SUBSTANTIATING THE ROLE AND IMPORTANCE OF PUBLIC FINANCIAL AUDIT IN THE EFFICIENT MANAGEMENT OF PUBLIC FINANCIAL FUNDS THROUGH THE LENS OF PUBLIC SECTOR RISKS

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Abstract: *In this article, the author starts from the observation that public financial management, including public financial control and audit, must take into account the problems and risks inherent in the public institution model itself, but also those specific to a country and its public sector at a certain time. Applying methods such as the method of scientific abstraction, the method of induction, the method of deduction, analysis and synthesis, the author comes to the conclusion that the safest public sectors, implicitly public institutions, are those from countries with developed democracies, namely - Denmark, Finland and Norway, followed by those from Germany and Canada. The following, according to the level of risks, are some post-socialist countries: Estonia, Slovakia, Slovenia, Lithuania, Latvia, Poland. Hungary, Romania and Bulgaria represent countries with public sectors facing high risks related to corruption and government effectiveness. Armenia and the Republic of Moldova face high risks at the level of the sector and public institutions. This finding suggests the conclusion about the lack of efficiency and effectiveness of the internal and external public financial audit activity.*
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JEL Classification: *H5, H6, H83.*

1. Introduction

Internal and external financial audit activities have been expanded worldwide to protect public institutions, including those at the local level. Although numerous studies examine internal financial audit in public institutions and external financial audit of public institutions, providing further development in these areas, none of them dealt with the development and introduction of a specific methodology for identifying and assessing risks in the public sector and public institutions.

A public financial management regime, including adequate public financial control and audit, must take into account the following two categories of problems and risks:

a) inherent in the public institution model itself, but also

b) those specific to a country and its public sector at a given time.

2. The inherent risks of the public institution

Referring to the inherent risks in the public institution model itself (category a), the author considers the following to be the main ones:

- public institutions can use public money for purposes other than those provided by the legislative authority (Parliament, local council, etc.) and the executive authority (Government, town hall, etc.);
- public institutions can convert the national wealth into uses other than those provided by the legislative authority (Parliament, local council, etc.) and the executive authority (Government, town hall, etc.);
- public institutions can, directly or indirectly, increase the public loan beyond the limits approved by the legislative authority (Parliament, local council, etc.) and the executive authority (Government, town hall, etc.);
- public institutions may engage in corrupt practices for the illicit enrichment of ministers, officials or favored friends or complicate the application of anti-corruption rules;

- public institutions can serve as vehicles for the circumvention of financial and administrative rules by line ministries or other parties;
- it is possible that the finances of the public institution are not properly consolidated in the financial reports of the executive authority (Government, town hall, etc.);
- accountability provisions such as transparency, performance reporting, financial reporting, control and auditing may be weak or non-existent;
- the rights of citizens to appeal against the decisions of the public institution may be compromised;
- the executive branch may not have sufficient powers to impose remedies or sanctions when public institutions fail to meet their responsibilities.

It is important to note the following risky situation which, if it exists in a given country, must be fully integrated into a public institution reform strategy:

- qualified personnel, IT systems or public financial funds may not be available in sufficient quantity to achieve the concepts of public financial control, public audit and governance expressed in legislation; even if the legislation incorporates the type of safeguards required, not applying them represents an invitation to failure.

3. Public sector risks from the perspective of public financial audit

In order to argue and evaluate the risks faced by a country and its public sector (category *b* of problems and risks) from the perspective of substantiating the role and importance of financial audit in the effective management of public financial funds, the author developed and applied the following algorithm:

a) at the first stage, indicators were selected that capture the risks and vulnerabilities of the public sector and implicitly of public institutions and that can be mitigated or removed through an effective internal and external financial audit activity;

b) the information sources for the selected indicators were identified;

c) the variation thresholds of the values of these indicators were identified;

d) countries were selected which, in addition to the identified variation thresholds, will serve as benchmarks in the analysis process. We mention, in this context, that countries from the category of developed democracies were selected; EU countries, but with a post-socialist past; CIS countries and countries with poorly developed democracies;

e) the values of the selected indicators were determined for the countries included in the analysis, including the Republic of Moldova;

f) for the selected indicators and the selected countries, the matrix of risks faced by public institutions in these countries was developed and quantified, and the position of the Republic of Moldova among them was identified.

Table 1 presents the indicators identified by the author with their characteristics.

Thus, for the perception and evaluation of the legal risk (related to the legislation) the following are used:

- Rule of Law Index. The Index is designed and monitored by the World Justice Project® (WJP) - an independent, multidisciplinary organization working to promote the rule of law around the world; and
- Regulation Quality Index. The index is designed and monitored by the World Bank Group.

For the perception and assessment of the risk of failure of the government's activity, the following are used:

- Government Effectiveness Index. The Government Effectiveness Index is an index developed by the World Bank Group;
- Shadow economy as a percentage of GDP.

For the perception and evaluation of the risk of corruption, the following are used:

- Corruption Control Index. The Corruption Control Index is constructed by the World Bank Group;
- Corruption Perceptions Index. This index is developed and monitored by the non-governmental organization Transparency International.

Table no. 1. Risk assessment indicators related to public institutions

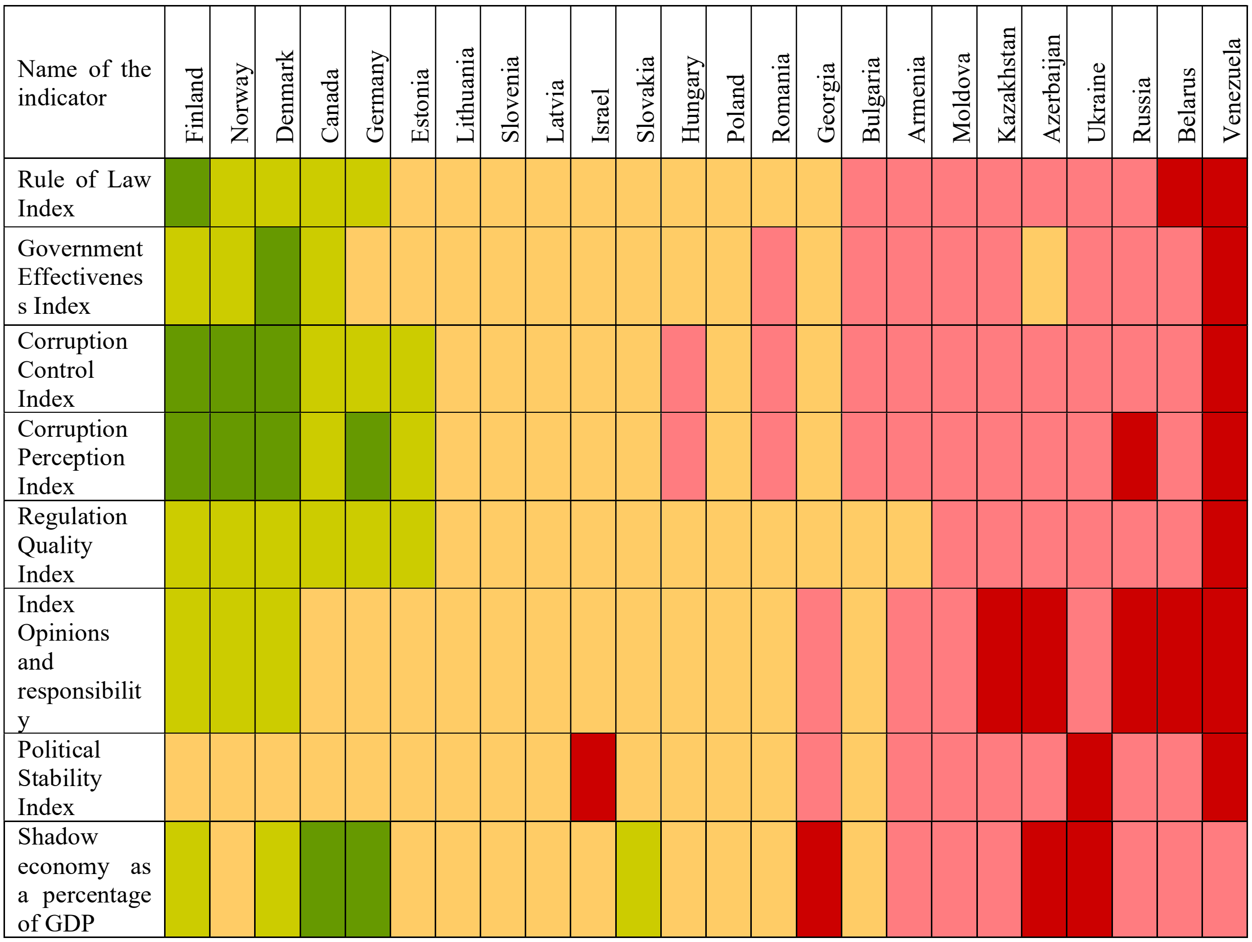
Name of the indicator	Indicator definition	Variation limit
Rule of law index	The Rule of Law Index captures perceptions of the extent to which agents trust and respect the rules of society and, in particular, the quality of contract enforcement, property rights, the police and courts, and the likelihood of crime and violence.	Min. -2,5: (weak level) Max. +2,5: (strong level)
Government effectiveness index	The Government Effectiveness Index captures perceptions of the quality of public services, the quality of the civil service and its degree of independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.	
Control of corruption	The Control of Corruption Index captures perceptions of the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as state capture by elites and private interests.	
Regulatory quality index	The Regulatory Quality Index captures perceptions of the government's ability to formulate and implement sound policies and regulations that enable and promote private sector development.	
Voice and accountability index	The Voice and Accountability Index captures perceptions of the extent to which citizens are able to participate in the election of their government, as well as freedom of speech, freedom of association and free media.	
Political stability index	The Political Stability and Absence of Violence/Terrorism Index measures the perception of the likelihood that the government will be destabilized or overthrown through unconstitutional or violent means, including politically motivated violence and terrorism. The index is an average of several indices, such as those from the Economist Intelligence Unit, World Economic Forum and Political Risk Services.	
Corruption Perceptions Index	The Corruption Perceptions Index is an indicator of perceptions of public sector corruption, i.e. administrative and political corruption. Indicator values are determined by using information from surveys and corruption assessments collected by a variety of reputable institutions.	100 = no corruption
Shadow economy, percent of GDP	Shadow economy as a percentage of total annual GDP. The detailed estimation methodology derives from the work of Medina and Schneider (2018).	

Source: developed by the author based on international statistics.

In the author's opinion, these risks are, on the one hand, important aspects that oblige the institutions responsible for the internal and external public financial audit to immediate detection and management activities, and, on the other hand, the evolution of these indicators, determines the formulation of the necessary conclusions - vis-à-vis the quality of the internal and external financial audit.

The results of the evaluation of these indicators are presented in table 2.

Table no. 2. The matrix of risks faced by public institutions, 2021



Note: The level of risk is established by comparison with the range of variation

Critical risk	
High risk	
Moderate risk	
Low risk	
Acceptable risk	

Source: developed by the author according to the Global Economy International Database.

Depending on the recorded values and the limits related to the indicators considered in this analysis, the author established the following risk categories: critical risk - represented in red, high risk - represented in pink, moderate risk - represented in beige; low risk – represented in light green and acceptable risk – represented in dark green.

From the data reflected in these two tables, it follows that the safest public sectors, implicitly public institutions, are those in countries with developed democracies, namely - Denmark, Finland and Norway, followed by those in Germany and Canada. This finding indicates the existence of one of the following situations regarding the financial audit: - either the political, economic and social environment, being relatively safe, facing acceptable or low level risks, determines the specificity of financial audit activities (the audit has a rather reactive role); - either it is of such a nature, including as a result of internal and external audit activities (audit has a proactive role); - either both situations occur at the same time.

The following, according to the level of risks, are some post-socialist countries, including countries from the former USSR: first of all, Estonia, Slovakia, Slovenia, Lithuania, Latvia, Poland. In this case, the risks faced by these countries are predominantly of a moderate level. This finding suggests the need to intensify and streamline financial audits at the level of public institutions in these countries.

Hungary, Romania and Bulgaria represent countries with public sectors facing high risks related to corruption and government effectiveness. Obviously, these conclusions must be found in the redirection of financial audit activities to eliminate these risks.

The situation of Armenia and the Republic of Moldova is a complicated one in this regard. Both countries face high risks at the level of the sector and public institutions. This finding suggests the conclusion about the lack of efficiency and effectiveness of the internal and external public financial audit activity.

At the same time, countries such as Russia, Belarus, Ukraine, Kazakhstan, Azerbaijan have public sectors and public institutions that face critical risks in certain segments.

We mention in this context that according to the International Standards of Supreme Auditing Institutions, ISSAI, issued by the International Organization of Auditing Institutions, INTOSAI, public financial audit services are intended to provide assurances regarding the financial information prepared by authorities or public sector entities regarding to their use and management of public funds and assets (ISSAI, 2020). The result of public financial audit services, presented in the form of audit opinions and/or reports, can serve as a basis for holding responsible persons accountable. As such, financial auditing is an important part of the accountability process for public finances.

4. Arguing the role of audit in the public sector of the Republic of Moldova through the unfavorable evolution of macroeconomic indicators.

Considering the conclusion of the OECD (2022) which is based on the finding that 11 out of 35 of its member countries have debts of more than 100% of GDP, and the consequences of the Covid-19 pandemic and the military conflict in Ukraine are increasing government spending, good public debt management is essential.

Figure 1 shows the level of public debt to GDP in a range of countries in 2021.

Public sector auditing, including internal and external financial auditing, is required for government accountability, and forecasts suggest these demands will increase. The predictions are based on the reality that resources are limited in the public sector as citizens demand more services, better infrastructure and joint responses to crises (such as the Covid-19 pandemic and the war in Ukraine). Citizens also contribute to governments' limited revenues. To meet the needs of citizens, governments frequently resort to debt instruments, with public debt rising globally; to the request for foreign financing through grants, the expansion of the inflationary phenomenon.

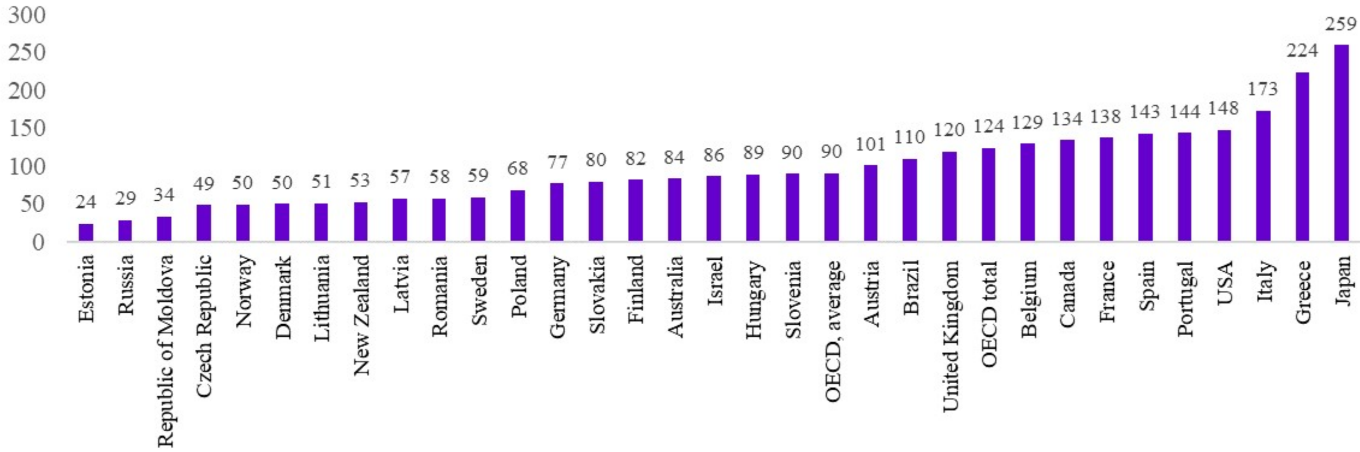


Figure no. 1. Public debt in % of GDP in some countries, 2021

Source: developed by the author based on OECD information (2022).

The problem of public debt, although it is at a low level compared to the countries included in the analysis represented in figure 1, is also amplified for the case of the Republic of Moldova (table 3).

Table no. 3. Evolution of public sector debt in the Republic of Moldova

	2018	2019	2020	2021	2022
Public sector debt, million lei	57,881.3	57,932.5	72,639.4	81,828.3	98,480.9
GDP, million lei	192,508.6	210,378.1	199,734.0	241,871.0	272,555.9
Public sector debt in % of GDP	30.1	27.5	36.4	33.8	36.1

Source: developed by the author on the basis of MF, 2022a.

Table 4 reflects the increase in the budget deficit in the Republic of Moldova, in particular, under the impact of the COVID-19 pandemic (in 2020 it recorded over 5% of GDP) and the war started by Russia in Ukraine (in 2022 it recorded over 3% of GDP).

Table no. 4. The evolution of budget aggregates in the Republic of Moldova

	2018	2019	2020	2021	2022
Expenses and non-financial assets of BPN, million lei	59,608.9	65,975.6	73,269.8	82,013.5	100,374.0
BPN revenues, million lei	57,995.9	62,949.2	62,650.0	77,373.0	91,505.4
incl. grants received in BPN, million lei	387.4	1,602.6	649.6	2,447.4	4,539.4
Budget deficit at the BPN level	-1,613.0	-3,026.4	-10,619.8	-4,640.5	-8,868.6
GDP, million lei	192,508.6	210,378.1	199,734.0	241,871.0	272,555.9
The share of the budget deficit in GDP, %	-0.84	-1.44	-5.32	-1.92	-3.25
Share of grants in total BPN revenues, %	0.7	2.5	1.0	3.2	5.0
Share of budget grants in GDP, %	0.2	0.8	0.3	1.0	1.7

Source: developed by the author on the basis of MF, 2022b.

Partially, as can be seen from table 4, the budget deficit is financed by increasing the public debt, but, for the most part, the grants obtained from the development partners of the Republic of Moldova cover the negative difference between BPN's revenues and expenses. Thus, although under the impact of the pandemic, the share of foreign grants in the total BPN was reduced in 2020 compared to 2019 by 1.5 p.p., in 2022 this indicator reached 5% or 1.7% of GDP.

At the same time, the amplification of the inflationary phenomenon has a considerable contribution to the financing of the budget deficit, which can be seen from the content of table 5.

Table no. 5. The evolution of the inflationary phenomenon in the Republic of Moldova

	2018	**2019**	**2020**	**2021**	**2022**
Consumer price indices (CPI), previous year=100	103.05	104.84	103.77	105.11	128.74

Source: developed by the author based on information from the National Bureau of Statistics of the Republic of Moldova.
Available at: https://statbank.statistica.md/PxWeb/pxweb/ro/40%20Statistica%20economica/40%20Statistica%20economica__05%20PRE__PRE010__serii%20anuale/PRE010100.px/?rxid=8e69070f-3ac5-4b22-ab66-eab8ee8cc25a

In terms of economic trends, the European Commission (2012) and the Mowat Center (2014) highlight resource scarcity as an important trend that future governments will face towards the 2050s and 2030s respectively. Amplifying these conclusions that were formulated well before the COVID-19 pandemic and the war in Ukraine, it logically follows that the Covid-19 pandemic crisis will likely lead to a recession and increase in public debt, making financial resource constraints a major feature for the future of the public sector, despite governments' desires to increase economic growth rates, post-pandemic. Citizens need accountability for any government support given to private sector organisations, as well as any increase in public debt.

Governments are therefore challenged to undertake “a paradigm shift”, “innovation” and “inclusive strategies” (European Commission, 2012), especially since, in addition to the consequences of the COVID-19 pandemic crisis and Russia's military aggressions in Ukraine, natural disasters are also expected to increase (National Intelligence Council, 2012).

5. Conclusions

The conclusion that emerges from these analyses, is that the public audit, especially the financial audit, both internal and external, must be streamlined to such an extent that it ensures, through all the techniques and tools at its disposal, rational use of public financial means. Moreover, it is quite possible that current and future macroeconomic developments will require several cooperative audits (i.e. joint, coordinated or parallel audits).

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