FINANCIAL AUDIT IN THE CZECH MUNICIPALITIES AND THE LOCAL GOVERNMENTS

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Abstract

The paper deals with some aspects of financial audit in municipalities and local governments provided in accordance with the Act no. 420/2004 Coll., on financial audits in municipalities and the local governments. The paper examines middle-term time data gathered and revealed by the Ministry of Finance of the Czech Republic and compares results of financial audits performed by external audit companies and superior municipalities. An attention is paid to error rates identified on the base of data published in auditors reports and their trends, and to expenditures paid for financial audit services. Considering the fact that financial control by the Act no. 420/2004 Coll. concerns more than 7 000 Czech municipalities and the local government units that administer substantial financial sources, it is evident that the role of financial audit is significant. Gathered data suggests that majority of municipalities prefer its superior municipality to an external audit company for purposes of audit. Possible reasons are commented further. Surprisingly, error rates computed from data published by superior municipalities are higher than those determined from data presented by external audit companies. Financial audit performed by external companies also seems more costly.

Key words: audit, financial audit, public sector, financial reports, financial control

JEL Code: H83, M42, M48

Introduction

Generally, audit can be understood as an examination of quality of something. This paper deals with audit of financial statements in environment of municipalities and the local governments. Public sector units usually dispose of considerable financial and material sources, so effective audit of their financial reports should be very beneficial. The value of public sector audit is closely examined by Hay and Cordery. Their paper (Hay and Cordery, 2017) uses a literature review based on widely-used explanations for the value of auditing in general. These explanations are comprised of an agency role, an informative role, an insurance role, a management control role, a governance role, and a confirmative role. The authors summarize evidence that public sector auditing adds value, and develop suggestions about how its benefits might be increased. They also state that public sector auditing still has not been as widely examined as it should.

Even earlier, Baber (1983) for example explored the role of auditing in the public sector. In his study he has reflected the relationship between the supply of auditing in the public sector and political competition expected in future elections. He used cross-sectional data from the state governments that has indicated positive correlations between state audit budgets and measures of political competition.

Communicative value of audit reports is debated in a study devoted to non-financial information included into audit report (Hecimovic, Martinov-Bennie, 2022). The authors state that despite the organization going to considerable lengths to understand needs of audience and audit criteria while preparing audit reports, communicative value of the audit reports seems still questionable.

A definition of "good auditing" consisting of three principles, i.e. independence, professionalism, and recognizing the people, is presented by Gustavson and Sundstrom (2016). The authors come from few cross-country studies that examine the effects of auditing quality on public sector corruption. According to them auditing may have a positive effect on national level of public sector corruption and if it is organized according to above mentioned principles it may contribute to well-functioning public administration with a low degree of corruption.

Audit quality in the context of the extent to which auditors mitigate management bias in public sector financial reports is examined in a paper that exploits pre-audit financial statements of selected national health service units (Greenwood, Zhan, 2019). The authors find evidence that auditors act to reverse management bias in the case of a pre-audit deficit, but find no similar evidence in the case of pre-audit surplus. So the authors infer that in the case of surplus, these findings are rather consistent with interests of auditors being aligned with management, rather than audit principles. The authors seem that both public and non-for-profit managers manage earning to report small surpluses close to zero by managing deficits upwards and surpluses downwards. Under agency theory auditors should act in the interest of their principles and reverse the bias. But the authors confirm this assumption only in the case of pre-audit deficits.

Another study (Barrett, 2012) deals with performance auditing in the public sector. The author examines whether it addresses real or perceived expectation gaps in the public sector. He points out a range of seemingly conflicting observations about the contribution of performance auditing to better public administration. According to the author confusions revolve around differing political and public expectations of such audit, and also the value assessed, reflecting perceptions of assurance and performance, and the coverage of administrative and policy effectiveness. The author also points out the conflict of understanding of what needs to be achieved by those responsible and accountability for the required results in the public administration.

Performance auditing in the public sector was also a subject of interest of a systematic literature review (Rana, Steccolini, Bracci, Mihret, 2021) that analyzed about 125 papers. This review occupies among others with accountability and performance improvement in public sector, tensions and contradictions of influence, independence of performance audit and its other potential conflicts.

1 Main aim and methodology of the paper

This paper examines audits of financial statements performed by superior municipalities and external audit companies under the Act no. 420/2004 Coll., on financial audits in municipalities and local governments and related regulations in middle-term period. It comes from the Ministry of Finance of the Czech Republic database and summarizing reports published by the Ministry of Finance. Under the Act no. 420/2004 Coll., on financial audits in municipalities and the local governments, more than 7 thousands municipalities and the local governments are obliged to undergo the audit in accordance with legal requirements. Obliged units are entitled to select an audit performer, i.e. either its superior unit, or an external audit company but an audit has to be performed in compliance with the above mentioned law.

Main aim of the paper is to determine a share of units that have chosen superior municipalities and audit companies in period 2017 - 2021 and its trends, and to discuss possible reasons. Further, the paper compares audit results in two above described segments of audit performers using error rates.

Error rates are computed with utilization of audit report summaries published by the Ministry of Finance of the Czech Republic (2018 - 2021). Audit results are compared using error rates computed for partial years as a ratio of a specific result type to the total number of results performed by superior municipalities or audit companies.

Audit results indicated in audit reports can be divided into three types. “Type A” represents report in which no faults were identified. So called “type C” result (more serious) means a breach of budget rules, inaccuracy or incorrectness of accounting, altering of records, overstepping of competences, non-corrections of previous flaws and so on. “Type B” result represents errors other than typ C (less serious). Errors rates were computed for period 2018 - 2021 as the total error rates for result A separately, and B and C (errors) together. Fot the segment of superior municipalities as a performer were error rates further observed separately in given time period. Audit expenditures at both segments of performers were further compared for 2021. Regrettably, earlier data were not accessible.

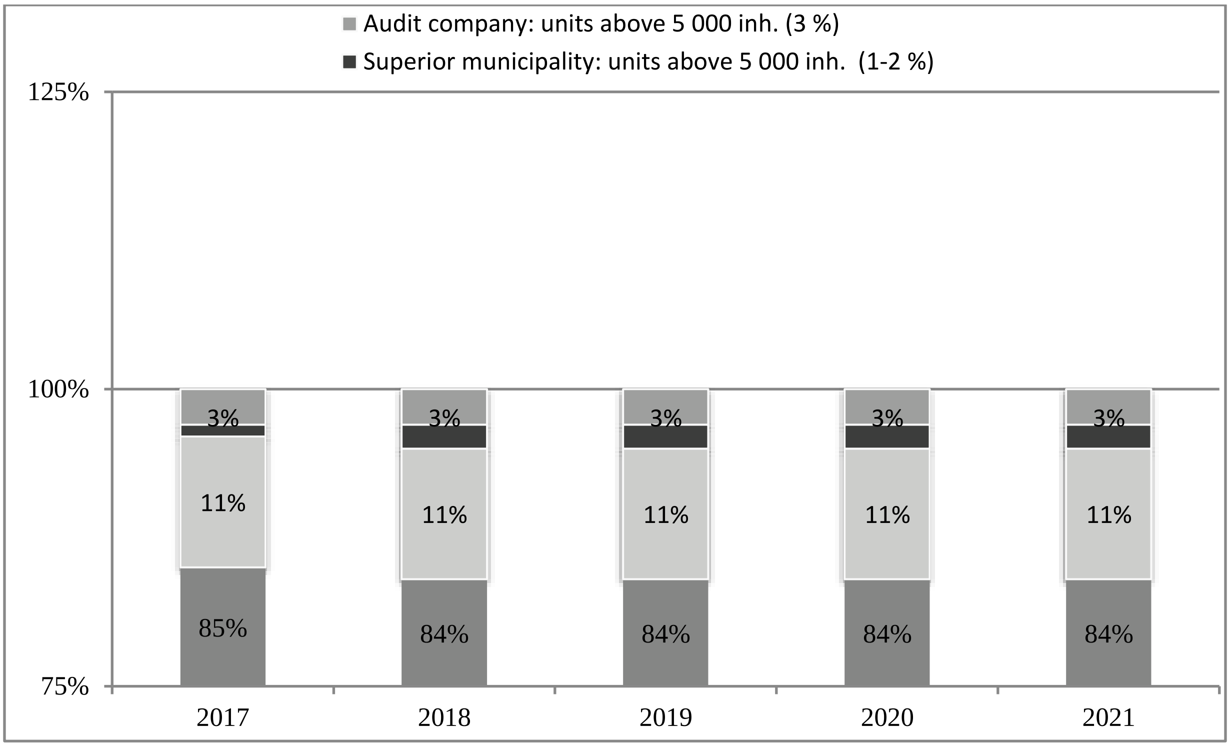
As for main data sources, scientific papers, relating legal regulations, and database of the Ministry of Finance of the Czech Republic, its summarizing reports, and supplements were used for period of 2017 to 2021 (closely see in references). Used results concerned approximately 6 310 public sector units.

2 Research results and discussion

As it was stated before, obliged municipalities may choose a realizer of financial audit themselves. Figure 1 describes a share of superior municipalities and audit companies on financial audits provided in accordance with the Act no. 420/2004 Coll., on financial audits in municipalities and local governments from 2017 to 2021. Obliged units were divided in two groups, i.e. municipalities up to 4 999 inhabitants ("small" units) and municipalities above 5 000 inhabitants for this purpose. Share of small units on the total of 6 310 municipalities observed oscillates around 95 %. As figure 1 implies, vast majority of small units (85 - 84 %) have applied for financial audit processing their superior municipality. Audit companies have performed financial audit in selected period of time for 11 % of small companies roughly. This proportion seems unchanged in the middle or even longer-time period as the Ministry od Finance of the Czech Republic summarizing reports suggests. The same portion can be observed even in 2013 and following years.

In a segment of municipalities with more that 5 000 inhabitants that represent only about 5 % of the total, a situation differs slightly. These units use audit companies for purposes of financial audit more often. Thanks to their small total number also a share of audit companies is very low (3 %), while a share of superior municipalities oscillates about 1-2 % totally. If we look closely at a segment of municipalities with more than 5 000 inhabitants, we can see that about 42 % have used services of their superior municipality and about 58 % services of audit companies. Possible reasons of this state and unvarying trend will be discussed later. A deeper insight into summarizing reports further suggests that this situation varies more significantly in regions.

Fig. 1: Share of superior municipalities and auditor companies on financial audit of obliged municipal units



Source: own processing with utilization of the Ministry of Finance of the Czech Republic database: Výsledky Přezkoumání Hospodaření. Ministerstvo financí České republiky. (2023, May 15). https://www.mfcr.cz/cs/verejny-sektor/rizeni-a-kontrola-verejnych-financi/prezkoumavani-hospodareni/vysledky-prezkoumani-hospodareni

Table 1 presents error rates calculated on the base of results published in audit reports according to a realizer of financial audit. As it implies, total error rates of obliged units where audit was performed by superior municipality fluctuate between 35 and 20.8 % from 2018 to 2021 which means that almost 80 % of audited units have prepared their financial statement without any error in last 3 years (result A). Only in 2018 total error rate has reached 35 %. Number of errors published in audit reports has decreased in reported period of time absolutely and also a time trend has developed positively.

Tab. 1: Development of error rates and audit expenses reported by superior municipalities and audit companies

	2021	2020	2019	2018
Error rate by a type: superior municipality (%):				
- type B errors	52.6	55.7	56.1	59.6
- type C errors	47.4	44.3	43.9	40.4

Total error rate: superior municipality (%): - without error in audit report (result A) - with error in audit report (errors B and C)	 79.2 20.8	 78.0 22.0	 77.0 23.0	 65.0 35.0
Total error rate: audit company (%): - without error in audit report (result A) - with error in audit report (errors B and C) - ambiguous result or no report	 83.0 16.5 0.5	 82.8 17.0 0.2	 81.0 18.0 1.0	 78.0 21.0 1.0
Audit expenses: superior municipality: - bill Czech Crowns - %	 128.8 46.9	 x	 x	 x
Audit expenses: audit companies: - bill Czech Crowns - %	 145.6 53.1	 x	 x	 x

Source: own processing with utilization of the Ministry of Finance of the Czech Republic database: Výsledky Přezkoumání Hospodaření. Ministerstvo financí České republiky. (2023, May 15). https://www.mfcr.cz/cs/verejny-sektor/rizeni-a-kontrola-verejnych-financi/prezkoumavani-hospodareni/vysledky-prezkoumani-hospodareni

Total error rates computed from audit reports performed by external audit companies were lower in comparison with those performed by superior municipalities which is interesting. They have fluctuated from 21 % in 2018 to 16.5 % in 2021, again with decreasing trend. Moreover, low percentage of reports (from 0.2 to 1 %) prepared by auditing companies had ambiguous result or they even were not published by obliged units which is in a conflict with Act no. 420/2004 Coll., on financial audits in municipalities and local governments.

This result may be surprising and deserving a deeper observations, specially when some studies concerning public sector reforms called repeatedly for external audit performers instead of control from the side of the superior municipality referring to bigger independence or objectivity. It seems that a trend of lower error rates in the case of audits companies is constant with a rough difference of 5 %, with the exception of 2018 when it was even 14 %. It is necessary to remind that financial audit is performed by external audit companies only in 14 % of cases, in 86 % of units audit is performed by a superior municipality (see fig. 1). But still, obtained data does not suggest somehow indulgent attitude of the superior authority in comparison to external auditors. Moreover, as for audit expenditures, external audit companies claimed more than 53 % of total audit costs (i.e. 145.6 bill CZK in 2021), while superior municipalities 47 % (i.e. 128.8 bill CZK). Previous data was not possible to gain. A described disproportion between number of audited units, audit results, and audit expenditures in two traced segments should be a subject of further observations.

The Ministry of Finance of the Czech Republic in its summarizing reports publishes among others a deeper insight into type of errors on the base of a methodology of the Act no. 420/2004 Coll., on financial audits in municipalities and local governments and further regulations (see chapter 1). As tab. 1 implies, errors indicated as C (more serious) have represented from 40.4 to 47.4 % between 2018 and 2021 while errors of type B (less serious) from 59.6 to 52.6 %. Type C errors have represented less than 50 % of the total in all observed years which may be a positive finding, but their share was growing (about 7 % between 2018 and 2021). On the other hand, the total number of errors and number of B errors identified in financial reports decrease faster in the long term period which means increase of C errors share. According to the Ministry of Finance of the Czech Republic summarizing report for 2021, the main errors of type C related to accounting misconducting, budget rules misconducting, value added tax, and public procurement malpractice.

Act no. 420/2004 Coll., on financial audits in municipalities and local governments enables besides other to carry out partial audits. This enables to spread financial audit into several blocks, to prevent time press, and to remedy possible current errors. Mainly bigger municipalities use partial audits frequently which is also probably one of the main reasons why obliged units prefer their superior municipality to audit company. Further reasons may be lower audit costs, methodical assistance of superior municipalities or the Ministry of Finance, a closer knowledge of public financing specifics, flexible or established communications, or others.

Conclusion

This paper deals with audit of financial reports under the Act no. 420/2004 Coll., on financial audits in municipalities and local governments and related regulations. This act obliges more than 7 000 public sector units to undergo financial audit annually and enables them to choose an audit performer. Examined data suggests that vast majority of obliged units prefer their superior unit to external audit company for that purpose. Probable reasons of this state may lie in a possibility of partial audits, methodical support, lower costs, knowledge of public financing specifics, or established communication.

Further comparison of total error rates in audit reports proved that there exist no indications of any benevolence or favoring from the side of superior units as audit performers, when their error rates are slightly higher than in the case of external companies. Moreover, external audit companies are more costly at a significantly lower share of audit performed. Besides, in several cases audit reports prepared by audit companies contained ambiguous results, or their reports were not presented by obliged unit at all which is in a contradiction with law. Closer comparison of audit results seems worthy of further investigation.

Audit under the Act no. 420/2004 Coll., on financial audits in municipalities and local governments and related regulations does not concentrate only on a formal and a content compliance with above mentioned rules, but also refers to 3E principles. So further possible course of investigation could be directed also on this specific area.

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