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***PLANNING AND DELIVERING A RISK-BASED AUDIT WITH  
REFERENCE TO THE INTERNATIONAL STANDARDS OF AUDITING***

**Audit reports**

*Practice of the French Audit Chambers*

The French chambers review the management of local authorities and local public institutions (hospitals, secondary education establishments, social housing associations, etc.). They may also audit the accounts of semi-public companies and subsidized associations, as well as those submitted by public service delegations. Generally, the chambers undertake these audits within the context of their programme (cf. C. Descheemaeker's presentation). The audits are aimed at reviewing, successively:

- the regularity, that is conformity with the law, of public expenditure and levies;
- economy in the use of public funds;
- the results achieved.

Observations addressed to management form the object of a 'right to reply' procedure, at the end of which the conclusions arising from the audit are made available to the general public.

This presentation is divided into two sections: the first focuses on the methods and procedure of "observation reports" (I), the second on the risks identified in these reports (II).

**I - METHODS AND PROCEDURE FOR OBSERVATION REPORTS**

• **The idea of observation reports**

Once their work is completed, it is essential that the audit chambers report back *directly* to the relevant managers: this enables a "management dialogue" to be commenced, which is necessary for implementing possible recommendations. The audit of financial management, thus, ends in the production of "observation reports" (as distinct from investigation reports properly speaking), written and signed by the president of the chamber. These documents must also be distinguished, in France, from "judgements" passed during audits – conducted simultaneously or not – of accounts produced by public accountants working within local public bodies.

*Administrative interventions (by category of organisation)*

	2001	2002	2003	2004	2005
<b>Organisations subject to the rules of public accounting</b>					
<i>Local authorities</i>					
Final observation reports	244	224	272	256	303
Other administrative interventions	179	220	107	99	125
<i>Local government-owned corporations</i>					
Final observation reports	144	100	223	197	217
Other administrative interventions	125	146	129	228	90
<i>Specialist government-owned corporations</i>					
Final observation reports	134	190	98	143	111
Other administrative interventions	183	269	80	67	58
<b>Organisations not subject to the rules of public accounting</b>					
<i>Semi-public companies</i>					
Final observation reports	23	22	28	43	41
Other administrative interventions	7	6	8	29	8
<i>Subsidized associations</i>					
Final observation reports	33	33	37	47	45
Other administrative interventions	13	13	15	17	11
<b>Total observation reports</b>	<b>578</b>	<b>569</b>	<b>659</b>	<b>686</b>	<b>717</b>
<b>Total other interventions</b>	<b>507</b>	<b>654</b>	<b>339</b>	<b>443</b>	<b>292</b>

Source: Court of Audit, Public Report 2006.

The fact remains that, at the time of the financial management audit, the French audit chambers can refer the case to a specialist administrative court – the Budget and Finance Disciplinary Court (CDBF) – comprising non-elected administrators along with, in certain specific cases restrictively noted in law, locally elected officials. Moreover, when actions are likely to be classified as criminal (corruption, falsification of documents, etc.), the audit chamber has an obligation to inform the prosecuting authorities.

- **Respect for the principle of the 'right to reply'**

In order to protect the reputation of individuals and the financial interests of the organisations being audited, the hearing to consider a report of investigation on management is not public. This is why mechanisms are in place aimed at ensuring an essential right to reply. The two-way nature of the proceedings is an essential guarantee offered to management and the right to reply is enshrined in the profession's "guidelines".

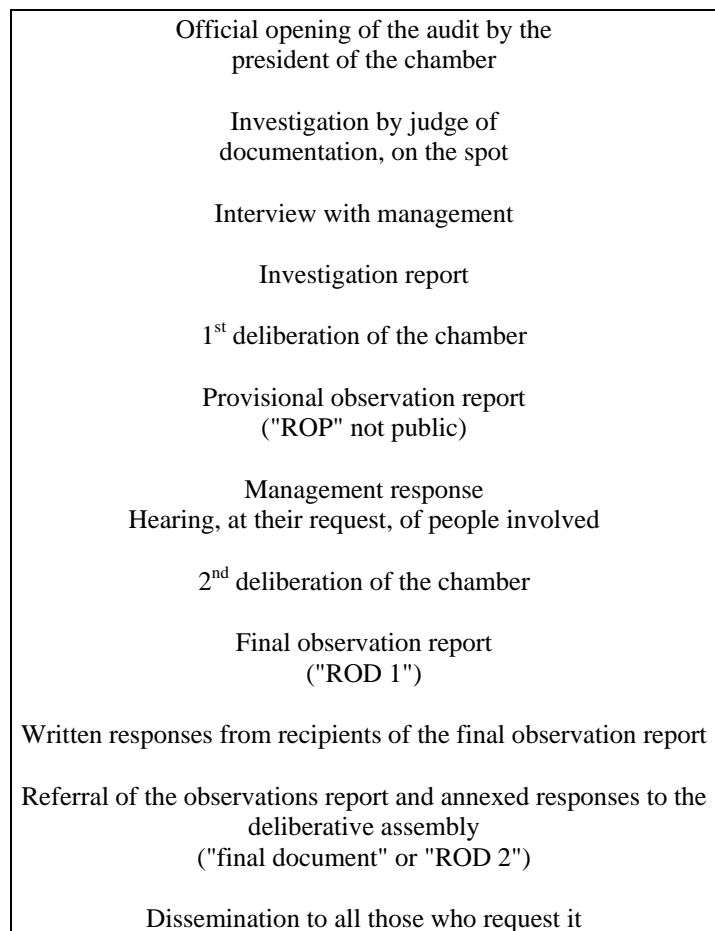
Management has the right to respond, within a period of at least two months, to the "provisional" (confidential) observations formulated during the first deliberation of the collegiate body (see table below).

In the course of the second deliberation, the chamber judges make their "final" observations in the form of an observation report.

Management, where appropriate assisted by its advisor, has the option of being heard prior to this deliberation, as do any possible third parties involved.

These guarantees are offered to all managers in post at the time of the noted facts.

Before being referred to the local authority assembly for discussion, the final observations report may, within a one-month period, form the object of a management response, which is then attached to it.



- **The recipients of management observations**

The main recipients of the observation reports produced at the end of the audit are the local executive and its deliberative assembly. A copy of the report is sent, for information, to the *Préfet* and to the senior accountant in the public finance office of the *département*.

In addition, the audit chambers may also send "administrative" observations to the Court of Audit with a view to possible ministerial intervention in relation to problems raised by the application of certain texts. Where appropriate, the chamber may propose reforms. The annual public reports (general public report) or thematic public reports (specific public report) issued by the Court of Audit, which include the observations made by the regional audit chambers, are sent to the President of the Republic and to Parliament. They are published in the Official Journal and widely reported by the media.

- **Communicability of observations report**

Through its management review and its observations, the audit chamber contributes to safeguarding the financial interests of the organisations which it audits. By informing the

local executives and their deliberative assemblies, it enables them to prevent or correct possible malfunctioning.

The general public are also informed of observation reports. Their dissemination is at the initiative of the main recipients of the report. The content of these reports is, nonetheless, freely available to access. Any member of the general public who so requests, may find out the audit chamber's observations once these have been referred to the deliberative assembly (or more precisely once this assembly has met following communication of the chamber's observations, even if they do not have to deliberate on them). Reports can be accessed on CD-Rom and, for most recent reports, on the Internet server of the audit offices with judicial status ie the Court of Audit and the regional audit chambers ([www.ccomptes.fr](http://www.ccomptes.fr)). This deliberate transparency on the part of Parliament helps to improve local democracy.

- **Recourse to appeal against observations**

The observation reports produced by the chamber do not entail sanctions. They include only findings and recommendations. Not being judicial acts, they are thus not open to appeal. However, the audit chamber does rule on requests to rectify final observations made by senior executives of the audited organisations or by any person involved explicitly or by name.

- **Follow-up to observations**

Once the audit is completed, it is the audit chamber's task to monitor implementation of the "preventive" recommendations formulated and possible commitments made by the authority. For this, the chamber establishes a system for monitoring the follow-up given to the audit results. The chamber may have to ask for supporting evidence from the audited organisation in order to be able to undertake this evaluation and it may also decide to organise a "follow-up audit" to check the progress being made by the authority. (cf. *C. Descheemaeker's* presentation).

## **II - THE RISKS IDENTIFIED IN OBSERVATION REPORTS**

- **The idea of risk in the local sector**

1°) The thing that strikes one most in the local public sector is the diversity of tasks and competencies. Decentralisation laws require the French local authorities to now exercise ever greater powers, in the most diverse of sectors. This expansion of their areas of intervention is accompanied by potentially increasing risks:

- financial risks: related more particularly to the methods of external funding of activities and to the budget lines of the public finance department. They may also be the result of a bad *a priori* assessment of an investment transaction or even poor monitoring of subsidized bodies;
- legal, even judicial risks: related, for example, to the award of public contracts, to public service delegations, to the links maintained with associations.

2°) A risk ensues as the result of three factors:

⇒ the impact (in terms of consequence, severity, seriousness or challenge), measured on the basis of financial, legal or even political criteria;

⇒ the probability of risk occurrence (frequency);

⇒ the degree of reducibility (can internal audit bring this risk under control?).

In general, strategic risks (with a strong impact) are identified by the authority and brought under control. However, experience shows that particular attention must be paid to low but recurring risks, neglected within internal audit but the cumulative impact of which may end up being significant.

- **"Auditing internal audit"**

Internal audit is an organisational system that comprises the procedures for processing the accounting information of an organisation, and the procedures for verifying the correct processing of this information. The aim of internal audit is:

- to safeguard assets by implementing procedures that prevent errors (involuntary: errors by omission, data input errors, errors of principle) and fraud (intentional: with or without embezzlement of funds);
- to improve the performance of the organisation by implementing efficient procedures.

This is why, during a financial management audit, at the stage of getting to know the organisation, the regional audit chambers undertake an "audit of internal audit" with a view to understanding the procedures in place and ensuring the existence of good internal audit, in order to guide their investigations and establish the level of depth of the financial management audit. Nevertheless, within a local authority, internal audit does not permit responses to such questions as "What to choose?" or "Which direction to go?". Defining strategies is not the task of internal audit. Other complementary approaches are therefore required.

- **The audit procedure**

There are various possible ways of identifying risks, the three main approaches being the following:

⇒ by objectives: this is a question of identifying the strategic objectives of the organisation, of listing the risks that may compromise their achievement, and then, if necessary, establishing the controls that need to be put in place.

⇒ by risks: this is a question of identifying proven risks for the whole of the area under study, by listing incidents that have already occurred and then complementing this with a consideration of the potential risks inherent to the activity.

⇒ by processes: this is a question of breaking down the authority into processes and sub-processes and understanding their operational objectives before identifying the major risks that may compromise their achievement (for example, for a *département* involved in social and medico-social work: processing of individual requests, etc.).

This last approach, which has the advantage of taking as its starting point the actual activity of the authority's different services and tasks, is often more familiar to a large

authority that may already have commenced a Quality approach. Regardless of structural changes, and based on documentary resources, it enables sectoral risks and responsibilities to be more easily identified.

These three approaches are not, however, mutually exclusive and may be simultaneously undertaken during an audit carried out by the audit chamber.

- **The issue of risks in observation reports**

1°) Detecting financial risks remains the primary objective when analysing the financial situation of local authorities and the basis of the methods used by the chamber.

The survey into "*communal authorities facing serious financial difficulties*", the conclusions of which were published in a public report of the Court of Audit in 1995, showed that a clear deterioration in their financial situation was most often the result of a concurrence of tension factors – a low or even non-existent margin for financial manoeuvre – and the taking of disproportionate risks.

The examples given in the survey show that the greatest risks involve investing in activities aimed at encouraging the rapid economic development of the authorities in question: tourist facilities, rental factories, town and country planning. A paradox may be seen in the fact that activities that are predominantly industrial or commercial are very often the source of the most serious financial difficulties. The reason is undoubtedly that these operations are generally credited with an expected or supposed profitability (without which they would not be initiated) and which, with hindsight, is often over-estimated.

2°) The rules applicable to the local authorities are, in France, the result of a compromise between the need to balance budgets and a desire to give a true and fair of an organisation's financial and assets situation. Regardless of the varied and changing form that this reconciliation of budgeting principles and accounting rules may take, the financial constraints can bring a risk to bear on the quality of accounts, all the more so when the public accountant has no possibility of exercising real control over the accuracy of end-of-year operations.

The 2005 annual report of the Court of Audit gives the results of a survey carried out by the regional audit chambers into the reliability of the accounts of local authorities, highlighting the reality of these risks.

From the point of view of rendering a faithful image of results, this survey highlights a certain number of factors that tend to over-estimate the real situation of the authorities:

- the noting of losses is delayed, for current debts, or incomplete, particularly for significant losses likely to result from the failure of semi-public companies;
- the carrying forward of expenses is common, anomalies having been noted in almost one third of the authorities in the sample;
- the possibility of staggering costs is used excessively, in order to face up to, in particular, exceptional costs that were not anticipated in the formation of provisions;

- the income from transfer of assets remains incorrectly allocated to covering operating expenses, the entry in the accounts not having been correctly anticipated or made.

Since then, changes to the accounting directive applicable to the communes have endeavoured to do away with or reduce some of these dodges.

3°) The audit experience shows that the risks are also related to processes, both vertical and transverse, operational and support.

*Classification of risks identified in observation reports*

- deficient strategy, monitoring and evaluation (absence of tools for transparency of public policies or of operating reports for activities),
- deficient security of information systems,
- lack of knowledge of assets and workforce,
- deficient security of goods and people,
- lack of control over public procurement,
- lack of control over service delegations,
- lack of control over allocations and subsidies,
- lack of security in financial benefits, particularly to individuals,
- failure to respect specific legislation (social support for children, etc.).

Many of the powers or tasks of local authorities may be transferred or entrusted to public or private bodies. This indirect management establishes links and leads to financial risks, making it a special area of application of management audit within the authorities. The authorities' accounts provide little information on those of their commitments which are exposed to risks. Their capital commitments not provided for in the accounts (loan guarantees, leasing agreements still to be covered, subsidies through annuities, other liabilities) are not systematically informed about with regard to, in particular, the category of "other liabilities" likely to result from, particularly, their involvement in semi-public companies. This is why custom dictates that we should consider the right perspective, for an authority, to be that of consolidating risks rather than consolidating accounts.