a weak one can certainly impede them. The second lesson was that dissemination strategies have to be care-fully planned. They should be flexible and diverse to allow for cross-fertilization, and they need to be looked at again after the findings are in, to examine their significance for different stakeholders. In that way, however uncomfortable the study conclusions, auditors and evaluators can be better prepared to make their case, and to adopt a dissemination strategy that will eventually provide a hearing for their study findings.

Conclusions

This paper has argued that public auditors and evaluators serve the societal purpose of accountability in government, and that, as such, they cannot insulate themselves from the larger political components of that purpose. The author has drawn on experience at the GAO to describe the different paths taken in PEMD to try to integrate the political and public demands of accountability, without renouncing the critical requirements for independence, objectivity and credibility within the study processes of the divisions audits and evaluations. Four efforts were made: to understand the specifics of the PEMD's political environment; to negotiate studies in such a way as to maximize their chances of technical and political success; to expand public involvement in PEMD studies and increase staff access to data; and to improve pub-lic awareness of PEMD findings through stronger dissemination strategies.

This is not, however, to argue that auditors and evaluators are the only instru-ments of accountability, although it may sometimes seem so. To be effective, they count on legislators to ask the right questions and help them access the data they need; they count on executive branch actors to speak honestly and openly about their programs; and they count on the press to tell the public about what they are finding in their accountability studies. So auditors and evaluators are not alone in their responsibility.

But the political environment in which they work can seem disorderly, confus-ing, complex and difficult to auditors and evaluators. And even though this world of competing political interests emerges from an Enlightenment spirit of balance and compromise, the problem is that all things cannot—and should not—be bal-anced and compromised in audits and evaluations. Findings are findings, after all, and sometimes, as Albert Hirschmann once said, "it is more important to knock down false knowledge" and mistaken beliefs about what is

happening in govern-ment, than "to achieve some sort of modus vivendi" (Hirschmann, 1994). Indeed, whether in authoritarian regimes or in ideological democratic administrations that shield their decision-making and manipulate their data, the ancient art of speak-ing truth to power may still be the noblest task that auditors and evaluators can accomplish in their accountability role.

"Truth" however, is not so easily arrived at, especially in the volatile political environment that has been described. Although the emphasis here has been on inte-grating the audit/evaluation principle of independence with the political/public goal of accountability, it is also the case that the need to improve audit and evaluation methods is a continuing part of the quest for truth (i.e. accuracy and credibility). In this effort, auditors and evaluators can learn much from each other. In particular, auditors could usefully borrow from evaluators in two areas: first, by moving beyond the case study or the criteria-referenced design to include methods that can address cause-and-effect questions; and second, by much greater involvement in the assur-ance and confirmation of data, validity and reliability (this last being especially criti-cal in todays electronic environment). As for evaluators, two audit areas are ripe for borrowing: first, more persistence and determination in achieving the kind of political consensus around evaluative independence that auditors have long since gained for their enterprise; and second, a much greater focus on costs and savings in the assessment of program effects, and also in the formulation of policy. These are not, of course, the only areas in which methodological improvements need to be made, but they would certainly constitute important steps in credibility enhancement, and in the rather slow-moving cross-fertilization between the two fields.

In short, the suggestion here is not only that auditors and evaluators should better integrate their studies with the political and public framework that engenders and tests them, but also, that the methodological credibility of audits

and evaluations requires no less a commitment to ongoing development and improvement.

Conciliating politics with technical work that stands or falls on its objectivity and methodological credibility can be a tall order, even in quieter political times when there is acceptance of the idea that thoughtful questioning is an appropriate approach to public policymaking. But when ideology takes over in government, the auditor or evaluator is like Tolstoys General Kutusov, trying to stay afloat dur-ing the Napoleonic wars:

"The commander is always in the midst of a series of shifting events, and so he can never at any instant consider the whole import of an event that is occurring. Moment by moment, the event is imper-ceptibly shaping itself, and at every second of this continuous, unin-terrupted shaping of events, the commander is involved in a most complex play of intrigues, worries, contingencies, authorities, projects, counsels, threats and deceptions, and is continually obliged to reply to innumerable questions addressed to him, which constantly conflict with one another" (Tolstoy, 1954).

Like Kutusov, auditors and evaluators are pushed and pulled and bullied by political partisans who care only for outcomes, not methodological triumphs. But unlike Kutusov, they have at least two real opportunities for detachment, first at the design phase of their work, and then, during the writing of the study report. It is at these points that the time and calm can be found to think not only about the strength and credibility of findings, but also about achieving the political goals of accountability studies.

The suggestions offered here have worked well in practice, and although they are not revolutionary steps, they do expand some traditional notions of audit and evaluation. They can certainly help auditors and evaluators move forward in under-standing both the legitimacy and societal purpose of public audits and evaluations, and in integrating the various requirements of political accountability within

their studies. Over time, they can hope to improve the "fit" of their work within their political universe, and play a more meaningful role in fulfilling the accountability obligation to the public.

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9

Governance and Accountability : a Legal Approach to Auditing

Introduction

The legal regulation of company audits in Australia has come under significant scrutiny in the past three years, prompted by some significant corporate collapses in 2001, most notably HIH Insurance (which led to an inquiry by a Royal Com-mission) and One.Tel. In the wake of these events, there were four major and separately conducted reviews of the legislative framework governing auditors and audit work. These reviews culminated in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act.*

The first of these reviews commenced in August 2001, when the Federal Minister for Financial Services commissioned Professor Ian Ramsay to review the require-ments for the independence of auditors and audits, the findings of which were published in October that year (Ramsay 2001). In addition to the impetus supplied by the recent company failures, the review was also prompted by a perception that overseas developments on auditor independence had moved ahead of the Australian requirements. Six months later, in April 2002, the Federal Parliament's Joint Standing Committee on Public Accounts and Audit commenced its own review of independent

auditing, reporting in August of that year (JSCPAA 2002). This was the first time that the Committee had undertaken an inquiry into private-sector audit issues (JSCPAA 2002, p. *vi)*. Then, in June 2002, the Federal Treasurer announced a review of audit regulation as part of the government's Corporate Law Economic Reform Program. The outcome of that review (known colloquially as 'CLERP 9') was published in September 2002 (CLERP 2002). Finally, the three-volume report of the HIH Royal Commission was published in September 2003, containing, as part of its broad inquiry into the HIH collapse, a review of and reform proposals for auditor independence, audit reports and audit committees (HIH Royal Commission 2003). Each of these reports was factored into the drafting of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cwlth), which was introduced into Parliament in December 2003. The Bill was debated and amended in Parliament, and was assented to on 30 June 2004. The resulting Act made significant changes to many aspects of the Corporations Act. Most notably these include to the law relating to the conduct of audits, to the appointment and in-dependence of auditors, and to company financial reporting requirements.

The audit requirement

It has long been a basic statutory requirement that a company must have its annual financial report audited and must obtain an auditor's report about the conduct of the audit. Currently, this requirement is found in s. 301 of the *Cor-porations Act 2001* (Cwlth). This requirement has been imposed since the earliest Australian company law statutes. The first Australian companies legislation to include mandatory financial reporting requirements, the *Companies Act 1896* (Vic), was enacted 'in the wake of large-scale company losses, land fraud, and bank and building society failures' (Peirson & Ramsay 1983, p. 288). Section 28(1) of that Act stated that:

> No balance-sheet of any company shall deemed to be filed ... unless the same shall have subscribed thereto or indorsed thereon a certificate signed by the duly appointed auditors that such auditors have audited the same and have certified to the correctness or otherwise of the said balance-sheet.

Before outlining the current legal requirements for company audits, it is useful to examine some of the rationales that have been provided for these mandatory audit rules over the past 100 years.

Rationales for the Audit Requirement

The mandatory audit requirement must be understood against the underlying requirements about the public disclosure by companies of their financial affairs. Mandatory public financial reporting was introduced in the United Kingdom by the Joint Stock Companies Act in 1844. Whilst these requirements were deemphasised in the subsequent Companies Act 1862, they have since formed a major part of modern corporate legislation and corporate regulation. At the time, these requirements were prompted by concerns over the incidence of corporate fraud. The rationale for these requirements was summed up (some 70 years later) in Mr Justice Brandeis' famous aphorism that 'sunlight is the best disinfectant, electric light the best policeman' (Brandeis 1913, cited in Weiss 1979, p. 575). This concern about the importance of protecting investors from financial fraud has persisted as one of two interwoven rationales for mandatory financial audits. It is premised on ideas of investor susceptibility and lack of expertise. The as-sumption is that potential victims of corporate misconduct will be able to take note of this publicly available and professionally verified information, and take appropriate steps to protect themselves, or to seek their own remedies.

The second rationale is that audits promote confidence and empower investors to make rational and informed financial decisions. This policy was described by Street CJ

in Eq in *re Castlereagh Securities Ltd* ([1973] 1 NSWLR 624, p. 638) in the following way:

> A sound share market and the ability of shareholders to reach reliable conclusions are dependent upon shareholders, brokers and financial experts having access to full and reliable information concerning the affairs of companies. The courts do not, and directors should not, yield to the laconism that the only financial information most shareholders want is the figure on their dividend cheques. It is the clearly discernible intention of the companies legislation that companies should make adequate disclosures to enable shareholders individually, and the market collectively, to reach informed judgments. Over value and under value are both obnoxious. Where authentic details are not forthcoming, inference and even speculation inevitably take over. Decisions based on gossip or on inside information are concomitants of an unhealthy market.

Economic theory has also emphasised this argument. For example, audits are said to 'improve the reliability of financial statements, make them more credible and increase shareholders' confidence in them' (Panel on Audit Effectiveness 2000, cited in Ramsay 2001, para. 4.01). In this way audits are said to 'add value' to the financial statements and to the capital markets in general (Ramsay 2001, para. 4.02). The statutory requirement for an audit is then said to reinforce these credibility-enhancing and value-adding functions, providing an independent third party who can verify the financial information produced by a company. In theory, this reduces the costs that users of that information would otherwise incur if they had to verify it themselves. Auditors thus serve as 'reputational intermediaries', assisting the efficient operation of the market for corporate in-formation (Corbett 1994, p. 850, referring to Gilson & Kraakman 1984).

A different justification for the mandatory imposition of audit requirements can be found in the 'concession' theory

of company incorporation. According to this theory, the grant by the State of independent legal status to a company creates a private actor with special powers and capacities (for example, the company's capacity to issue shares and to enter into contracts). This special status is therefore said to carry certain obligations. On this view, the requirement that a company should publicly disclose its financial affairs on a regular basis and be subject to an audit is the quid pro quo for the grant of incorporation by the State. On this view, when an auditor is engaged to meet the company's statutory audit requirement, they can thus be said to be performing a dual function. The first function may be described as 'private'. It arises from the contractual relationship between the auditor and the company. This contract imposes various duties on the auditor, which are discussed later in this chapter. Breach of these duties may result in an action for damages brought by the com-pany against the auditor. Secondly, there is a more public function. The compan-ies legislation not only requires that an auditor should report to the company about its financial statements, but also that this report should become part of the public record about the company. Moreover, while they are conducting the audit and reporting to the company, the auditor is under a number of *statutory* obligations which cannot be contractually modified. The auditor is prohibited by the statute from contracting out of any liability for breach of their duties to the company (Corporations Act, s. 199A). Furthermore (as noted below), an auditor is required to inform the Australian Securities and Investments Commis-sion (ASIC, the regulator responsible for enforcing the Corporations Act) if the auditor suspects a contravention of the Act has occurred. In this sense, the audit is part of the wider public system of corporate regulation. There is, clearly, a tension between these private and public roles which is most evident when considering the question of an auditor's liability to persons outside the contrac-tual relationship (a topic dealt with later in this chapter).

The following discussion focuses on the audit obligations of public companies. A public company is required to appoint an auditor *(ss.* 327A & B). Following the CLERP 9 reforms, the auditor may be either an individual, a firm or a com-pany (s. 324AA). This requirement first applies within one month after a com-pany has been registered, and this initial appointment must be made by the directors. The auditor who is appointed at this time holds office until the first annual general meeting of the company (s. 327A(2)). At that meeting the company, acting through its voting members, is required to appoint an auditor who will hold office until either death, removal from office, resignation, incapacity by reason of lacking the relevant qualifications, or because of a 'conflict of interest situation' *(ss.* 327B(2)-(2C)).

Two features of these requirements are worth emphasising. First, in the absence of any disqualifying factor, the auditor holds office indefinitely, not for a fixed term. One qualification to this is found in the new provisions (introduced by CLERP 9) concerning audit rotation for companies listed on a stock exchange. If an individual plays a significant role in the audits of a listed company for five successive years, then they cannot play a significant role in the audit of that company for another two years (s. 324DA). Thus, if the company has appointed an *individual* as its auditor, a new auditor must be found at the end of the five-year period. But, on the other hand, if the auditor is a firm or company, and the lead or review auditor[8] has played a significant role in audits for the past five successive years, then the firm or company may continue to act as auditor, provided that it uses another person in the lead or review capacity *(ss.* 324DC &DD).

Secondly, in formal terms, the appointment of the auditor is a decision that is made by the members of the company, rather than its directors. Indeed, the Act requires that before the annual general meeting, the auditor must be nominated by a member (s. 328B). This underlines the

theory that the auditor is part of a process whereby members are able to monitor the performance of the directors and managers of the company. Of course, in practice the board has a significant degree of influence on the selection and appointment of the auditor. The members will usually make their decision by following the recommendation put to them by the board.

The auditor's formal accountability to the members is also emphasised by the fact that an auditor may only be removed from office by a resolution passed at a general meeting, initiated by the directors or members of a company (s. 329). ASIC has indicated its view that this section 'is designed to protect the auditor from manipulation by directors and to protect members of the company from an auditor who wishes to resign rather than conclude an audit which is proving difficult or controversial' (ASIC 1992, para. 2). Notwithstanding the obvious purpose of this section, it is rarely used. For example, a study of the annual general meetings of 271 Australian listed companies found that the removal of the auditor had not been an agenda item in any of the meetings held between 2001 and 2003.

Statutory Functions of the Auditor

The statutory function of an auditor is to provide an independent and expert assessment of the annual and half-yearly financial reports prepared by a company, and to prepare a report to the company's members. The statutory framework for company audits is narrowly defined. First, it does not extend to audits outside the annual and half-yearly timetable. A company may choose to undergo an audit outside of this framework (for example, in preparation for a potential takeover defence). Second, within the framework of annual or half-yearly audits, as Fogarty and Lansley point out, the auditor's role 'is restricted to commenting on historic financial statements produced by the company twice-yearly: ... it does not extend into arguably the most important area of disclosure — continuous disclosure'. Nor does the audit involve any assessment of 'the prudence of

business decisions made by manage-ment' (Ford, Austin & Ramsay 2003, p. 521). And third, the statutory framework does not regulate non-audit work performed by auditors. The CLERP 9 reforms did not impose any prohibition or restriction on the supply of non-audit services by auditors to audit clients. Instead, amendments to s. 300 simply require the directors of a listed company to include in the company's annual report a state-ment that describes the dollar amount paid to the auditor for non-audit services during the year, to state whether the directors are satisfied that the provision of those services is compatible with the general standard of independence for auditors, and to explain the reasons why the directors are satisfied about this (s. 300(1 IB)). This contrasts with the position in the United States, where the Sarbanes-Oxley Act of 2002 prohibits auditors from providing certain non-audit services contemporaneously with the audit (see s. 201).

Looking at the statutory functions in more detail, when conducting the audit of a company's annual or half-yearly financial report, the auditor is required to:

- form an opinion about whether the financial report complies with the Corporations Act and with the applicable accounting standards, and gives a true and fair view of the company's financial position. The auditor must then report to the members about the opinion they have formed. If the auditor forms the opinion that the financial report does not satisfy any of these requirements, then the auditor's report must state why [ss. 307(a), 308(1) & (2))
- form an opinion about whether:
- the auditor has been given all information, explanations and assistance that is necessary for the conduct of the audit
- sufficient financial records and registers have been kept by the company to enable a financial report to be prepared and audited

- other records and registers required by the Corporations Act have been kept (ss. 307(b)-(d)).

These requirements that the auditor must 'form an opinion' reflect the common law requirement which, as we will see, says that auditors should conduct their audits actively, rather than relying passively on information supplied by com-pany officers and employees. In addition to these 'opinion forming' requirements, the auditor must also:

- conduct the audit in accordance with the auditing standards that are made by the Auditing and Assurance Standards Board (s. 307A). This requirement was introduced by the CLERP 9 reforms; its intention is to give legislative backing to the auditing standards (CLERP 2002, p. 27)
- give the directors of the company a declaration that the auditor has not contravened the auditor independence requirements in relation to the audit (s. 307C, introduced by CLERP 9: the auditor independence requirements are discussed later)
- report on and describe any defect or irregularity in the company's financial report, including any 'deficiency, failure or shortcoming' relating to the corporation's financial records, other records and registers, and information given to the auditor (s. 308(3)). The company has a right to sue for damages as a result of a breach by the auditors of this duty [*A WA Ltd v. Daniels* (1993)
- notify ASIC if the auditor has reasonable grounds to suspect that there has been a contravention of the Act that is either significant or is one that cannot be adequately dealt with in the auditor's report or by bringing it to the attention of the directors. As a consequence of the CLERP 9 amendments, the auditor must also notify ASIC of any attempt to unduly influence, coerce, manipulate, mislead or otherwise interfere with the conduct of the audit (s.311).

Statutory Powers

To discharge their statutory audit and reporting requirements, the auditor has certain powers and entitlements under the Corporations Act.

The auditor has a right of access to the books of the company, and may require any company officer to provide such information, explanations or assistance as the auditor needs for the purposes of the audit (s. 310). For their part, company officers are under a positive obligation to allow the auditor access to the books (including registers and general documents) and to give the auditor any inform-ation, explanation or assistance which is required (s. 312).

In an unlisted company the auditor is *entitled* to attend the general meeting and to be heard on matters concerning the audit (s. 249V). If the auditor does attend the AGM then the members must be given a reasonable opportunity to question the auditor about the conduct of the audit, the preparation of the audit report, the accounting policies used by the company in preparing its financial statements, and the independence of the auditor (s. 250T). As a result of the CLERP 9 reforms, the situation for listed companies is different. In this type of company members have the right to submit written questions to the auditor prior to the AGM (s. 250PA). Moreover, the auditor of a listed company is *required* to attend or be represented at the company's AGM (s. 250RA). The impact of this mandatory attendance requirement will be slight. The study of 271 AGMs referred to earlier found that auditors already attended the AGM in 94% of cases. Having said that, the study also suggests that this attendance has frequently been sym-bolic rather than functional: the study suggests that most questions directed to the audit report will be answered by the chair of the meeting instead of the auditor, and that auditors rarely speak at meetings (Bottomley 2003, pp. 31-2).

Contract and Tort Duties and Liabilities

In addition to statutory requirements, auditors must

also comply with duties imposed by the common law concerning the conduct of the audit and the detec-tion of malpractice. These duties are based in the tort of professional negligence, arising from the relationship between the auditor and anyone to whom the auditor owes a duty of care, and also in contract, arising from the engagement contract with the company.

Duties to the Company

The basic duty of an auditor when conducting an audit is to use a reasonable degree of skill and care. The parameters of this duty were first set out in the late 19th century in a series of cases culminating in *re Kingston Cotton Mill Co (No 2)* ([1896] 2 Ch 279). In that case, Lopes LJ used what became a frequently invoked metaphor, stating that the auditor's role was to act as 'a watch-dog, but not a blood-hound'. This meant that:

> ... [the auditor] is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful ([1896] 2 Ch 279, pp. 288-9).

A Legal Approach to Auditing

During the 20th century, however, the courts gradually moved away from this image of the auditor as an alert but passive watch-dog. As Moffitt J put it in 1970 in the landmark case of *Pacific Acceptance Corporation Ltd v. Forsyth:*

> Since the classic statements concerning the auditors were made last century there have been considerable changes in the organisation of the affairs of companies either operating singly or as groups, in their merger or takeover and in their accounting systems, and there

> have been continuing and increasing experience of and notoriety of danger signs in respect of mismanagement, fraudulent or otherwise, of companies often brought to light by "economic squeezes" as they are termed ((1970) 92 WN(NSW) 29, p. 73).

Justice Moffitt's judgment contains a lengthy and sustained analysis of the auditor's duty of skill and care in the conduct of a company audit. The case in-volved an action by a company against its auditors, alleging negligence arising from a breach of contractual duty. In finding for the company, Justice Moffitt acknowledged that 'auditors are not insurers' — that is, they are not expected to detect any and all errors and fraud that may occur in company financial statements. Nevertheless, he held that in planning and carrying out a company audit, the auditor 'must pay due regard to the possibility of error or fraud' ((1970) 92 WN (NSW) 29, p. 63). The auditor's duty is to go behind the company's books and determine the true financial position of the company ((1970) 92 WN (NSW) 29, p. 63). This means that the auditor must design and carry out proced-ures which have a reasonable expectation of detecting 'a substantial or material error or fraud' in the company's affairs ((1970) 92 WN (NSW) 29, p. 65). The auditor will design those procedures by drawing on his or her previous experi-ence of how fraud and error are likely to be hidden in corporate financial state-ments. The implementation of the audit program requires that the auditor must personally check and examine these matters. In particular:

> ... if the existence of a document which is under the control of the company is material to the audit, it is the duty of the auditor acting reasonably to examine the document for himself unless there are some specific circumstances which make it reasonable to accept something less than proof by inspection ((1970) 92 WN (NSW) 29, p. 70).

In contrast to the approach taken in the *Kingston*

Cotton Mills Case, Moffitt J held that an auditor does not comply with the standard of reasonable skill and care by simply relying on the assumption that company directors and officers have fulfilled their respective duties to the company. Thus, the auditor is required to make inquiries at the appropriate level. The auditor may rely on the corporation's system of internal control, but only after it has been appraised, its strengths and weaknesses have been ascertained, and it has been tested.

The next major Australian case concerning an auditor's duties to the company did not introduce any new dimensions to the duties already discussed, but the magnitude of the claim did attract considerable attention to the issue of auditors' liability. The case involved an action for breach of contract brought by Cam-bridge Credit Corporation Ltd against its auditors. Cambridge Credit was a finance corporation involved in real estate development. It had issued debentures under the terms of a trust deed. The money raised from the debentures was in-vested in real estate. The trust deed imposed a limitation on the ability of Cam-bridge Credit to issue further debentures. This limitation required the company to maintain a certain ratio of debentures to shareholders' funds; if that ratio was breached, the trustees were empowered to appoint a receiver. The company's 1971 annual accounts wrongly overstated the value of the shareholders' funds. Nevertheless, the auditors certified that the accounts gave a true and fair view of the company's financial position, and also certified that the issue of further debentures would not breach the ratio defined in the trust deed. Cambridge Credit continued to conduct business and to invest in real estate. During the crash of the property market in 1974, Cambridge Credit, along with a number of other property companies, collapsed. When it failed to make an interest pay-ment to the debenture holders, the trustee appointed a receiver to the company. Cambridge Credit sued the auditors, alleging a breach of contract in relation to the certification of the 1971 accounts. At first instance, Rogers

J held that the auditors had been negligent in failing to require that adjustments be made to the 1971 accounts. If those adjustments had been made, the trustee would then have been alerted and appointed a receiver. At that time the company's deficit would have been significantly less than that which existed in 1974. That breach of duty in 1971, said Rogers J, was the substantial cause of the collapse of the corporation in 1974, since the corporation had continued trading on an inad-equate financial basis. His Honour ordered that $145 million damages be paid by the auditors. On appeal, the decision was overturned by a majority on the grounds that, while the 1971 audit involved a breach of contractual duty, this was not the cause of the loss suffered by the corporation in 1974. The Court of Appeal found that the collapse of the property market, due to government inter-vention, broke the chain of causation. It was also held that the loss was too remote from the negligent act.

As Chief Judge of the Commercial Division of the NSW Supreme Court, Rogers J had a further opportunity to rule on the duties of auditors, five years later, in the landmark AWA *Ltd v. Daniels* decision ((1992) 10 ACLC 933). AWA Ltd had entered into what was then the relatively new world of foreign exchange deal-ings. The lone employee appointed to manage AWA's foreign exchange opera-tions was initially very successful: AWA's foreign exchange operation looked as though it would become 'the largest dollar generating department' in the company ((1992) 10 ACLC 933, p. 985). Overtime, however, the situation became quite different. Ultimately the employee's foreign exchange activities caused a loss to AWA of almost $50 million. This loss was concealed by various methods, including the making of unauthorised borrowings from a number of banks on behalf of AWA.

During this period the defendant audit firm, Deloitte Haskins & Sells, was en-gaged by AWA to conduct two audits. The firm had a long association with AWA. The

partner in charge of audits (Daniels) was a long-standing friend of both the general manager and the internal auditor of AWA. The first audit was a statutory audit of the company's 1985/86 financial statements; the second was a non-statutory audit conducted between late 1986 and early 1987 in response to AWA's fears of a possible takeover. In neither of the audits was the full extent of the company's foreign exchange problems disclosed, although the Court found that the audit partner had recognised and noted the defects in AWA's system of internal control as early as June 1986.

AWA admitted that, in relation to foreign exchange dealings, its systems of in-ternal control and record- and account-keeping were deficient. Nevertheless, the company sued the auditors for damages from breach of contract, claiming that the loss was caused by the auditor's failure to draw attention to these defi-ciencies and to note the problems in its reports. The company's claim was that the auditors were responsible for detecting and reporting deficiencies or inad-equacies in the company's systems. For their part, the auditors denied any breach of duty to AWA, and claimed for contributory negligence on the part of the company.

Justice Rogers found that the auditors had been negligent. He also upheld the auditor's claim of contributory negligence. His Honour found that AWA's responsibility for negligence was 20%, while the auditor was 80% responsible. The AWA chief executive officer was ordered to contribute 10% of the auditor's 80% liability. In dealing with the liability of the auditors, Justice Rogers em-phasised the point made by Moffitt J in the *Pacific Acceptance Case,* namely that an 'auditor's duty has to be evaluated in the light of the standards of today' ((1992) 10 ACLC 933, p. 990). Justice Rogers' decision highlighted a number of specific aspects of the auditor's basic duty to exercise care and skill:

- *A duty in relation to the examination of the*

company's financial records: Rogers J emphasised that, consistently with the obligation that is now found in the Corporations Act, s. 307(c), the auditors should form an opinion that proper financial records have been kept by the company. In the *AW A Case,* His Honour found that the auditors had failed in this regard.

- *A duty in relation to the process of gathering information:* when doubts were raised about the scope of authority of the employee in charge of the foreign exchange operations, the auditors were then under a duty to make inquiries from senior management to ascertain the true position about the nature and extent of that authority. As Rogers J put it, 'in case of doubt, an auditor is required to inquire' ((1992) 10 ACLC 933, p. 954).
- *A duty to bring matters to the attention of management during the conduct of the audit:* according to Rogers J, the auditors were under an obligation to bring deficiencies in the company's internal controls to the attention of management in the first instance. This duty persisted for the duration of the audit process. His Honour observed that it was 'negligence of the first order' for Daniels to have waited until the conclusion of the audit to bring these matters to the attention of the managers ((1992) 10 ACLC 933, p. 990).
- *A duty to follow up:* when it became apparent that management had failed to respond adequately, Rogers J held that the auditors had a further obligation to report the matter to the board: '[T]he absence of internal controls in AWA ... were of such importance that the defendants came under a duty to report them initially to management. Failing action to rectify the position, they had to be reported to the Board' ((1992) 10 ACLC 933, p. 964).

On appeal by the auditors, Justice Rogers' findings on the negligence of the auditor were upheld [*Daniels v. Anderson* (1995) 13 ACLC 614). The Court of Appeal disagreed, however, with the apportionment of liability made by Rogers J, and reduced the damages by one-third. Nevertheless, the Court stressed the responsibilities of an auditor when problems are discovered:

> If the auditor in the course of evaluating internal control and other auditing procedures becomes aware of material weaknesses in or an absence of internal controls the auditor must ensure, usually by a communication in writing, that management becomes aware of these weaknesses on a timely basis. If management does not react appropriately the auditor must report the weaknesses to the board ((1995) 13 ACLC 614, pp. 645-6 per Clarke and Sheller JJ).

Duties to Persons Outside the Company

The private/public role of the auditor in conducting a statutory audit raises the question whether the auditor owes duties of care to individuals outside the company. Given that the audit report becomes a matter of public record, is a duty owed to anyone who has access to the audited accounts? In other words, do auditors play a role in the policy of investor protection for which a wider li-ability is justified?

In Australia, the answer to this question was finally settled in 1997 by the High Court's decision in *Esanda Finance Corporation Ltd v. Peat Marwick Hungerfords* ((1997) 23 ACSR 71). This decision resolved a difference between two lines of cases. One line of cases suggested a broad approach, under which auditors would owe a duty of care to a wide class of persons. One of the most influential decisions in this group of cases was *Scott Group Ltd v. McFarlane* ([1978] 1 NZLR 553), where a majority of the Court of Appeal in New Zealand held that auditors owe a duty of care to any person whom the auditors could reasonably foresee would need to use and rely upon the

audit report when dealing with the company. This conclusion was applied subsequently in a number of cases.

The second line of cases — upheld by the High Court — supports a narrow inter-pretation of auditors' liability to third parties. These decisions have often taken their lead from the words of Cardozo CJ in the US case *Ultramares Corporation v. Touche.* His Honour remarked that the liability of accountants (and auditors) for negligent misstatement ought to be restricted, otherwise they would be exposed 'to a liability in an indeterminate amount for an indeterminate time to an indeterminate class' (255 NY 170, p. 179 (1931)).

Prior to the *Esanda Case,* the standard-bearer for this narrow view of auditors' liability to third parties was the House of Lords decision in *Caparo Industries plcv. Dickman* ([1990] 2 AC 605). That case dealt with two questions: is any duty owed by an auditor to potential investors in a company who do not already own shares in the company, and is any duty owed by an auditor to existing share-holders in the company? On the first question, the House of Lords held that the auditors of a public company owe no duty of care to investors who rely on the audited accounts in deciding to buy shares in the company. The Court acknow-ledged that it might be foreseeable that potential investors would use the audited accounts, but foreseeability by itself is insufficient to establish a duty. The Court stressed that proximity was also required as a separate element, and that there was no sufficiently proximate relationship between the auditor and a potential investor to give rise to any duty.

On the second question, the House of Lords held that the auditor's duty in performing his or her statutory function is owed to the shareholders as a body, not to individual shareholders. The Court accepted that facts might arise which es-tablished a sufficiently proximate relationship between the auditor and an individual shareholder. This would require the auditor to know that the statement would

be communicated to the shareholder for the purpose of a particular transaction or type of transaction, and that the shareholder would rely on the statement in connection with that transaction ([1990] 2 AC 605, p. 641 per Lord Oliver). In such a case, however, the resulting duty of care would only protect the shareholder from losses in the value of shares which he or she already held. It would not protect the shareholder for losses resulting from the purchase of additional shares in reliance on the auditor's report. This is because, as a share purchaser, the shareholder would be in the same position as any other potential investor, to whom the auditor owes no duty ([1990] 2 AC 605, p. 627 per Lord Bridge). Some Australian courts had already accepted and applied the *Caparo* decision prior to the *Esanda Case.*[19]

In *Esanda Finance Corporation Ltd v. Peat Marwick Hungerfords* ((1997) 23 ACSR 71), the High Court was able to lay down decisive guidelines for Australian law about the liability of auditors to third parties. The Esanda finance company had lent money to a number of companies associated with a company called Excel. The loans were guaranteed by Excel. In deciding to make the loans, Esanda had relied on the accounts of Excel, which had been audited by Peat Marwick Hungerfords. The audited accounts did not disclose Excel's true financial position. Excel subsequently went into liquidation and Esanda claimed to have suffered financial loss as a result of the loan transactions. Esanda brought an action against the auditors, claiming that they were negligent in the audit of Excel's accounts.

The High Court held that the auditors did not owe a duty of care to Esanda. The Court confirmed that in an action for economic loss arising out of negligence, mere foreseeability of the possibility of harm arising from giving information or advice is not sufficient to impose a duty of care on the person giving the in-formation or advice. Esanda needed to prove that the auditor knew, or ought reasonably to have known of, three things ((1997) 23 ACSR

71, p. 78 per Brennan CJ). First, 'that the information or advice would be communicated to the plaintiff, either individually or as a member of an identified class'; second, that the information or advice would be communicated for a purpose that would be very likely to lead the plaintiff to enter into a transaction of the kind that the plaintiff did enter; and third, 'that it would be very likely that the plaintiff would enter into such a transaction in reliance on the information or advice'.

Justice McHugh identified several factors in support of this confined scope of liability ((1997) 23 ACSR 71, pp. 102-8), including a mixture of policy-based and empirical claims that:

- imposing a duty of care on auditors in favour of third parties would lead to an increase in the cost of auditing services, a decrease in competition for such services as smaller firms are forced out of business, and a reduction in the standard of those services as auditors reduce overheads in order to absorb the higher cost of insurance
- the intended beneficiaries of such a duty are 'a sophisticated group who have the means in most cases to take steps to avoid the risk of loss'
- the plaintiff's loss is caused primarily by the conduct of the company which is audited, while the role of the auditor in causing the loss is secondary
- sophisticated investors will face problems in proving reliance on the audit report, given that they are likely to regard the report as only one of many factors to take into account
- 'the factual issues that arise in auditor's liability cases ... make it almost impossible for an auditor to avoid a trial or settlement even when the auditor is not liable to the plaintiff
- such a duty would carry a prospect of 'vexatious or near vexatious litigation'

- such a duty would require an auditor to compensate investors for loss arising from their self-induced reliance where they were not prepared to pay for the auditor's work.

The *Esanda* decision indicates a significant shift away from the broad investor protection rationale discussed earlier in this chapter. It also favours a private conception of the audit function, as opposed to the public role identified earlier.

CURRENT LEGAL ISSUES

Auditor Independence

The corporate collapses of the 1980s were seen primarily as the result of neglect and mismanagement by company directors and officers. This led to major reforms to the law, both statutory and judicial, on directors' duties. By comparison, critical scrutiny of the collapses of 2001 has concentrated more on the role of the auditors.[20] In particular, there has been considerable speculation about the extent to which a lack of auditor independence contributed to the high-profile corporate collapses in Australia during 2001.[21] Both the Ramsay Report and the report of the Joint Standing Committee on Public Accounts and Audit had as

> "The role of directors has not been ignored. There have been some significant cases brought against directors, for example *ASIC v. Adler (No, 3}* (2002) 20 ACLC 576 (relating to the collapse of HIH Insurance), and *ASIC v. Rich* (2003) 21 ACLC 450 (relating to the collapse of One.Tel).

Their main focus the problem of maintaining auditor independence (Ramsay 2001; JSCPAA 2002), and over half of the reforms in the CLERP 9 legislation were directed at audit reform. Whether this unfairly perpetuates the scapegoating of auditors for company failure is a matter of debate (Fogarty & Lansley 2002, pp. 418-19). Nevertheless,

as the Ramsay Report noted, 'the importance of inde-pendence in the auditing context has become such that the terms "independent" and "auditor" can no longer be separated' (Ramsay 2001, para. 8.15).

Concerns about auditor independence are not new. There have long been provi-sions in the Corporations Act and in professional codes of conduct dealing with aspects of auditor independence (Ramsay 2001, para. 4.14). The courts have also commented on the importance of the auditor's independence, and the difficulties in maintaining it. In *Pacific Acceptance Corporation Ltd v. Forsyth,* for example, Moffitt J noted that while the shareholders appoint the auditor, most often it is the directors or senior managers who determine this appointment. Therefore the auditor may be under some pressure to produce a report which pleases those managers. The auditor 'is put in a position where there must often be a real and practical conflict... between his duty to the shareholders and his interest not to take action which may prejudice his reappointment or his relations with those with whom he works.'

Prior to the CLERP 9 reforms, the statutory independence requirements for auditors were relatively straightforward. A person could not be appointed as an auditor if they were an officer of the company, or if they, or any corporation in which they were a substantial shareholder, owed more than $5000 to the company or its related entities. As the Ramsay Report noted, these provisions fell short of a general requirement of auditor independence (Ramsay 2001, para. 5.03). The CLERP 9 reforms, based upon the recommendations of the Ramsay Report but also taking into account findings of the HIH Royal Commission, cast the net of auditor independence much more widely and are expressed in much more detail. These reforms include the auditor rotation requirements discussed earlier in this chapter.

Following the CLERP 9 reforms, the Corporations Act

specifies both general and specific independence requirements for auditors. The general requirement focuses on the need to avoid 'conflict of interest situations'. It is set out in ss. 324CA-CC (applying, respectively, to individual auditors, members of audit firms and dir-ectors of audit companies). A 'conflict of interest situation' exists whenever the auditor is not capable of exercising objective and impartial judgment in conduct-ing the audit, or at least a reasonable person would conclude that this is the case. This involves looking at the relationship between the auditor and the company, and its current or former directors and managers (s. 324CD). The effect of this general requirement is that if an auditor engages in audit activity and they are aware of the existence of a conflict of interest situation, they commit an offence unless they take all reasonable steps to end that situation. They must also inform ASIC within seven days of becoming aware that the conflict of interest situation exists. If the auditor is not aware of the situation, they commit an offence if they do not have in place a quality-control system that would have been reasonably capable of making them aware that the conflict of interest situation exists.

The specific independence requirement creates further offences, focusing on particular 'relevant relationships' that constitute a breach of the auditor's inde-pendence when they are engaged in audit activity. The Act defines 19 such re-lationships (s. 324CH). Some are role relationships (e.g., where the auditor is an officer or employee of the audited company), others are property relationships (e.g., where the auditor has an asset that is an investment in the audited com-pany), and the remainder are financial relationships (e.g., where the auditor owes money to, or is owed money by, the audited company). The Act then lists the persons associated with the audit to whom these different types of relation-ships apply (ss. 324CE-CG). The listed persons include immediate family members of the audit team, and suppliers of non-audit services from the audit firm.

These independence requirements are reinforced by the further requirement that the auditor must declare to the directors of the audited company whether there have been any contraventions of the auditor independence requirements (including the auditor rotation requirements) (s. 307C).

Notwithstanding their detail, the regulation of auditor independence goes beyond these new statutory requirements. The independence requirements introduced by the CLERP 9 reforms are primarily concerned with what Michael Power calls 'organizational independence' (Power 1999, p. 132). That is, the reforms define the independence problem in terms of the relationship between the company and the auditor. Power argues, however, that there is a second dimension to audit independence — he calls it 'operational independence' — which focuses on the *audit process* rather than the auditor (Power 1999, p. 132). Here there are two questions. First, regardless of their degree of organisational independence, how much does/should the auditor rely on company managers for information? This is a question that has tended to occupy the courts, typified by the *Pacific Acceptance* decision described earlier. For example, in defining the common law duties of auditors, the courts have concentrated on the obligation to 'go behind the company's books' and determine the company's true financial position. Of course, auditors must be dependent, at least to some extent, on information supplied by the company. This was recognised in the *AWA Case,* where the court emphasised the auditor's duty to inquire. So the second question is whether the auditor is able to draw independent conclusions from this information. Power suggests that for this to be possible, auditors must have an independ-ent knowledge base on which to *assess* the information: there must be 'clear rules of auditee conduct and robust techniques for determining compliance with these rules' (Power 1999, p. 133). This aspect of operational independence is the domain of the auditing (and accounting) standards referred to earlier in this chapter.

When it is seen with these added dimensions, auditor independence becomes a much more complex regulatory goal.

Limiting Auditors' Liability

Since the 1970s the quantum of civil claims against auditors has produced con-tinuous debate about the extent to which auditors should be liable for economic loss incurred when a company fails financially. The auditing profession has ex-pressed its concern that there is an 'expectation gap' between the auditors' legally defined role and what the investing public expects:

> The general public believes that the auditor has a responsibility for detecting *all* fraud, while the auditing profession believes its responsibilities are limited to *planning* the audit so that there is a reasonable expectation of detecting *material* fraud (Gay & Pound 1989, p. 118, emphasis in original).

The question has been whether the narrowing of this expectation gap is best left to the episodic application by judges of concepts such as foreseeability, proximity and reliance, or whether statutory intervention is required. On one view, legislative reforms are unnecessary, given the tight limitations imposed on auditors' liability to third parties in the *Esanda Case,* and the use of contrib-utory negligence principles in *Daniels v. Anderson* (Fogarty & Lansley 2002, p. 425). The other view looks for legislative certainty. In Australia, the CLER.P 9 reforms have taken the latter approach.

CLER.P 9 introduced two methods by which the liability of auditors for loss might be restricted.[23] First, the reforms introduced a system of proportionate li-ability for economic loss or property damage arising from misleading or deceptive conduct in relation to a financial product or financial services. The idea of pro-portionate liability is that the defendant's liability is directly proportionate to the degree of their responsibility for the loss or damage that has

been incurred. This scheme replaces the system of joint and several liability under which a plaintiff can recover the whole amount of the loss from any one or more of the

> "in addition to these methods of reducing liability, it should be noted that under legislation in New South Wales and Western Australia (the *Professional Standards Act 1994* (NSW) and the *Professional Standards Act* J997JWA)), professional associations (including accountants) can limit (or 'cap') the liability of their members for financial loss in certain situations. Under the *Treasury Legislation Amendment (Professional Standards) Act 2004* (Cwlth), this state legislation is applied to certain types of liability under the Corporations Act and the Trade Practices Act.

A Legal Approach to Auditing

defendants, regardless of the relative degree of fault of the defendants. Secondly, the reforms permit an audit firm to incorporate as a limited liability company on certain conditions (for example, each director of the company must be a registered company auditor). The immediate consequence of incorporation is that the company, unlike a partnership, is a separate legal actor. Prima facie, it is the company, rather than its members or directors, that incurs legal liability for its actions. This separation of the company's liability from that of the auditor members of the company does not, however, insulate the auditor members from liability. An audit member who is negligent in the conduct of an audit may be liable along with the audit company. The advantage of incorporation, though, is that other non-negligent auditor members will be shielded from liability.

CONCLUSION

It is too early to say what effect the flurry of legislative reforms that were intro-duced in the wake of the corporate failures of the early 21st century might have. Indeed, the broader literature on law reform and legislation suggests

that, not-withstanding the number of reports, reviews and inquiries that preceded these changes, it may be difficult to produce conclusive assessments of their impact and effect. There are likely to be different views about what is to count as an effect of this legislation, and how this is to be measured. This is not a new problem; some years ago John Griffiths drew attention to the distinction between the direct and indirect effects of legislation (Griffiths 1979, pp. 351-6). Direct effects occur when the people to whom the legislation is directed comply with the letter of the rules. Indirect effects are the consequences of that compliance. In the case of the CLERP 9 reforms, the intended direct effects presumably include the delivery of audit services by auditors who are not disqualified by 'relevant relationships' with the audited company. This should be relatively easy to measure. The indirect effects that are hoped for (presumably) are audit processes and reports that are trusted by shareholders and that 'add value' to the company's financial statements. This will be less easy to gauge. One thing is clear, however: the prevention and regulation of corporate wrongdoing and failure cannot be made the responsibility of any one group. Since the 1980s, the roles of directors, senior managers, institutional shareholders and auditors have each come under regulatory scrutiny in Australia. In the United States, lawyers have been added to this list. Problems of corporate governance and accountability are complex; regulatory responses need to avoid attempts at simple fixes.

"See the Sarbanes-Oxley Act of 2002, s. 307 (requiring lawyers to report evidence of material violation of securities law or breach of fiduciary duty to the chief legal counsel or chief executive officer of the company, at first instance, and to the audit committee thereafter!.

10

History and Evolution of Social Accounting

Social accounting and audit is a framework which allows an organisation to build on existing documentation and reporting and develop a process whereby it can account for its social performance, report on that performance and draw up an action plan to improve on that performance, and through which it can understand its impact on the community and be accountable to its key stakeholders.

Definitions

"Social Accounting" is a process whereby an organisation may monitor and evaluate its work, report honestly on its achievement (and failings) and improve its performance through more informed planning and better management. "Social Accounting" engages the stakeholders of an organisation, involving them in the process of assessment and recognising accountability to them. Like any accounting system, to be effective, social accounting must be customized to the needs of each organisation- one size does not fit all. Stating from stated values and objectives, "Social Accounting" isa framework which builds on the existing reporting, compliance and quality standards organisations already have, spotting the gaps to be filled. Talking about "Social Accounts? is expecting to see in them an account of an organisations environmental policies, practices and

impact. The term of "Social Accounting" has led some perceive to it as separate from environmental accounting, rather than another aspect of the same thing. "Social accounting" is about the process of recording, consulting, analysing and then reporting the process.

Social book-keeping: the means by which information is routinely collected during the year to record performance in relation to the stated social objectives.

Social Audit: the process of reviewing and verifying the social accounts at the end of each social audit cycle (the actual audit). The term "Social audit" is also used generically for the concept and for the whole process;

Stakeholders: those people or groups who are either affected by or who can affect the activities of an organisation.

The Background of Social Accounting

Social accounting as an approach began developing in the UK in the early 1970s, when the Public Interest Research Group established Social Audit Ltd. This organisation carried out, and publicised, investigations into the operations of large public companies, without necessarily gaining their permission or co-operation. Whilst lending support to consumer pressure, there is an argument that this had a negative effect on accountability, as organisations sought to ensure that sensitive information was hidden from such investigations. Globalisation has brought with it a wide realisation that companies do not operate in isolation, but can have marked impacts on the environment and people at local, national and global levels. This has led to an increasing awareness of CSR, and the triple bottom-line? of business success n measuring the business not only in its financial performance, but by its social and environmental impact as well. Traid Craft and the New Economics Foundation (NEF) pioneered a form of social accounting in the early 1990s that is voluntary in nature and rooted in engagement with stakeholders. This

can assist organisations, both commercial and NGOs, in understanding and improving their social impact.

Social accounting is a way of demonstrating the extent to which an organisation is meeting its stated social or ethical goals. Whilst independently verified, the organisation itself owns the process of data collection and analysis and the process is driven by indicators the organisation sets in consultation with stakeholders, as opposed to being based on standards or criteria determined externally. This is balanced by the principle of benchmarking, which whilst still developing, should enable organisational comparisons where possible. Technically, the terms 'social accounting' or "social audit" refer to specific parts of a process now bestowed with the much more unwieldy title of "Social and Ethical Accounting, Auditing and Reporting? (SEAAR). In practice, the shorter titles tend to be used interchangeably to refer to the entire process. Whichever title is used, the process should involve all three steps:

- internal data collection and analysis procedures (accounting)
- an independent audit of the results (auditing) a mechanism for disseminating the outcome more widely " (reporting)

A process that stops short of auditing and dissemination is termed a "Social Review".

The Principles of "Social Accounting" Multiperspective

To ensure that the voices of all the key stakeholders are heard and where they are not, to ensure that all omissions are explained satisfactorily. The community sector was early in the field of developing practical and workable methodology for social accounting and social audit.

Comprehensive

To ensure that social accounts are prepared regularly (year-on-year) so that social In Scotland, Strathclyde

Community Business Ltd recognised the need to understand, account for and report on the social benefits of the community accounting becomes embedded within the culture and systems of the organisation, contributing to:

- Management of performance
- The ability to report effectively on what has been done
- Accountability to stakeholders
- Creating recognised through which stakeholders are empowered " to influence the organisation

Comparative

To ensure that the organisation makes year-on-year comparisons of performance, and relates the performance to appropriate benchmarks, and other external standards and also to allow other stakeholders to make comparisons between organisations.

Verification

To ensure that the social accounts are checked and approved by an independent auditor or panel

Disclosure

To ensure that the findings of the social accounts are reported to stakeholders and to the wider community in the interests of accountability and transparency and to develop dialogue with stakeholders about the issues raised.

How is "Social Accounting" implemented? The current practices

The community sector was early in the field of developing practical and workable methodology for social accounting and social audit.

In Scotland, strathclyde Community Business Ltd recognised the need to understand, account for and report on the social benefits of the community businesses which were being established in the 1980s throughout Scotland.

SCBis thinking and experimentation led to what became known as 'the Scottish model? which, blended with the experience of the New Economics Foundation working with Traid Craft pic , was published later in 'Social Auditing for small organisations: the Workbook'. The social audit model described in this present workbook derives from the Scottish/NEF model.

In England, the Industrial Common Ownership Movement (ICOM) through its Beech wood College near Leeds developed during the 1980s a social audit model aimed in the first instance at worker co-operatives. This model was piloted in the early 1980s and has since been developed by the Social Enterprise Partnership into the Social Audit Toolkit and used within the community sector, especially in the context of a number of trans-national European programmes.

In the 1980s, both ICOM and Community Business Scotland included a social audit clause in the model constitutions which they were offering to the cooperative and community enterprises they advised and it is now quite common practice in the UK for community-based organisations to include the commitment to do a social audit within their constitution.

In more recent years the practice of social accounting and audit has begun to expand ignificantly in the community sector.

The Scottish model was tested, by John Pearce of Community Enterprise Consultancy and Research, in the early 1990s with community enterprises in Lothian Region in Scotland and also with worker co-operatives in Nottinghamshire.

The Beech wood model, as developed and adapted by the Social Enterprise Partnership into the Social Audit Toolkit, has been used by a number of social enterprises in the English Midlands and, more recently in conjunction with an OCN accredited course, in the Bristol area.

In Northern Ireland the Co-operative Development Agency (now known as NICDA Social Economy Agency) promoted a training course in social accounting and auditing which has been accredited by the Open College Network. The model used draws both on the Scottish/NEF and the Beech wood models and the training program continues to be delivered regularly.

In Liverpool a Social Audit Initiative was launched by the CBED Unit (Communitybased Economic Development) of the City Council in 1996. Facilitated by John Pearce, the Initiative has made use of an updated version of the Scottish/NEF model and an Open College course was accredited in 1999.

The New Economics Foundation (NEF), in association with the Association of Chief Officers of Voluntary Organisations, attracted lottery funding to run a pilot social audit program for 13 voluntary organisations throughout the UK (Social Auditing for Voluntary Organisations SAVO) between 1998 and 2000. NEF was also associated with a pilot program with four English housing associations, funded by the Housing Corporation.

In Scotland Community Business Scotland Network (CBSN) launched a Social Audit Program in 2000 with two clusters of community organisations undertaking training and preparing social accounts in Craig Millar (Edinburgh) and in rural Aberdeen shire and Moray. A continuing series of training workshops was organised around the country and it is planned to introduce an accredited training course in 2001.

Many other community-based organisations are known to have developed their own styles of social accounting and audit, for example: the Black Country Housing and Community Services Group; Total Coverage (a workers co-operative in Southampton); a group of organisations in Cambria; the Shetland Community Enterprise Network.

In Europe, social accounting and audit has featured in

a growing number of EU funded transnational programmers using both the Scottish/NEF and the Beech wood/SEP models, with increasing evidence of crossover or 'convergence' between the two.

In Italy the social co-operative movement has developed its own form of social balance sheet.

Further a field, COMMACT Aotearoa has run a pilot program for ten community organisations in New Zealand, adapting the Scottish/NEF

model. Community organisations in India, the Philippines, South Africa, Canada and the US are amongst the many others who are now experimenting with appropriate forms of social accounting and audit to suit their needs.

It is not possible to record here all the social accounting and audit initiatives in the community sector nor indeed is it possible to know all that is happening. The experience becomes richer and more diverse all the time and a challenge for those involved is to ensure that lessons learned can be lessons shared and to develop common standards that are relevant and appropriate.

The Need for 'Social Accounting'

If 'Social Accounting' is to move ahead both within the social economy and become a force for change in others sectors, several things need to happen:

The development of models of good practice so that the credibility and legitimacy of the social audit is strengthened.

The approach of 'Social Accounting and Audit' needs to be strengthened and extended within the social economy.

'Social Audit and Accounting' needs to be made more visible as an innovative practice originating from within the social economy, but with increasing relevance to other sectors (public and private/commercial).

CONCLUSION

The conclusion drawn is that social accounting is not a means of, nor an alternative to, impact assessment, but rather a framework methodology into which impact assessment can fit. However, the benefits of the methodology are numerous, including not just an increase in transparency and accountability, but also the development of a focus on organisational learning, the embedding of organisational information systems and the systematic improvement of stakeholder dialogue.

In the corporate world, genuine social accounting has been one of the first major stepping stones in improvements in corporate social responsibility. For many corporates that embark on the process, it is the first time that serious attempts have been made to go beyond financial measurements and understand the social (& often environmental) impact that the organisation has on its stakeholders. Thus such exercises are viewed as a good step towards social impact assessment. However, for many organisations involved in enterprise development, social objectives have often been a driving force rather than a secondary issue. Many of them have struggled since their inception to collect information amounting to a social impact assessment in order to legitimise their existence - to donors, if not themselves. Therefore, whilst the discipline of a methodology for stakeholder engagement and regular reporting will spur the organisation on to improve and embed methods of M&E, the social audit process will not of itself provide beneficiary level impact assessment information, as

some expect. Rather, the hard work of developing good quality monitoring and evaluation systems remains crucial and the need for periodic impact assessment studies will remain.

Social accounting and audit should be an empowering process, not a means of control. The organisation defines its own objectives and values and determines along with its

stakeholder's the indicators to be used to measure performance. The social accounts report on all aspects of the organisations work and performance, not just on those aspects for which it receives funding. For social accounting and audit to work effectively, the funding stakeholders have to come to see themselves as one group amongst a number of stakeholders and to understand (and value) the different perceptions and priorities that different stakeholder groups have. Social accounting and audit will only be empowering if all stakeholders agree to hear the voices of each other and allow the organisation to act accordingly. That empowerment will be debased if one stakeholder group were to seek to determine how the social audit should be done and to use it for its own purposes rather than for the benefit of the organisation

11

Social and Environment Auditing : Theory and Practice

Introduction

The past decade has witnessed a remarkable growth in the number of European companies reporting publicly on various aspects of their environmental and social performance. Whilst for many this has simply entailed providing fairly rudimentary, and generally qualitative, environmental and social performance information within the annual report, leading edge reporters have gone much further. For this latter group, predominantly, but not exclusively, large companies operating in 'sensitive' industrial sectors, the preferred means of dissemination has become the production on an annual basis of a substantial 'stand alone' report featuring copious quantitative, as well as qualitative, data, the reliability of which is increasingly likely to be attested to by an external verifier. My task in the present paper is to attempt some critical evaluation of this latter phenomenon with a view to informing public policy debate. In doing so I draw on my own research experiences and, in particular, my participation as a judge and member of the shortlisting panel for the Association of Chartered Certified Accountants (ACCA) Environmental (later Sustainability) Reporting Awards scheme since its inception in 1991.

SOCIAL AND ENVIRONMENTAL REPORTING AND AUDITING : AN EVALUATIVE FRAMEWORK AND BRIEF HISTORY

The evaluative framework I am operating within derives from the following, fairly widely cited, definition of social and environmental reporting and auditing as being:

> "the process of communicating the social and environmental effects of organisations' economic actions to particular interest groups within society and to society at large. As such, it involves extending the accountability of organisations (particularly companies) beyond the traditional role of providing a financial account to the owners of capital, in particular shareholders. Such an extension is predicated upon the assumption that companies do have wider responsibilities than simply to make money for their shareholders."

Particularly noticeable in the above definition is the lack of any reference to the now seemingly ubiquitous 'business case' for a more environmentally and socially aware approach to corporate reporting practice. Companies going down this route may well find it efficacious in terms of reputation enhancement and risk management, with a consequent beneficial effect on the 'bottom line'. On the other hand they may not, and for me this is of little concern. The whole raison d'entre for social and environmental accounting lies in its potential to make certain aspects of corporate activity more transparent to external stakeholders, who may then be empowered to hold corporate management accountable for their actions insofar as they are affected by them. My standpoint is unashamedly normative and predicated on the notion that conventional accounting (including potentially much social and environmental accounting) practice, with its overriding focus on the interests of wealthy capital providers in, predominantly, western nations is fundamentally flawed and pernicious in its influence. In simple terms, accounting's preoccupation with financial performance as

the sole yardstick of organisational success leads inevitably to its implication in the environmental destruction, social dislocation and exploitation of the weakest members of society consequent upon such a narrow interpretation of 'success'. Current corporate social and environmental reporting initiatives are therefore to be judged on the basis of whether they offer more emancipatory alternatives that may improve the situation in terms of delivering greater levels of organisational accountability.

Whilst social disclosure within the medium of corporate reports is far from being a recent phenomenon, and can indeed be traced back to the beginning of the twentieth century (see, for example, Guthrie and Parker, 1989), the issue first achieved real prominence in the 1970's. This was largely a natural consequence of the debate then raging concerning the role of the corporation in society at a time of rising societal expectations and emerging environmental awareness. More perceptive managements speedily grasped the public relations benefits of producing, at least rudimentary, social reports which attempted to convey a picture of corporate responsiveness to key societal concerns.

Within Western Europe, external social reporting initiatives in the 1970's exhibited an overriding emphasis on the enterprise-employee relationship, largely as a result of continuing debate at that time over the status of labour and its position in the enterprise. A notable exception to the general reporting pattern is, however, provided by the activities of a number of larger German companies, particularly those operating in the chemical and oil industries, whose published *socialbilanz* attempted to present the corporation's performance and results as they affected the total societal environment. Prominent amongst these companies is Deutsche Shell whose 'goal directed' reporting, employing quantitative indicators to describe the attainment of wide ranging social objectives, and attempting to integrate such data with traditional financial reporting, has been (probably largely unwittingly) resurrected in the

new wave of environmental and sustainability reporting initiatives of recent years.

Whereas business experimentation with social reporting in the 1970's was certainly innovative, more so it has to be said on the other side of the Atlantic, the prevailing climate of voluntarism generally produced reports that were largely public relations driven and served to portray the reporting organisation in a favourable light.[1] A notable exception to this general pattern is, however, provided by the activities of the UK based independent research and lobbying organisation Social Audit Limited. Adopting an uncompromising stance of holding to public account the activities of powerful economic entities, Social Audit Limited conducted a number of critical exposes (audits) of the social and environmental performance of major commercial organisations, publishing the results in its journal *Social Audit Quarterly* (1973-6). Not only do these exercises provide a fund of ideas and tools for researchers (and reporters) today, but they also offer a yardstick by which modern corporate reporting initiatives may be judged in terms of the claims made by their exponents that they are informed by the ideals of transparency and accountability[2].

The dawning of the 1980's heralded pretty much the end of widespread experimentation and debate concerning social accounting as the 'New Right' policies of the Thatcher - Reagan era appeared increasingly to hold sway. Admittedly, the employment dimension continued to figure in much reporting practice, with, in the UK, employee consultation issues receiving widespread, if somewhat cursory, attention reflecting largely government initiated moves to weaken trade union influence. Similarly, community issues began to figure in UK corporate reports as the private sector gradually took over responsibilities for regional economic and social development abdicated by central government. However, here again disclosure was very sketchy, and certainly social and environmental issues in general became peripheral, at best, as far as much corporate reporting practice was concerned.

In sum, voluntary corporate social and environmental reporting initiatives prevalent in the 1970's appeared to lose all impetus during the 1980's, apparently reflecting fading public interest in such issues. For Roberts (1990) macro-economic factors, notably rising rates of unemployment consequent upon a slow down in economic growth, were instrumental in focusing attention on economic priorities and away from matters of corporate social performance. There were, however, exceptions to this general rule. Significantly, the public accountability pre-occupations of Social Audit Limited were carried forward by a number of UK Local Authorities which undertook plant closure social audits seeking to highlight the human and public financial cost of the run down of much traditional manufacturing activity in the early to mid eighties (see Harte and Owen, 1987). Of greater long term impact, however, was the tentative flowering of the social investment movement in Europe, with the UK leading the way in the launch of ethical investment funds offering investors the opportunity to invest in accordance with environmental and social, as opposed to exclusively financial, criteria. Despite such activity, and notwithstanding the dramatic growth in recent years of the ethical investment market (see, for example, Kreander, 2001), one would nevertheless have been hard pushed to predict at the end of the 1980's the seemingly inexorable rise in corporate environmental reporting activity which began in the early '90's and has continued to the present day.

The Rise of Environmental Reporting and Auditing

There have been numerous surveys published over recent years of the extent of environmental reporting at a European and wider international level, and a full review is beyond the scope of this paper. A flavour of the growth in popularity of 'stand alone' environmental reports amongst larger companies may be conveyed, however, by referring briefly to the series of surveys published by KPMG on a

triennial basis since 1993. Looking at reporting practice amongst the top 100 companies in eleven countries (including nine from Europe[3]) over the four survey cycles the following pattern emerges;

Year of survey	*Percentage of companies producing a corporate environmental report*
1993	13%
1996	17%
1999	24%
2002	28%

(*Source* : KPMG International Survey of Corporate Sustainability Reporting, June 2002, p.12)

Traditionally, within Europe, German and Scandinavian companies have led the way in terms of numbers of reports published. However, in the latest (2002) KPMG survey the UK has taken the lead with 49% of top 100 companies producing separate environmental reports. Other major players are the Netherlands, Finland and Germany, all exhibiting around 30-40% reporting rates. Also worthy of mention is the significant rise in the number of French companies reporting, up from 4% in 1999 to 21% in 2002, possibly indicating an anticipation of the mandatory reporting requirements introduced from financial year 2002 onwards. Finally it should be noted that the incidence of reporting tends to be skewed between industry sectors, with utilities, chemicals and synthetics, forestry, pulp and paper, oil and gas, and transport traditionally exhibiting higher reporting rates'[4].

That the practice of environmental reporting has grown amongst key market players throughout western Europe is perhaps not surprising in view of the wide variety of influences that have been brought to bear on the process from a myriad of sources. These have included.[5]

- Supra-national bodies. Prominent here have been the United Nations Environment Programme (UNEP)/SustainAbility Engaging Stakeholders initiative launched in 1994, which has served to increasingly turn the spotlight on 'non-reporters', and the European Union's Eco-Management and Audit Scheme (EMAS) with its requirement for disclosure and verification.
- National Governments. Generally the focus has been on encouragement and development of voluntary reporting guidelines, such as the UK Government's DEFRA/DTI Environmental reporting Guidelines published in 2001. As noted earlier, however, France has recently opted for a legally mandated approach, following the earlier examples of Denmark, Norway, Sweden and the Netherlands.
- Who have all provided some, generally limited, legal backing for environmental reporting. Focus tends to be placed, however, on the annual financial report, rather than a special purpose report, as the medium for disclosure.
- Business Organisations. Initial work undertaken by the International Chamber of Commerce (1991) in developing its Business Charter for Sustainable Development has been carried forward in recent years by the World Business Council for Sustainable Development. Additionally, business groupings at various national levels, notably the Confederation of Business Industry in the UK, have been proactive in drawing up reporting guidelines.
- Industry Associations. Perhaps best known here, certainly in Europe, are the European Chemical Industry Council's (CEFIC) Responsible Care Programme's reporting guidelines.
- The Accounting Profession. The umbrella organisation for the European accountancy

profession, the Federation des Experts Compatables Europeens (FEE) has been particularly active in developing both guidelines for providing assurance on environmental reports and a conceptual framework to underpin such reporting. Additionally, international accounting firms have been heavily involved in verification and consultancy work, whilst national professional bodies have actively promoted research into environmental (and social) accounting issues.

Prominent amongst the latter has been the UK Association of Chartered Certified Accountants (ACCA) which, amongst many initiatives, launched an Environmental Reporting Awards Scheme in 1991. The scheme has grown over the years to encompass the sustainability and social reporting, in addition to environmental reporting, dimensions and has also given rise to the launch of a European Awards Scheme (EERA) in 1996 which now draws on contributions from accountancy bodies in fifteen European countries[6].

Significantly, increased incidence of environmental reporting has been accompanied by a discernible improvement in the quality of reports produced. Early disclosure initiatives largely consisted of providing sketchy, generally qualitative, information within the annual financial report, or the production of a separate 'green glossy' amounting to little more than a crude publication relations exercise. As Adams et al (1995) put it in their study of disclosure practices in 150 of the largest European companies;

> "the typical company provides purely discursive information, describing only some of its activities in some sectors (often only for domestic operations) with no information on external benchmarks or plans and fails to place information provided in any context".

A sense of continual improvement from such a low base level is, however, clearly conveyed by the successive annual

reports of the judging panels for the ACCA UK and European reporting awards schemes. Here, for example, we find reference to improvement in structure and content, with fewer blatant public relations exercises, a willingness to convey bad, as well as good, news, continual improvements in the reporting of performance against stated quantified targets, an increased prevalence of verification statements and the steady development of industry wide performance indicators enabling intra-sectoral comparisons to be made.

Notwithstanding the absence of definitive regulatory guidance, a coherent and comprehensive reporting framework has also steadily emerged. One can now expect the typical stand alone report[7] to feature:

- **An organisational profile** presenting an overview of the organisation in terms of size, markets served and key environmental impacts.
- **Evidence of board level commitment,** generally comprising a statement from the organisation's CEO which explains in broad terms the environmental management strategy being pursued.
- **A (definitive) environmental policy statement** committing the organisation to pursue specific goals and objectives in terms of managing, measuring and reporting environmental performance. The policy statement is used as a basis for generating comprehensive and detailed targets against which performance may be measured.
- **Targets and achievements** addressing key issues concerning, for example, natural resource and energy usage, waste generation and emissions to air and water.
- **Performance and compliance data** employing physical and financial measures in order to demonstrate progress towards achieving stated performance targets. Increasingly, physical data is

set in context via benchmarking against statutory limits or industrial averages, and normalised data (i.e. presented in terms of quantities per unit of product etc.) employed to give an indication of efficiency and performance improvement. Financial data predominantly comprises selective investment figures and cost savings achieved through the establishment of more efficient environmental management procedures, although leading edge companies are increasingly employing activity based costing techniques to capture and disclose more fully environmental expenditure.

- **Environmental Management Systems** are described which pinpoint repsonsibility for managing various aspects of environmental performance. One can also expect to find here information on internal environmental audit procedures and progress towards certification standards such as ISO or EMAS.
- **An independent Verification Statement.** Whilst initially verification centred mainly on systems compliance recent practice has addressed more complex issues such as completeness of reporting and acceptability of performance, whilst also offering recommendations in terms of systems improvement, performance and disclosure practice.
- **Site level data** is provided for organisations operating from multiple sites. Generally, this comprises brief summarised qualitative and quantitative data (*e.g.* physical indicators, key actions undertaken, serious incidents and detail on the environmental management system employed). Transparency of local operations is often heightened by specifically naming a management contact on site.

Leading Edge Environmental Reporting Practice : A Critique

As the above, of necessity brief, overview indicates,

corporate environmental reporting practice amongst its leading edge exponents has made considerable strides in terms of rigour and completeness over the past decade. It is however now appropriate to strike a somewhat cautionary note.

At the outset it must be stressed that the reporting practice I have been describing is a minority pursuit even amongst the largest (top 100) companies in all European countries. Far too many significant players in environmentally sensitive industries continue to supply, at best, brief and rudimentary information as part of their financial reporting package. Outside of the top 100, amongst 'second tier' companies and SME's environmental reporting is largely conspicuous by its absence[8].

Even amongst leading edge reporters a number of problem areas remain. Recent ACCA and EERA judges reports, for example, draw attention to reporters not making clear their strategic priorities and thereby failing to prioritise targets, with the result that a mass of often over-aggregated data is produced which is difficult for the reader to navigate his, or her, way through. Additional problems typically identified are that links to financial reporting are often unclear and explanations of performance variations lacking, with more attention needing to be paid to trend analysis thereby enabling some interpretation of performance improvement or deterioration.

Of course, it may be argued that weaknesses such as those outlined above are only to be expected at this stage of development of environmental reporting and, judging by the experience of recent years, improvement can be confidently anticipated. However, certain problem areas appear to be somewhat more intractable. Prominent amongst these is the vexed issue of report verification. Reference has already been made to the fact that verifiers have recently shown more willingness to address issues such as completeness of reporting and acceptability of performance in contrast to their earlier virtually exclusive

focus on systems compliance issues[9]. However, a fundamental issue remains concerning the independence of the verification process. Put simply, verifiers are appointed by corporate management and effectively report their findings to corporate management. A clear contrast can be drawn here with the financial audit process where, at least as far as legal theory is concerned, auditors are appointed by shareholders and report to the same constituency on management stewardship of funds invested.

The issue of verifier independence is, in fact symptomatic of a much deeper problem. This is the prevailing confusion as to the stakeholder groups the company is seeking to communicate with via the environmental reporting process, and, equally fundamentally, how such groups are to be able to use the information provided, and verified, in order to hold management accountable for their actions. Little real thought seems to have gone into the corporate governance ramifications of environmental reporting, save possibly for the Turnbull Report's (1999) reference to issues of risk management together with some vague notions of enlightened self interest. The latter pre-occupation is neatly summarised in the 1992 report of the ICAEWs Environment Research Group which suggests that:

> "A company will be wise to ensure that appropriate information is provided to all those groups - whether they are groups with which it has direct contract, or in society generally - which are in a position to take action, in the light of their perception of a company's environmental performance, that may directly or indirectly affect the company's present or future position."

Unfortunately, as Tricker (1983) has so cogently argued, such global concepts of general accountably to a wide amorphous set of "stakeholders" are likely to amount to little more than a "mirage of responsiveness to meet pseudo demands".

Clearly, there is a need to prioritise particular stakeholder interests within the environmental reporting exercise and direct reports more specifically towards the information requirements of the selected stakeholder group(s). Should, for example, shareholders be identified as the primary constituency for environmental reports, reporting weaknesses identified earlier, such as a failure to identify strategic priorities and lack of integration with the financial report in terms of clearly identifying the "bottom line" implications of the company's environmental management strategy, must be urgently addressed. Indeed, serious reservations can be expressed as to the efficiency of a separate environmental report for communicating with the shareholder group whose primary focus is always likely to be the annual financial report.

Even a casual reading of the overwhelming majority of environmental reports produced over recent years does, however, suggest that shareholders are not the only, or indeed primary, stakeholder group of concern. Clearly there is an apparent desire expressed, at least implicitly if not always sufficiently explicitly, to address a much wider audience. This observation gives rise to the identification of the most fundamental problem area with the initial wave of environmental reporting exercises - namely a tendency to privilege the physical environmental dimension to the almost complete exclusion of the social.

Given that companies going down the environmental reporting route invariably claim to be committed to pursuing **sustainable** business practices in response to the

10

agenda laid down in the Brundtland Report (World Commission on Environment and Development, 1987), omission of any consideration of the social dimension is unfortunate in the extreme[10]. As will be recalled, the Brundland Report was at pains to stress that the environment cannot be considered in isolation from human

actions, ambitions and needs, and clearly underlined that, "... links between poverty, inequality and environmental degradation formed a major theme in our analysis and recommendations" (p xii). In other words, excluding any consideration of the social dimension, or in the Brundtland Report's parlance, issues of eco-justice, in terms of both inter and intra generational equity, results in attention being focussed on merely the symptoms, not the causes, of environmental problems.

Crucially, for stakeholders other than shareholders their assessment of the sustainability, or otherwise, of business performance is highly likely to be informed by social as well as purely environmental concerns. For example, introducing provision of secure employment as one simple measure of intra generational equity can dramatically alter perceptions derived from looking at single dimensional (physical) environmental reports as to a company's contribution to sustainability. The case of the privatised utilities in the UK in the early 1990's provides an instructive example here. Companies drawn from the water, power and telecommunications industries were very much at the forefront of innovative environmental reporting practice, and indeed figured prominently in shortlists of leading reporters in the early years of the ACCA's awards scheme. At the same time, as Shaoul (1998) and Williams and Haslam (1995) for example graphically illustrate, these organisations were busily engaged in shedding labour in order to finance increased dividend payouts to shareholders. Ironically it would appear that what amounts to human wastage here resulted from the same 'efficiency' motive that drove environmental performance. It is indeed difficult to class any societal structure arising from such a process as 'sustainable' however successfully eco efficiency objectives have been pursued.

The overriding problem with the environmental reporting initiatives we have been discussing lies in their virtually exclusive focus as the eco efficiency dimension of

sustainability. Implicit is an assumption that environmental challenges can be met within a 'business as usual' scenario without the necessity of fundamentally re-examining basic social and economic values and life styles. Such a view fails to take on board the complexity of sustainability as a concept within which the eco justice dimension, with its concern with issues on inter and intra generational equity, is central. It is also this latter dimension that is often of primary importance to the stakeholder groups which the reporting exercise purports to address. Provision of secure employment was used as a fairly simple illustration in this context, although many other examples, perhaps most notably community impact issues within both developed and developing countries, could equally well have been employed.

In addition to stakeholder information needs not being met, mention has also been made of the fact that corporate governance mechanisms have not evolved so that stakeholders can effectively use information provided , or highlight information not provided, with a view to influencing corporate decision making. In essence, stakeholders within the environmental reporting process, unlike shareholders within the financial reporting process, appear largely disenfranchised and therefore unable to hold corporate management accountable in any meaningful sense. Interestingly, a new wave of corporate sustainability reporting which arose in the late 1990's, and appeared as largely a natural extension of earlier environmental reporting initiatives, appears, at least on the surface, to address both the problems of information deficiency and stakeholder exclusion. It is to a consideration of these new initiatives in 'sustainability' reporting that we now turn our attention.

The Move Towards Sustainability Reporting

In addition to the predominantly eco-efficiency centred environmental reporting initiatives appearing from the early 1990's onwards an alternative, more socially rounded

reporting somewhat reminiscent of the German *socialbilanz* of the 1970s, has also recently began to emerge. Pioneering this development were avowedly 'values based' organisations, most notably Etodyshop and the Co-operative Bank, whose initial forays into what became initially termed social and ethical accounting, auditing and reporting (SEAAR) were taken up by more mainstream companies in the latter part of the 1990's. Significantly, at the forefront of this movement have been companies who some years previously were equally pro-active in the early years of the environmental reporting revolution. Prominent examples here are the oil giants Shell and BP Amoco and privatised utility conglomerates such as BT and United Utilities. KPMG's (2002) survey referred to earlier gives an indication of the growth of this phenomenon in noting that amongst their top 100 samples by 2002 approximately one third had incorporated social (and economic) issues into what had previously been a purely environmental report. Indeed, the scale of change has been such that the ACCA was led to introduce a sustainability reporting category into its long running UK awards scheme in 2001.

Whilst terminology applied to these reporting initiatives varies greatly, with report titles ranging, for example, through 'Social and Environmental', 'Partnership' and Corporate Responsibility in addition to 'Sustainability' , the initiatives have broadly two themes in common. Firstly, some attempt is made to address the economic, environmental and social dimensions within the confines of one report, a process for which Elkington (1997) memorably coined the phrase 'triple bottom line reporting', and, secondly, a commitment expressed to involve stakeholders directly in the reporting process. The latter dimension is clearly evidenced, for example, in reports such as BAA's. 'Towards Sustainability' (1998/99) where it is noted that "This report... is part of our commitment to stakeholder dialogue and our internal drive for continuous improvement' and a reference in United Utilities (2002) 'Social and Environmental Performance Report' to the

development of "...a stakeholder interest map to capture the key interests of our audiences".

Significantly, as was the case for environmental reporting, sustainability reporting initiatives have been accompanied by the appearance of a range of standards and guidelines designed to secure the quality of reports produced[11]. Particularly prominent amongst these are the Global Reporting Initiative's Sustainability Reporting Guidelines (GRI, 2002) and the Institute of Social and Ethical Accountability's (ISEA) Foundation Standard AA1000, originally launched in 1999 and undergoing review at the time of writing.

Originally convened by the Coalition for Environmentally Responsible Economies (CERES) in partnership with the United Nations Environment Programme (UNEP), the GRI has evolved into a multi-stakeholder international initiative incorporating the active participation of corporations, NGO's consultancies, trade unions and accountancy bodies amongst other interest groups. Its overriding aim is unequivocally stated as being to enhance "the quality, rigour and utility of sustainability reporting." To this end, the Guidelines offer a comprehensive set of reporting principles and structured report content that incorporates performance indicators for the economic, environmental and social performance dimensions. Whilst the environmental; indicators, which are able to draw on extant practice, are not surprisingly the most highly developed, the social indicators prescribed are by no means insignificant. These latter address the key areas of labour practices and decent work, human rights, society (including issues such as community impact and bribery and corruption); and product responsibility and certainly present a demanding agenda for reporting companies to follow. Equally significantly, the central importance of stakeholder dialogue in informing the reporting process is made quite clear.

"A primary goal of reporting is to contribute to an

ongoing stakeholder dialogue. Reports alone provide little value if they fail to inform stakeholders or support a dialogue that influences the decisions and behaviour of both the reporting organisation and its stakeholders."

With membership mainly drawn from the corporate sector, consultancy organisations and leading professional accountancy firms, ISEA represents a similar multi-stakeholder initiative avowedly committed to 'strengthening the social responsibility and ethical behaviour of the business community and non-profit organisations'. Unlike the GRI initiative, ISEA's Foundation Standard AA1000 doesn't directly concern itself with prescribing reporting formats, but rather with specifying the internal processes organisations should employ to secure reporting quality. Significantly, the standard clearly notes that, "Engagement with stakeholders is at the heart of AA1000." Underpinning the standard's approach to stakeholder engagement is the fundamental principle of 'inclusivity'. Put simply, this entails the reflection of the aspirations and needs of all stakeholder groups at all points of the process, from issue identification through performance measurement and reporting to the final feedback stage at the conclusion of the cycle. Most fundamentally, attention is also drawn to the necessity for reporting organisations to define governance procedures in order to secure the inclusion of stakeholders centrally in the process.

Taken together, the GRI and ISEA initiatives, along with the growing practical response from economically significant corporates, seem to hold out the promise of significantly enhanced transparency in terms of social and environmental performance and predicate a meaningful extension of accountability to stakeholders. Indeed, the approach advocated and followed appears, at least on the surface, to draw inspiration from the pioneering efforts of Social Audit Ltd. referred to earlier. There is, however, one fundamental difference.

The motivations underpinning Social Audit Ltd's work

are clearly underlined by Charles Medawar, one of the leading figures in the organisation; "We have, in fact, a democratic bias. We believe that corporate power should be exercised to the greatest possible extent with the consent and understanding of ordinary people. We believe that people should be encouraged and allowed to share responsibility, but that, at present, they are not and are imposed upon instead. The question of secrecy and accountability is fundamental here" (Medawar, 1976, p.390, emphasis added).

The radical edge of this earlier social accounting and auditing movement is noted by Geddes (1992) who suggests that it represents nothing less than a fundamental assault on prevailing market-based economic orthodoxy. Not surprisingly, companies didn't buy into this vision and Social Audit Ltd's activities were carried out with a distinct absence of corporate co-operation. By stark contrast, the impetus for the new wave of reporting activity has come from companies themselves, seemingly persuaded by the 'business case' for going down such a route.

It is indeed most noticeable how keen advocates of the new reporting initiatives are to persuade companies how beneficial the process can be. SustainAbility's (1999) *Social Reporting Report* (1999), for example, draws attention to benefits in terms of identification of weaknesses in management control of high risk activities, and enhanced stability enabling the organisation to mitigate against unexpected shocks. For their part Gonella et al (1998) note that;

"A stakeholder-based company is one that in many respects is most fit to take advantage of the technological and regulatory changes that underpin and enable the globalisation of trade, production and marketing" (p.15).

Gonella et al further acknowledge that the process "has a strong emphasis on being useful in managing the organisation as well as increasing transparency and

accountability" (p.81). Interviews conducted with a sample of leading corporate players, representatives of major professional accounting firms, consultants and representatives of NGO's by Owen et al (2001) largely confirm suspicions that a 'managerial turn' is coming to dominate the reporting process. In particular, corporate responses suggested that commitment to stakeholder engagement is largely confined to managing stakeholder expectations and balancing competing interests, whilst leaving much scope for the exercise of managerial discretion. Certainly, there was very little in the way of anticipation of any need to radically overhaul corporate governance mechanisms in order to incorporate systematic reporting cycles.

In essence, as Owen et al (2000) note, the new wave of sustainability reporting is inextricably bound up with a process of stakeholder management that has effectively displaced any meaningful moves towards expanding corporate accountability towards stakeholders. Swift (2001) illustrates this point further in noting that corporations are engaging in stakeholder dialogue and utilising information gleaned for the purpose of self reporting on their trustworthiness simply as part of a reputation building process. Crucially, there are no links to **rights** to information built in, so what are we witnessing is a 'soft' form of accountability at best, with power differentials between the organisation and its stakeholders remaining unaltered.

Lacking in the current voluntarisitic reporting climate is any acknowledgement that substantial elements of largely unaccountable power have to be wrested from narrowly conceived corporate interests if any meaningful extension of accountability to stakeholders is to be achieved[12]. As Frank (2001) so cogently puts it; "What we must have are not more focus groups or a new place where people can express themselves... but some countervailing power, some force that resists the imperatives of profit in the name of

economic democracy" (pxvii). Equally amongst advocates of sustainability reporting there seems little appreciation of the fact that stakeholder conflict, rather than harmony, permeates much economic activity (see Shaoul, 1998), and that such conflict is invariably resolved in favour of the economically powerful shareholder group. As Jones (1999) points out in drawing attention to the continual downsizing of even profitable firms at the bestest of the all-powerful capital markets, we have a situation where an unresistable combination of external financial hegemony and internal bureaucratic control procedures conspire to prevent organisations from being socially responsible in anything but an instrumental sense.

Against such a background, stakeholder dialogue and engagement processes however well meaning are highly unlikely to pose any read threat to the economic 'imperatives' of globalisation which pay scant head to the interests of employees, consumers and communities[13]. Essentially, in the absence of any meaningful reform to corporate governance processes, designed to pass over real elements of power to stakeholder groups other than capital providers, we are left with simply a corporate led dialogue (or monologue?) agenda. The overwhelming advantage enjoyed by corporate interests in terms of the financial and expert power they are able to bring to the process indicates that this can hardly be otherwise. The control the corporate constituency is able to exert is likely to be all the more complete as they are well represented in the workings of influential bodies such as ISEA and the GRI, a situation that contrasts starkly with the very independence from such interests that characterised the work of Social Audit Ltd.

A Tentative Prognosis

Over the past decade, environmental reporting, and more recently sustainability reporting, has become firmly established practice for a sizeable minority of the largest companies throughout Europe. The network of institutional support and encouragement for the process from

government, industry, professional and pressure groups, together with the first forays into legislative requirement in some parts of Europe, suggests that the current reporting wave will not meet the same fate as the earlier 1970's initiatives. One can also confidently predict a rise in the proportion of companies progressing from purely environmental reporting into a more rounded sustainability approach incorporating the social and economic dimensions. The key question is, however, whether or not this reporting development heralds an era of significantly extended levels of corporate accountability to stakeholder groups other than capital providers?

Turning first to the longer established environmental reporting domain, which is likely to remain populated by companies outside the 'top tier' for some time to come, such an extension of accountability is severely limited. Certainly, the degree of rigour now brought to the process by leading edge exponents has achieved significantly increased levels of transparency in terms of the (physical) environmental ramifications of corporate activity. Indeed, for profit seeking shareholders, one could argue that the potential for enhanced accountability is offered, should reports do more to clearly indicate strategic priorities (and related targets) in terms of managing environmental risk and spell out the 'bottom line' implications of the strategies pursued. For other stakeholders however, save perhaps for ammunition being supplied for pressure group activity, it is far more difficult to establish much of a case in accountability terms. This is for two significant reasons. Firstly, in excluding the social dimension reports fail to address key sustainability issues of concern to non-financial stakeholders. Secondly, there is a complete failure to close the reporting loop in terms of establishing appropriate institutional mechanisms for stakeholders to use information gleaned from the reporting exercise in influencing corporate decision making.

For its part, sustainability reporting with its commitment to incorporating the social dimension into the reporting domain offers much in terms of transparency with

respect to issues of key stakeholder concern. Clearly, at this early stage of development a great deal remains to be done as regards the quality and robustness of data disclosure in the social (and economic) spheres. In drawing attention to this issue, the ACCA UK Sustainability Reporting Awards judges report (2002) notes that, "Undoubtedly the new version of the GRI sustainability report guidelines... will aid the advancement of economic and social reporting". Certainly, the take up rate for GRI, particularly on the part of major multinationals across the globe, is encouraging with currently some 140 companies actively using the guidelines in preparing sustainability reports[14].

As noted earlier, the GRI Guidelines present a challenging agenda for would be reporters with reports prepared on this basis certainly achieving a high level of transparency. Significant progress is already being made by leading edge reporters in terms of communicating employment and community impact data, with websites being used most effectively to convey detailed quantitative information. However, huge problems remain to be overcome. Most notably, as the ACCA judges report observes, organisations have to consider how growth in profitability, based on the 'business as usual' scenario that currently holds sway, can be reconciled with the pursuit of sustainable development in a world that is subject to significant ecological (and one might add, social) stress.

A further sensitive issue, just as was the case with environmental reports, concerns the process of verification. At the current time two verification models exist. The first is broadly based on a fact checking exercise, often restricted in scope, and the second intertwines a consultancy role with the audit function in offering direction on overall strategy, thereby raising serious concerns over independence. Clearly, much further thought needs to go into developing a verification process combining independence and rigour with the provision of information that is both intelligible and useful to stakeholders. The cost of such an exercise

would be a far from trivial matter, of course, should there be any desire to match the degree of rigour (theoretically) brought to the annual financial audit exercise. Most fundamentally, the question again arises as to how useful a verification exercise can be that purports to be conducted on behalf of stakeholder groups largely excluded within existing governance arrangements from using the information provided in order to influence corporate decision making.

The essential point, as Owen et al (1997) drawing on earlier work by Power (1994) have stressed, is that administrative reform in the shape of developing new reporting systems, in isolation can do little to achieve real social change. Rather, it must be accompanied by institutional reform designed to empower stakeholders by instituting more participatory reforms of corporate governance. In the absence of such reform, sustainability reporting, however well intentioned its practitioners may be, is highly unlikely to elicit much in the way of stakeholder involvement and hence lose much of its purpose[15]. Surprisingly, for some leading commentators reform is a fairly unproblematic issue. Elkington (2001), for example, in claiming that we stand on the threshold of a new era of stakeholder capitalism, simply suggests that successful companies, "...will have to focus growing attention on business eco-systems of which they are part, seeking to co-evolve with a much wider array of stakeholders...." and,"... business will increasingly find itself with no option but to co-evolve global governance systems appropriate to the 2st century". Unfortunately, information gleaned from current reporting exercises, strongly suggests Elkington's optimism to be somewhat misplaced. Stakeholder dialogue processes appear to be very much one way, company controlled exercises designed simply to canvas stakeholder views on various aspects of performance. It is indeed difficult to see how such initiatives can amount to anything more than sound market research or (the largely discredited) 1980's vintage joint consultation exercises. Certainly, they fall far

short of ISEA's vision of reformed governance procedures designed to secure the inclusion of stakeholders centrally in the reporting, and more importantly decision-making, process referred to earlier[16]. Quite bluntly, reports produced in these circumstances amount to little more than fashion statements rather than offering a means of enhancing public accountability.

Looked at from a UK context, I must confess to much pessimism concerning the likelihood of institutional reform. The long drawn out deliberations of the UK Company Law Review Steering Group have resulted in a White Paper (cm 5553, Modernising Company Law, July 2002) which simply concludes that; "...the basic goal for directors should be the success of the company in the collective best interests of shareholders, but the directors should also recognise, as the circumstances require, the company's need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the company's impact on the community and the working environment."

Whilst for economically significant companies some provision is made for publication of environmental and social information in a (to be legally required) Operating and Financial Review Statement this is subject to relevance and materiality considerations[17]. Significantly, the White Paper notes that, "It will, of course, be for directors to decide precisely what information is material to their particular business."

For the UK then, voluntarism prevails and a meaningful extension of corporate accountability to stakeholders is off the agenda. Of course, for a number of countries in mainland Europe, a more pluralistic route in corporate governance matters has been followed in post war years. It remains to be seen whether progress along these lines is continued and social and environmental reporting thereby established as a truly worthwhile exercise. However, here again, the climate of voluntarism underpinning corporate

social responsibility issues subscribed to by the European Union gives little cause for real optimism. At the present time we simply appear to be drowning in a sea of stakeholder rhetoric which, in the current political and economic climate, leads us up a blind alley as far as extending corporate accountability is concerned. Reference was made earlier to a recent significant growth in the ethical investment market. Given the absolute primary awarded to the interests of financial capital by European legislatures it can be argued that, for those seeking to promote the cause of corporate accountability, focussing attention on the operations of the capital markets, in particular the unaccountable power wielded by institutional fund managers, offers more hope of success than engaging in corporate controlled stakeholder dialogue processes.

NOTES

1. Significantly, in a European context, the only legally mandated social reporting introduced in the 1970's the requirement for larger French companies to produce an annual social balance sheet *(bilan social)*, confined itself to matters appertaining to employment issues.
2. See Gray et al, 1996 chapter 9 fora fuller analysis of the work of Social Audit Ltd.
3. The European participants are Belgium, Denmark, Finland, France, Germany, Netherlands, Norway, Sweden and the UK, with the other countries represented being the USA and Australia.
4. Interestingly, communication and media companies also figured strongly in 2002 with a 46% reporting rate.
5. For a fuller discussion of these, and other, initiatives see Gray and Bebbington (2001).
6. For further information on the UK and European awards schemes, including copies of judges reports, go to www.accaglobal.com/sustainability.
7. Other reporting formats worthy of mention are EMAS reports which tend to be light on detail and relate only to individual sites and eco (or mass) balance reports. The latter are very

much confined to Austrian, German and Swiss companies, and whilst scoring highly on the completeness criterion in their identification of physical qualities of inputs, outputs (products and waste) and leakages and emissions from the production process, pose distinct problems in terms of comprehension.

8. For an empirical study and discussion of this issue in a UK context see Jackson *et.al.* (2000).
9. For a more detailed critique of these early verification exercises see Ball *et.al.* (2000).
10. Fora fuller elaboration of the following analysis see Owen (1995).
11. For a comprehensive description of the major social sustainability standards, see Henriquesand Raynard (2001).
12. The issues touched upon here are considered in more depth in Owen *et.al.* (2001).
13. Prominent amongst these processes are questionnaire surveys, interviews, focus groups and public meeting.
14. This figure is per a list updated on 5th August 2002 accessible at *www.globalreporting.org/GRI Guidelines/reporters.htm*
15. See, for example, the experiences of BT (*Ethical Performance,* Vol. 1 No. 9, 2000, p.8) and BAT (Ethical performance Vol. 4, No. 4, 2002, p.8)
16. A very rare example of a company beginning to address the corporate governance issuesof stakeholder based reporting is provided by the UK lottery operator, Camelot. Here, an advisory panel, consisting of individuals with professional expertise in stakeholder concerns, oversees the reporting process and advises on strategic matters. The panel is chaired by a non-executive director thereby providing a link to board level decision making.
17. On the criteria adopted this would cover about 1000 companies (i.e. less than 0.1 per cent of registered companies) responsible for about a quarter of corporate economic activity in the UK (cm5553, s 4.37).

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