THE ROLE OF AUDITING IN THE PUBLIC SECTOR

Maria da Conceição da Costa Marques, MsC
Master in Accountancy and Business Finance
Lecturer at the Instituto Superior de Contabilidade e Administração de Coimbra

e-mail: conceicao.m@netcabo.pt / mcc@ci.uc.pt

ABSTRACT

The enveloping program of reforms conducted by general governments has had as a result a new posture of the Administration towards the citizen, also known as New Public Management. The role of Public Managers now has a greater responsibility, as they must manage public resources with efficacy and efficiency. This new model requires a specialized control on the part of the State, which can control the correct actions to those responsible.

The old procedures for auditing have shown themselves to be insufficient and new mechanisms still have to be installed. The regular practice of auditing in the public sector, that can achieve new results, to evaluate the correct application of public resources, is a growing reality, although there is a long road completion. While advancing in this field, the process is not yet generalized, which can be a greater challenge to the government of a nation.

Public entities and private enterprises labour towards different objectives, use different techniques, which in matters of auditing requires development and adaptation of the appropriate methods for public institutions, in order to fulfill its necessities.

Due to this desideratum, this paper approaches the auditing function and traces the respective model within the context of the public sector, referencing what is done in Portugal in this area.

Keywords: control, audit, management, efficiency.
Introduction

In recent years, in most of the countries of the OECD, a program was implemented that encompasses the reforms and is directed towards introducing an advance in the services provided by general governments, while trying to meet their necessities and ensuring the efficiency and quality of those services, without forgetting the approximation with the citizens.

This new Administrative posture towards citizens is known as New Public Management and seeks to evaluate management in a new framework, which is regulated by the introduction of management models used in the private sector.

On the other hand, recent accounting frauds by large North-America enterprises, created distrust among users (consumers, investors, “stakeholders”\(^1\), etc.) towards most control bodies.

The occurrence of these episodes, with serious economic consequences, became a privileged vehicle with which auditing can conquer its own space of well earned credibility. In this context, auditing also sees its role increased, in the measure that it ensures the collective interest.

This paper refers and develops the latest tendencies in regards to public auditing, and emphasizes the role that the same can fulfill in state organizations.

1. Control and the Public Sector

1.1 External control and internal control

In a Sovereign State, all of the current organisational structures, whether of the State and all of its Bodies, whether of the Private sector, should follow the existing judicial requirements for that specific moment.

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\(^1\) Interested party in financial statements.
Thus being, that the administration and the management of public goods and funds should be regulated by the rigorous fulfillment of the necessary legal requisites, obliging the control bodies to that verification. The enlargement and area of competency for these bodies has as an objective, the role of responding to the demands of modern society.

The State, as a social and juridical entity, has evolved and financial activity has taken a position of notice, which provides a decisive contribution in the building of institutions.

The principle of legality has had throughout the years a role of primordial importance, while today, organisations are faced with a need to conjugate this traditional branch with other indicators which are indispensable to the decision process.

It is fundamental to complete this legal regime with controls over management actions, to be able to evaluate if economic management of (scarce) public resources is performing in a correct manner and if it is a target of specialized control. In other words, if an efficient, economic, equitable, and ecological management of those resources is ensured. It is here that the action of review and control bodies are essential.

In Portugal, the national system for public finance control presents itself as follows:
**External control** has as a main characteristic the fact that it is done by professionals external to the institution, gifted with high level technical and professional qualifications in order to conduct auditing. It is not part of any plan or level of financial management of the Public Sector, also, it can and should evaluate internal control.

The regular and rational use of public funds constitutes a condition that is essential to accurate management of public finances, and towards the objectives that are achieved. This way, so that the whole process can reach the desired efficiency, it becomes indispensable for each State enable an efficient superior auditing entity, conferring it total independency by law.
According to the Portuguese Constitution, the Court of Auditors (AC)\(^2\) is the fundamental entity of the national system of external financial control – as an independent body – that has the jurisdictional powers over all public entities, audits legality, regularity of revenues, public expenses, and appraises the financial management while having the authority to determine financial responsibilities.

Law n. 98/97, of August 26 – law of organisation and Court of Auditors process – consecrates to this body the ability to exert financial control in regards to the portuguese juridical order, both on national territory, as well as foreign. The powers of jurisdiction and financial control of the Court of Auditors encompass the State, Autonomous Regions, Local Governments, public institutes and social security institutes.

Entities with a public or private nature mainly financed by State budget or in which there are public capitals, are also subject to the financial control of the Court of Auditors.

**Internal control** is a company organisational plan that incorporates a set of methods and procedures that ensure the protection of assets and trustworthy accounting records, and that the activity is developed in an efficient way according to management objectives (Marques de Almeida, 1998d, p. 202).

Depending on the dimensions of the organisation, internal control can also assume lesser or greater relevance, being certain that in large organisations, the implementation of an internal control system is absolutely indispensable, in order to secure the fulfillment of pre-established objectives.

In recent years in Portugal, a significant effort has been made on the matter of internal control, since up to 1995 little or nothing had been idealised on the subject. Thus, with Law-Decree n. 166/98, of June 25, the Government has instituted an internal control system of the financial management of the State (SCI), where the importance given by the Government towards the control function is highlighted, while trying to promote the diffusion of a “control culture” in all levels of financial management for the State.

\(^2\) In article n.216 of the Portuguese Constitution says that “The Court of Auditors is supreme authority surveillance in regard to the legality of public expenses and judgement of accounts that the law sees fit to be submitted to it... “
With the institutionalization of the General Inspection of Public Management (IGAP), through the Law-Decree n. 220/98, of July 17, as high level inspection with attribution and competence in strategic control, and under the assumption that by controlling the management of human resources and administrative modernization, it is controlling a large piece of the State Budget, an important and far-reaching step has been taken.

The so-acclaimed modernization of Administration implies that institutions should be evaluated, and also the agents involved, ensuring a model of responsibility and performance indicators for each of the intervenient in Public Management. The IGAP can provide a large contribution in the execution of these objectives at the level of empowerment of the agents and indication of obtained results.

1.2 Reach and effects of control

Control entities can not simply restrain themselves to the control of the strict fulfillment of legality on the part of general governments, they should also lean towards management control, in which there is the evaluation of the accomplishment of goals and objectives. In other words, when controlling the management of a specific public body, the economy, efficiency and efficacy of its actions should be evaluated – the auditing of the three “E’s”, since only in this way can it be confirmed if the programs were followed and if the goals and objectives were accomplished, in accordance to the time and cost conditions.

This path is so important that nowadays it has become usual for the citizens themselves to want to know if public resources were used and invested in an efficient manner, taking into account the satisfaction of the collective needs. According to AECA (2001, p.36), with the control, it is hoped to obtain an appropriate and effective use of public funds, increasing the search for a rigorous management and regularity in administrative action and information.

1.3 Types of control

The control exercised by the Court of Auditors can be previous, concomitant and successive. Previous control is designed to verify if the expense generating
instruments or the representatives of direct or indirect financial responsibilities are in accordance with the law and if they fit the budget.

Successive control or “a posteriori” has as an objective the evaluation of the budget execution of the State Budget (OE) and of the autonomous regions budget in order to provide opinions of the accounts, analyse internal control systems, as well as conducting audits of the accounts.

Concomitant control of the public financial activity, equally provided for in the law of organisation and process of the Court of Auditors (Law n. 98/97), is that which is conducted during the management activity, being a measure that is in increasing use by the Court.

Due to the established functions and existing mechanisms, it is hoped that the auditing function becomes ever more useful and specialized, thus contributing to the betterment of public management.

2. Public Sector Auditing

2.1 Framework

For the IFAC\textsuperscript{3} “Auditing is a verification or examination of the documents of accountability executed by an auditor with the objective of providing him the ability to express an opinion of those documents in such a way as to provide them with greater credibility” (AC, 1999,p.30).

The definition by INTOSAI\textsuperscript{4}, according to the same source, tends towards public finances, as “Auditing is an examination of operations, activities and systems of a specific entity, to verify that they are executed or function in conformity with certain objectives, budgets, rules and requirements”. As can be noted, there are common aspects in both definitions.

\begin{itemize}
\item \textsuperscript{3} Definition given further ahead.
\item \textsuperscript{4} Idem.
\end{itemize}
Referring to public sector auditing, it can be said that it is still far from what is done in the private sector. For enterprises, it is of growing importance that financial statements transmit a true and appropriate image of the financial situation, of the results, and also of the cash flow. For public entities however, what matters is that the management of public funds has been adequate and was regulated by criteria of legality; therefore the traditional branch of public control.

However, these days, new ways of management are being adopted – New Public Management (NPM) – therefore relevance and information transparency are crucial as well as control. The citizen acquires a new role and become a fundamental element for public management, since it is to the citizen that the information will go.

The model for rendering of accounts has been suffering changes, precisely because it is the citizens who, through taxes, finance public activity, thus requiring access to public financial information. It is here that external control or auditing takes on a greater relevance, since the trustworthiness of accounts cannot be guaranteed if it is not accompanied by an auditing report. It cannot be said too often how indispensable the execution of public auditing and the reports of said audits have become.

The operational audit or the economy, efficiency and efficacy audit has a role of relevance in the new layout of the NPM since it introduces betterments in the efficiency and control of the output and in objective management.

Without a doubt, public accounting is an essential piece in the reform process that has been undertaken in the public sector, but there are difficulties in putting in practice immediately the reforms meantime created in this area, difficulties that have several justifications, from result, in large part, the search to obtain rendering of accounts by objectives.

Thus it is ever more imperious to reinforce the regular practice of public auditing, and that it reaches new ranges that can control the correct application of public funds, from a perspective of entity management control, so that in the future it is possible to change to evaluation audits of the quality of provided services, as already
occurred in New Zealand, pioneer country in matters of public auditing (Torres, 2002).

While in enterprises, the financial-economical situation\(^5\) is the target of greater interest, in general governments, the relevance is placed on accurate financial management and the resources of the entity. Since specific characteristics of the enterprising sector are attributed to the State, such as the inexistence of a competitive market, complexity and the time consuming process of decision making, and the strong reaction to change and the difficulty in evaluating the outputs, it is imperative to conduct audits. Even if there are great advancements in this field, the process is not generalized, which in our point of view creates a growing challenge to the governing of nations.

The audit is one of the means that the Portuguese Court of Auditors uses to elaborate the financial control of public entities under its jurisdiction, and given its ample competence and control powers, the audit, beyond financial aspects, increasingly targets aspects of management, environment, social utility, etc (AC,1999,p.30).

### 2.2 International Requirements for auditing the Public Sector

Since the end of the XIX century, specialists in accounting and auditing, especially from advanced countries, have sought to regulate their profession and harmonise and homogenize the requirements, practices and reports. The public sector was present almost from the start, which indicates the level of importance that this sector represents to the auditing profession.

The following graphic gives us an idea of **international bodies** that provide auditing requirements:

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\(^5\) In a profit-obtaining perspective
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<thead>
<tr>
<th>BODY</th>
<th>COMPETENCIES</th>
<th>DESTINATION</th>
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<tbody>
<tr>
<td>INTOSAI- International Organization of Supreme Audit Institutions</td>
<td>Groups supreme auditing entities (control bodies external to the State members)</td>
<td>The requirements approved on October 1991 constitute a reference to the auditing of the public sector</td>
</tr>
<tr>
<td>International Federation of Accountants (IFAC)</td>
<td>Created in 1977, heir and agglutinative of different international organizations of accounting and auditing professionals</td>
<td>Developed complete auditing requirements, which are a reference for the profession all over the world. In a later phase a comment has been added to each of the requirements about the application of the requirements to public sector auditing</td>
</tr>
<tr>
<td>IGAE – Intervención General de la Administración del Estado</td>
<td>The requirements established by the IGAE are applicable to all audits that are executed in the Spanish Public Sector of the State</td>
<td>The requirements should be observed by OCEX⁶, and by the private auditors that develop work for the public sector.</td>
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Table 1 -  *Source: created based on AECA, p. 95/97*

### 2.3. Types of auditing in the Public Sector

From the Declaration of LIMA on the basic lines of auditing, approved in the IX Congress of INTOSAI, there resulted the necessary inter-relation between control and public financial economy (AECA, 2001, p.101), becoming a regulating mechanism for legality, profitability, utility and rationalization of financial operations, to the point that it is used as a corrective measure. Consequently, auditing is a technique in the service of necessary control, but should not be considered as an end unto itself.

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⁶ Bodies of External Control of autonomous communities.
Thus results that the techniques and procedures of auditing cannot be the same for all control objectives, some of them having to be adapted to the intended goal. So, several types of auditing can be defined, in accordance to the target objective:

<table>
<thead>
<tr>
<th>Types of Auditing</th>
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<tr>
<td>Financial Audit</td>
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<tr>
<td>Audit of Legality Concordance</td>
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<tr>
<td>Audit of Efficacy or of Programs</td>
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<td>Audit of Economy and Efficiency</td>
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<td>Audit of Systems and Procedures</td>
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<td>Regularity Audit</td>
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<td>Operational Audit</td>
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<td>Comprehensive Audit</td>
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Table 2 - Source: AECA, 2001, p. 102

Pina, V. y Torres, L. (2001) organize control and auditing in the public sector as follows:

<table>
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<tr>
<th>CONTROL AND AUDITING IN THE PUBLIC SECTOR</th>
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<td>In function with the dependency of the Auditing Body</td>
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<td>In function with the objective</td>
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<td>In function with the moment</td>
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Financial auditing as for an objective the obtaining of reasonable assurance in accounts and to verify if the financial statements under analysis express, in all of its significant aspects, an image that is faithful to its patrimony, of the financial situation and the results of management, in conformity with the generally accepted accounting principles. In Portugal this is called Legal Certification of Accounts\(^7\).

In the public sector, these audits don’t represent significant differences towards the private sector. Excluding the “actors”, the existing differences are those that are related to the accounting and budget control, with the contents of accounting and with the users of financial information.

In the field of international harmonization of accounting and auditing principles and requirements, with the creation in June 1986 of the Public Sector Committee, the permanent committee of the Council of the International Federation of Accountants, there is a contribution to the coordination and harmonization of the necessities relative to financial, auditing and accounting information for all types of public entities (Pina, V. e Pradas, L.,2001). Of worthy note is the effort towards the normalization and harmonization of public auditing on the part of the International Organization of Supreme Audit Institutions –INTOSAI.

Audit of Legality Compliance has to do with the importance given to the following of legal requirements in regards to the public sector. The non-compliance of the legal requirements implies greater consequences to public organizations that to the private sector. Therefore, if among the objectives of auditing there is the verification of legal aspects we are before a model of auditing that is known as Legality Concordance.

\(^7\) Carried out in Portugal by Chartered Accountants.
Audit of Regularity, constitutes the majority of audits that are undertaken in the public sector, therefore the financial audit and the Legality Concordance are included in the same audit.

Audit of efficacy or of programs verifies in what measure the results were obtained and the predefined objectives for the entity, namely programs, services, activities and functions to audit.

Audit of economy and efficiency, deals with the way an entity manages its human and material resources, that is, if it takes economy criteria into account, which means acquiring at a minimum cost and in an efficient manner, thus productively.

Audit of systems and procedures, this model of auditing was designed with the public sector in mind. Before its appearance, its objectives either did not fit in with the area of the audit or were included in either the audit of efficacy or in the audit of economy and efficiency. It is adequate for institutions that have to follow rules and requirements of Administrative Law and have the preoccupation of verifying its concordance, and also has the preoccupation of detecting possible inefficiencies.

Operational Audit, results from the conjugation of the earlier models. The operational audit or the audit of economy, efficiency and efficacy assumes a role of relevance in the context of the New Public Management, since all of the attentions are turned towards the betterment of efficiency, the control of the output and objectives management.

According to Gauthier (cited by Pradas, 2002) “along with the traditional accounting system, which emphasises a concordance with legality, a consensus emerged about the necessity to introduce into the information provided by general governments an operational component which can declare accounts on the accomplishment of objectives in a perspective of efficacy and of efficiency”. Norman, 1995 (cited by Pradas, 2002) indicates that public accounting is “an essential element to the reforms of the public sector”. On the other hand, Pallot, cited by the same author, refers that the “quid pro quo of the augment in management autonomy is in the increase of rendering of accounts by results and in implementing more accounting practices”.

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2.4 Auditing principles and requirements in the Public Sector

Pina, V. y Torres, L. (2001) refer that the difficulties in establishing technical requirements for auditing which would guarantee the quality of the work, gave place to the consideration of some auditing principles and basic work procedures, generally accepted by the entire profession, which would come to be designated as generally accepted auditing requirements.

In this field, the notable effort of INTOSAI elaborated the Requirements of Auditing for application by the Superior Auditing Entities, of orientation character. Both the auditing requirements for the private sector and the auditing requirements for the public sector refer to the personal characteristics of the auditor, in the execution of the work itself as well as the audit report.

About the professional characteristics of the auditor, the requirements highlight aspects such as technical training, independence, and adequate professional responsibility. In Spain, the “Principles and Requirements of Auditing in the Public Sector” require the following characteristics from the auditor: technical training, and professional capacity; independence; professional diligence; responsibility and professional secrecy. In Portugal, the Court of Auditors on “Principles applicable to Auditors” includes independence, competency and diligence, which also encompass the same characteristics required by Spanish requirements.

The developing work, according to the requirements, should have adequate planning and respective supervision, analysis of the internal control system of the entity and should also determine the range of auditing procedures to apply, with the objective of obtaining elements destined to the elaboration of a valid and sufficient judgment as support for opinions and conclusions. In this manner, during the elaboration of the document it is essential to follow certain principles in the execution of the audit, developed according to the respective requirements:
3. **External Auditing reports of the public sector**

   **3.1 Characteristics and specifications**

The relevance of audit reports for the public sector is different from the audit reports of the private sector, due in part to the following facts:

- the range of users of the financial information of the public sector is much vaster.
- General governments should render account to all citizens.

The intended information by external users vary, even though it must be recognized that there are common points, such as the knowledge of accurate management of public resources and what is hoped they will do in the present and future. Either way, they also demand that the financial information be relevant and trustworthy, which can be obtained through auditing financial statements, with the use of experienced independent professionals.

The citizens want to have access to the information on the actions of the politics they elected, in order to pass judgments and act in conformity if there is such a need.
Only through adequate divulgation of public financial information, so that it is available to all who are interested, whether it be the subject of an audit or not, can a greater transparency of public sector management be achieved. This objective relies on a new philosophy of rendering of accounts, of which the audit report is a part.

In relation to the different types of audits, the following requisites can be included in the audit reports (Pina, V.y Torres, L.(2001)).

It is true that this type of rendering of accounts culture isn’t a part of Mainland Europe, but it is part of the Anglo-Saxon rules. Even after being audited, financial statements need to be divulged, and if they aren’t, it lessens their utility.

3.2 Requirements for the elaboration of audit reports

Once the auditing work is done, a report has to be created, as is defined in several different auditing requirements. For example, the INTOSAI requirements state:

“At the end of each audit, the auditor should prepare his opinion or information in written form, thus evidencing, in an adequate manner, the discovered facts; its contents should be easy to understand, it should be exempt of vague or ambiguous expressions, solely including duly documented information, and also, it should be independent, objective, impartial and constructive.”

According to External Control Bodies of the Spanish State, requirements can be established according to auditing reports, as the following table represents:

<table>
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<tr>
<th>Table of requirements relative to audit reports</th>
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<tr>
<td>Requirements for reports</td>
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<td>Adequate presentation</td>
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<td>Delivery to the receptors</td>
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<td>Adequate preparation</td>
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Regarding the different types of audit, the following requisites may be included in the audit reports of a public entity (Pina, V. y Torres, L. (2001):

### 3.3 Audit of Regularity (accounting and legality)

<table>
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<tr>
<th>Regularity Report Structure</th>
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<tr>
<td>1. Objective</td>
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<td>2. Range and Limitations</td>
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<td>3. Opinion</td>
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<tr>
<td>4. Audited financial statements</td>
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<tr>
<td>5. Conclusions and recommendations</td>
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<tr>
<td>6. Annexes</td>
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</tbody>
</table>

### 3.4 Audit of Economy, Efficiency and Efficacy

Surpassing the existing limitations in an audit of this nature, the reports of an operational audit include relevant information about the economy, efficiency and efficacy of the management of public resources.
The types of opinions used in public entities, coincide with the denominations and with the definitions of those used in the private sector, that is:

- Opinion without reserves
- Opinion with reserves
- Adverse opinion
- Abstain or refusal

### 3.5 Necessity of an external audit report of the simple and independent public sector

About the characteristics and contents of the audit reports of the public sector, the existence of extensive and imperceptible reports in some countries and of synthetic reports in others has been noted. Observe however, that the quality of the information should outweigh the quantity of the same.

Admitting that auditing reports in the public sector would be rigorously equal to those of the private sector, there would be clear advantages to the users, starting with the fact that the familiarization of the model would constitute, at the start, an element in its favor.

But the particularities which ensnare the public financial activities and the distancing of the citizens from general government, when compared to a stockholder of a company, leads to greater expectations from the auditor. In cause are questions
like management evaluation, accuracy of the public financial information, and if in private enterprises the main goal is profit, in public entities it is the providing of a vast range of information.

In the United States, the auditor provides a short report, which is annexed to the audited financial statements, of approximately 15 pages. This synthetic audit report which is annexed to the financial statements, does not dispense with the emission, in an autonomous form, of an analytical report both of the financial audit as well as an audit of legality and performance, as well as other aspects that the auditor considers appropriate. The reasons for the defense of a simple report annexed to the financial statements rely on the fact that it should be understood that it aids the user in formulating a judgment about the accuracy of the audited financial statements. Later, it may become necessary to analyze certain aspects in greater depth, relying at that time on the complementary report.

3.6 Contents of the audit report

The lack of normalization in the auditing reports has led to the auditing reports of the same nature, provided by distinct control entities or by different auditing companies, to present different structures, sometimes even having different contents.

That being said, there are indispensable elements that need to be included in the audit report, but it is up to the external control body to amplify, if it so chooses, the range of information to insert into the report, with the goal of increasing its comprehensibility.

In this manner, the basic elements of an audit report are as follow (Martínez y Fleixas 2002):

- Title
- Destination
- Accounts and Information audited
• Objective
• Responsibilities in the elaboration of the information and in the audit
• Description of the range and process of the audit, as well as the audit requirements applied
• Relevant Comments or Recommendations
• Internal Control
• Opinion
• Date and Auditor information

It is also wise to refer if the audit encompassed the totality of financial statements or only part. On the other hand, the auditor should provide an opinion about the accuracy of the information, the legality of the operations used, and in the case of an operational audit, its results.

At the level of commentaries, suggestions or recommendations, those aspects which need mentioning, for example, the internal control of the entity, these commentaries should be made brief, while indexing the detail to a complementary report.
CONCLUSIONS

The traditional concept of control (based upon legality), entered a crisis long ago. Therefore, General Government and Public Managers have been seeking new forms of management, which will enable them to provide better services to citizens. It is also assumed that the old auditing procedures are in no way sufficient, and that a new control culture is necessary.

In Portugal, there were significant changes in this area, which can be verified by the successive reforms in the Court of Auditors, which provided the adaptation to the objectives of a modern institution of external control.

In public finances, control assumes a relevant role, wherein it guarantees an efficient use of public funds allows a rigorous management and originates corrective measures in the actions of public powers and of the citizens, as fruit of the reports it produces.

The credibility of a Democratic State, which is at the same time efficient and transparent to its citizens also passes through the existence of independent control bodies, gifted with professionals with a high technical and qualified profile, from whom public management has much to benefit from. In function with this point of view and towards the new requirements expected, the regular practice of auditing the public sector will have to be installed.

The auditing function in public organizations is only possible if that culture is installed and is made a part of the rendering of accounts requirements. Then we will stand before a new scenario that passes through a new philosophy of responsibility and accountability, which will contribute greatly to the evaluation of efficiency in the public sector.

In this regard, note that auditing in the public sector requires professionals with a profile that is adequate to the specifics and intrinsic characteristics of this sector, therefore, professionals of exceptional quality. And in this role, it is up to us to
question if the foundations for the creation of a specialized area of chartered accountants has not arisen.
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