

INTERNAL CONTROL SYSTEMS IN CANDIDATE COUNTRIES

VOLUME I

REPORT TO SUPREME AUDIT INSTITUTIONS
OF CENTRAL AND EASTERN EUROPEAN COUNTRIES, CYPRUS, MALTA, TURKEY AND
EUROPEAN COURT OF AUDITORS

Prepared by the PIFC Expert Group
- Working Group on Audit Manuals -

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LIST OF ABBREVIATIONS

CC	Candidate Countries ²
CCA	Canadian Institute of Chartered Accountants
CEEC	Central and Eastern European Countries
CHU	Central Harmonisation Unit
COSO	The US Committee of Sponsoring Organizations
EA	external audit
EC	European Commission
ECA	European Court of Auditors
EU	European Union
EU Funds	European Union Funds (SAPARD, ISPA, PHARE, CARDS, other)
EUIG	European Union Implementing Guidelines (for INTOSAI Auditing Standards)
EUROSAI	European Organization of Supreme Audit Institutions
FCD	Financial Control Department
IA	internal audit
IAS	Internal Auditing Standards
IAU	Internal Auditing Unit
IC	internal control
ICS	Internal Control System
IIA	Institute of Internal Auditors
INTOSAI	International Organization of Supreme Audit Institutions
ISPA	Instrument for Structural Policies for Pre-Accession
IT	information technology
MF	Ministry of Finance
PHARE	Poland and Hungary Assistance to the Reconstruction of the Economy (European Commission)
PIFC	Public Internal Financial Control
SAI	Supreme Audit Institution
SAPARD	Special Accession Programme for Agriculture and Rural Development
SCC	Supreme Chamber of Control
SIGMA	Support for Improvement in Governance and Management in Central and Eastern European Countries (European Union and OECD)
VAT	value added tax

² Term "Candidate Countries" used in this Report conotates acceding, remaining and future candidates for EU accession: Albania, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, Slovenia, and Turkey.

SUMMARY

Purpose of this Report is to provide an effective overview of the state of development in introducing internal control systems in candidate countries, promote the exchange of knowledge and experiences among SAIs and initiate discussions on further developments in the area concerned.

Chapter 1: describes background and objectives of the Group, provides key definitions, and describes methodologies used in its research and order of its activities in preparation of this Report.

Chapter 2: describes in short the main challenges of introducing modern controls in candidate countries, consistent with international and European criteria and best practices.

Chapter 3: Based on description of existing internal control systems, gives an opportunity to highlight current situation in candidate countries regarding introduction of changes and development of ICSs. It also gives main results and conclusions concerning existing situation and progress made, and main problems encountered through SAIs experience and issues to be addressed for further improvement and development.

Chapter 4: describes a need for development of harmonised principles supplemented by technical guidelines and good practice guide for all candidate countries, its possible content, and supporting activities as the new professional challenge.

Chapter 5: indicates possibilities of modification/amendment/extension of internationally accepted and widely used auditing standards and guidelines in the light of new developments.

Chapter 6: gives general conclusion and highlights the main issues needed to be improved and addressed by the SAIs, all summarized in nine recommendations.

Report is supplemented with annexes containing additional materials that assist in reading and comprehending of the Report, identify good practices and provides some stimulating examples.

CHAPTER I: INTRODUCTION

1. Background

The co-operation between Supreme Audit Institutions (SAIs) of Central and Eastern European Countries (CEEC) started in 1993 when the European Court of Auditors (ECA) organised first seminar of the heads of these SAIs in Berlin, with a goal of creating closer relations. At the following seminar in Luxembourg in 1996, the heads of SAIs agreed to deepen their relationships on a continuous base. During the Presidential Meeting, which took place in Warsaw, in March 1998, the Presidents of the SAIs involved agreed that co-operation would be implemented by working groups, consisted of representatives of interested SAIs, which prepared documents and materials. The output of those groups required approval by the gathering of Liaison Officers representing all SAIs involved in co-operation, while final decisions were made by the Presidents. At the next meeting in Prague in 1999, co-operation was enlarged towards two more candidate countries: Cyprus and Malta, while on the meeting in Cyprus in 2001 co-operation was extended to Turkey as well. Today, Group has 16 members: SAIs from Albania, Bulgaria, Croatia, the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey (hereinafter referred to as *SAIs of candidate countries*) and the ECA. Since the establishment, group of mentioned countries, co-ordinated and assisted by the ECA and SIGMA, was acting through different Working Groups. A number of different seminars and workshops have been organised as topics of common interest could be discussed and best solutions found. Reports of Working Groups were presented and further discussed on regular meetings of *liaison officers*, while their conclusions and recommendations for improvement based on the annual work and activities were presented on annual meetings of heads of SAIs and the ECA.

Almost 10 years latter, *member SAIs* were still showing the need for further, continuous developing and extending the exchange of experiences and practices in the field of their role in audit. One of the topics, on which all members of the Working Group expressed a unanimous interest in, was audit of Internal Control Systems.

Following that, the Presidents of the Supreme Audit Institutions of Central and Eastern European Countries, Cyprus, Malta, Turkey (hereafter: *candidate countries*) and the ECA, at the Meeting in Bucharest in December 2002, decided to extend the mandate of the Working Group on Audit Manuals by establishing the new sub-group on Internal Control Systems. The State Audit Office of Croatia was given the task to prepare a report on Internal Control Systems in above-mentioned countries.

After report has been presented and discussed on the Meeting of Liaison Officers in October 2003 in Luxembourg, sub-group has been extended and renamed in "The PIFC expert Group". Today Group is consisted of the following members:

Maria Kysucka, Head of EU Funds Audit Department / The Supreme Audit Office of the Slovak Republic
Jan Pieter Lingen, Head of Cabinet of Member of the Court/ European Court of Auditors
Mark Babington, Audit Manager / United Kingdom National Audit Office
Rolf Elm-Larsen, Director / The National Audit Office of Denmark
Lidija Pernar, Assistant Auditor General / The State Audit Office of the Republic of Croatia – **chair and rapporteur of the Group**;

with support from **Nick Treen** from SIGMA³/OECD and **Robert de Koning** from DG Budget – PIFC and Enlargement.

2. Objectives of the Group

The intention of the Group is to support the Working Group on Audit Manuals in considering and developing the topic of common interest of all its members, through the following objectives:

- providing an effective update on state of the development in external auditing of internal control systems (ICSs) in candidate countries with the purpose to identify most common problems and to find most appropriate solutions;
- initiating discussions on how to get acquainted with and harmonising of the internal control/internal audit methodology established within the European Union (EU) and meeting the EU requirements; and
- promoting the exchange of knowledge and experiences among SAIs within the Group but also with SAIs of EU Member States, with intention to ensure appropriate, timely and effective ICSs.

3. Methodology and order of activities

After careful consideration of this wide and complex subject and after consultations with other member SAIs, ECA, and SIGMA at the meetings of liaison officers in Malta and Bucharest, outline of the Report has been developed and focused on three major areas:

Audit experience in candidate countries. Based on the follow-up on the implementation of the 11th Recommendation⁴ concerning the functioning of SAIs in the context of the EU accession, adopted at the Meeting of SAIs' Presidents in Prague in 1999, Report should give a brief description of ICSs in countries concerned, position and role of SAIs regarding those systems, recent audits of IC/IA systems and major observations, recent changes in SAI's methodologies, organisation or powers related to auditing ICSs and development of relations between SAIs and Internal Audit Units (IAUs) in public sector.

Application of the Generally Accepted Standards in the management of EU funds. The Report reflects on the EU requirements for financial control and the question how to deal with them more easily. Namely, candidate countries need to adopt and strengthen their procedures for managing and controlling public funds. In this context, SAIs are being asked to be a more proactive in assisting their Countries to strengthen their internal control systems with the aim at meeting EC regulations.

³ SIGMA is a joint initiative of the OECD and the EU, principally financed by the EU to support SAIs.

⁴ See Annex 1 of the Report

To play such an active and important role, SAIs should provide the necessary powers by the legal framework, *complemented by practical guidance which explain how to do this work*. Fully developed control and audit guides for the sound financial management of EU funds have become necessary.

So, one of the questions arisen from this consideration was *Is there a need for development of manuals and/or guidelines for auditing EU funds on the common base for all candidate countries and for all EU funds?*

General principles – new developments? The Report elaborates the general principles for the audit of ICSs in the framework of new developments. They also suppose to be considered and discussed in the framework of EU requirement for public internal financial control (PIFC) and the SAIs' involvement in promoting the concepts of these systems, and technical support when it comes to the question of auditing them.

Existing generally accepted standards are sufficient for financial audit. However, additional attention should be given to the audit of external aid, especially since the concept of managing those funds is different in various countries. In that sense, SAI's standards are likely to be improved and adjusted in a manner to reflect the SAIs particular duties and responsibilities as laid down in the Treaty and the Financial Regulation, and to take the European Community context into account.

As the accomplishment of the presented tasks required precise information from SAIs, a detailed **questionnaire** has been prepared and, together with the letter to the Presidents with explanation of planned activities, sent to all fifteen SAIs concerned. In addition to assist in the drafting of the final report, SAIs have been asked to provide a **brief description** of the ICS that operate in their countries as well.

Based on completed questionnaires, system descriptions, and all other relevant materials, short report has been prepared and together with the first results presented and discussed at the EUROSAI Seminar on Evaluation of Internal Control Systems, held in Prague in May 2003. The draft report has been prepared for the meeting of *liaison officers* in Luxembourg, while final report will be prepared for the Meeting of the presidents of candidate countries to be held in April 2004 in Riga, Latvia, together with the conclusions and recommendations on:

- how to reaffirm benefits of an external audit by SAIs in the area of assessment and development of ICSs, and consequently, to improve the management of public funds,
- how to best promote the involvement of SAIs in control of EU funds, taking into account the varying auditing mandates and systems among countries,
- is there a need for specific guidance for auditing EU funds and how to best respond to that, and at last
- based on experiences and in the light of carrying out audits according to the highest professional demands, to consider whether the need for development of current audit standards has been recognised.

In preparation of the Report results of the following WG's workshops were also taken into account:

- Public Sector External Policies and Standards held on 23-26 June 2002 in Sofia, Bulgaria;
- Methodologies for Audits of Public Internal Financial Control Systems, held on 23-25 September 2002 in Bratislava, Slovak Republic;
- Audit Quality Control and Assurance held on 22-24 October 2002 in Gdansk, Poland.

Conclusions from mentioned workshops are included in the **Annex 7** of the Report.

4. Main areas of consideration

Based on the concept presented above, following issues remain the core of this paper:

4.1. The Definition of Internal Control

The system of internal control is that which is developed to properly control the financial and operational procedures of any entity. Internal control can provide reasonable but not absolute assurance that assets are safeguarded, and that transactions are authorised and properly recorded in a way that allows for the timely identification and correction of material errors. Internal control is based upon a system of management information, financial regulations, administrative procedures and a system of accountability as well as strong formal project management. Internal control also provides a framework for risk management within audited entities, to allow organisations to both identify and mitigate risks.

Internal control is vital to ensure that resources are properly managed, and that accountability is maintained. Internal control systems also contribute towards the regularity and probity of public expenditure and provide assurance that money has been spent and activities have been carried out in accordance with any regulations governing them. In a number of member states and candidate countries internal control systems are also responsible for the management of risk within an entity, namely to prevent the entity from risking financial loss, a risk of failing to deliver its agreed programme of activities, or a loss of reputation brought about by poor management, fraud or corruption. Risk management is not intended to prevent work being undertaken, but to ensure that when an entity undertakes a programme of activities it has considered the risks that it might face, and developed an appropriate system of internal controls to manage and minimize the risks to occur.

Any system of internal control has a number of components. Firstly the system has to be established through financial and procedural rules, the system has to be operated by responsible and appropriately trained personnel, and subjected to independent review to ensure and assess whether procedures are working as intended. Usually this checking and monitoring role will be undertaken by an internal audit unit. Key to the operation of effective internal control is the attitude of the people who are responsible and accountable for its operation.

Management is responsible to establish and organize internal audit as a "supervisory function" within the organization's internal control system and connection between management, stakeholders and external audit., Internal audit also has a role in risk management, and can help in realization of the basic goals of an organization. In effect, internal audit is independent and objective, and provides assurance and consulting activity designed to add value and improve effectiveness of risk management, control and governance processes.⁵

The role of the external auditor will be to assess the work undertaken by internal audit and where possible rely on it. The external auditor may gain audit assurance from an effective internal control system, but to do so will need to ensure that it has operated correctly during the financial period. The external auditor will make a judgement on this following an assessment on the effectiveness of the internal control system, and also an assessment of the reliance that can be placed in the work of internal audit. Guidelines to help this assessment process are to be produced should the proposals made by the working group accepted.

It is important to remember that internal control systems are not just financial systems. They will also be designed to mitigate non-financial as well as financial risks, as it is important that an entity is both able to manage resources effectively, as well as implement an agreed programme. Once established internal control and risk management systems need to be regularly reviewed and updated to ensure their continuing effectiveness.

4.2. Definition of internal audit

Management of each organization (should) establish an internal audit unit in unique position to be able to furnish management with necessary analyses, appraisals, and recommendations. As such, it should provide a service of great value as regards the governance structure.

Internal audit is therefore defined as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps in accomplishments of objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes⁶.

As such, it is an important aspect of an internal control structure. The management of public entities should be clearly responsible for defining the role of internal audit and ensuring that it has an appropriate level of authority and independence, including the right to report to the highest level of management.

A crucial instrument in developing and providing effective internal audit services should be the Central Harmonisation Unit (CHU) – as a centre of excellence and experience.

However, CHUs should not be in charge for internal audit area only. They should be responsible for developing and harmonizing of control and audit methodologies based on EU and international best practice, co-ordinating the further development of sound financial management by promoting best PIFC practice and quality assessment/compliance testing including internal control system and internal audit throughout the public sector.

Role and functioning of CHUs, lessons learned in the past and CHU networking are described more in detail in **Annex 6** of the Report.

4.3. Co-ordination of external and internal auditors

In evaluating the effectiveness of internal control, the external auditor can use the work of their internal audit colleagues, who form one part of the internal control structure, and are well placed to provide the external auditor with guidance as to the effectiveness of the systems that are in place. The external auditor must always remember however, that responsibility for the overall conclusion drawn is ultimately that of the external auditor based on an examination of the systems in place, the quality of the internal audit unit, and the attitudes towards internal control and risk management of the entity under review.

To allow the work of internal audit to be effectively assessed, the external auditor has to understand purpose (role), procedures and methods of internal audit's work, as well as considering the quality of staff and the independence and objectivity that they bring to their work.

4.4. Internal Control Standards

The establishment of those demanding internal control standards is necessary, particularly in government, in view of its size; diversity; the volume of transactions; the multiplicity of records and numerous rules, regulations and laws. Because statutory provisions govern the management and control of public resources and public programmes, standards that govern and ensure such compliance are required⁷.

As a "living document", auditing standards should reflect, to the extent possible, the current trends, issues and concerns in auditing methodology and practice. In our case: current trends in designing, implementing and evaluating ICSs connected with the EU rules and requirements.

5. Risk Management

A very important issue for the development of modern and effective internal control systems and one that should be stressed is the risk management process.

Risk management is the systematic application of management policies, procedures, and practices to the tasks of analyzing, evaluating, controlling, and communication about risk issues. Here risk is understood as the probability for not reaching the objective of the organization.

⁵ www.theiia.org

⁶ www.theiia.org

⁷ INTOSAI Guidelines for Internal Control Standards, Chapter III, par. 16.

This definition links risk management directly to the above mentioned definition of internal control and creates a better appreciation of the two concepts.

Namely, internal control is the system by which the management within an audited body will seek to manage risk. The process begins with an overall strategy which states what each audited body's approach and attitude to risk is, and the policies it has developed to manage risk within acceptable limits. A risk management framework will not totally remove risk, be it financial or non-financial, but the framework in place should explain what level of risk is acceptable to the entity and how it manages its operations to keep risk within this threshold.

In determining risk, it is important that definitions used to categorise and assess risk are clear and consistent within the entity, and that management is clear how it is going to obtain assurance that risk can be handled appropriately.

Risk will always be defined according to what is acceptable to stakeholders. These can be members of the public, management, or political stakeholders within Parliament. To identify and manage risk successfully, management will need to be aware of what risks are acceptable to all stakeholder groups.

For risk to be identified and addressed, it needs to be consistently identified and defined, and needs to be documented and considered by entity management. This allows management to realise that nature of relationships between risks, for instance as one risk increases, does another risk increase or decrease accordingly. When evaluating risk, the auditor and the entity management need to consider the impact of the risk should it occur, and the likelihood of the risk occurring to determine a proportionate response. When considering risks it is important to evaluate possible financial or value for money issues, as well as risks to the delivery of services, the ability to overturn the risk at a later date, the quality of evidence you have about the nature and scale of the risk, as well as its potential impact.

Every risk needs a response. This can range from internal controls to prevent the risk from happening in the first place, to a decision by management that it is willing to accept the level of risk that an activity or project represents. Responses to risk need to be communicated to all of those involved in the risk management process, and the controls in place need to be regularly reviewed to ensure that they remain effective, provide good value for money and are clearly documented so that they can be reviewed by management and auditors alike. The review process should regularly consider the appropriateness of risks, and any changes to the perceived levels of risk need to be clearly explained to allow responses to be amended accordingly. It is important that an independent process of assurance is operated, perhaps through the use of internal audit to advice management whether their selection, evaluation and response to risk is appropriate.

At **Annex 10** is the SIGMA short paper which provides a simple but fuller description and explanation of what is risk management.

6. Rapporteur's note

Sincere thanks to all of colleagues from *member SAIs* who found space, within their busy schedules, to reply on questionnaire and through brief descriptions of ICSs reflect upon the situation in their respective countries and their SAI's approach.

Positive and supporting assistance and ideas given by Dieter Boeckem from the ECA and Ulrika Klingenstierna, Nick Treen, Roger Cazala and Lage Olofsson from SIGMA are also much appreciated and were taken into account in preparation of this Report.

Thanks to all other colleagues from SAIs of both EU Member States and candidate countries, as well as to the experts from European Commission for interesting discussions and useful suggestions made during the EUROSAI Seminar on Evaluation of Internal Control Systems held on 26-28 May 2003 in Prague.

The best way of learning is from the constructive examples and experiences that could be shared among SAIs. That is why we hope that further, more extensive discussions on the areas presented in this Report and continues exchange of relevant information will contribute to a better understanding so that existing problems can be identified, recommendations for improvements made and finally – easier solutions and remedial actions encouraged.

On behalf of the Group,

Lidija Pernar, State Audit Office of Croatia

CHAPTER II: INTERNAL CONTROL SYSTEMS – THE EUROPEAN UNION APPROACH

1. Introduction

There is a crucial role for the external audit to play in the development of effective internal control and risk management (see definitions in Chapter 1). For many reasons, SAIs often have a clearer perception of the challenges and requirements of sound systems of both financial and non-financial control than the government administration. It should be regarded as important part of their role to contribute positively to the enhancement of internal control systems. And it should be done not only by checking existence and evaluating relevance and performance of the systems, but also by disseminating the good practices identified in their audit work.

Raising Parliamentary awareness of the importance of risk management and effective internal control, as well as the awareness in other stakeholder groups should also be important task of SAIs.

In respect of that, the European Commission in the Chapter 28 (Financial Control) negotiations established the main criteria as follows:

- o Strong financial management and control systems and procedures covering "inter alia" managerial accountability and ex-ante control procedures (this means that management must devise systems to both prevent and detect breaches of internal controls, as well as having adequate internal and external audit arrangements to provide independent assurance that internal control systems have operated effectively, and mitigate risks to a level acceptable to all stakeholders);
- o Effective internal audit in place in budget institutions;
- o A central harmonisation and co-ordination function, for both financial management and control and internal audit, in place, preferably located in the Ministry of Finance (this is intended to provide consistency in the quality of internal control systems in place within the public sector, as well as providing a focal point for the dissemination of best practice and developing new and enhanced guidance).

The term financial control usually refers to the financial aspects of internal control. Such controls may be either ex ante (e.g. a pre-commitment visa control system) or ex post (e.g. after the event) (see also **Annex 8**). The European Commission attaches a slightly different meaning to the term "financial control". In this context, "financial control" covers both what the Commission terms "internal financial control" and "external audit". The former term is synonymous with what is usually referred to as financial control or control procedures devised and implemented by the management of an entity, adding the internal audit as an assessment tool of the financial management and control systems efficiency. The key difference between the terms financial control and audit is that financial control includes both ex ante and ex post controls, whereas audit is mostly ex post.⁸ Based on the experience in candidate countries, The Commission has developed and uses the term "Public Financial Internal Control" (PIFC),⁹ today frequently used in assessing the progress made by candidate countries in meeting the requirements for EU membership. A practical framework for key elements of PIFC is given in the **Annex 5** of the Report.

The concept of PIFC should not, however, be exclusive, and should not exclude auditors from considering operational, financial, business and reputational risks, to develop a risk management framework as outlined below. The objective of the risk management framework is to improve internal financial and non-financial control, and therefore it is equally important to consider controls over non-financial as well as financial risks. The risk to the ability of an audited entity to deliver a programme of work may not result in financial risk but may damage the delivery of important activity programmes, or may result in reputational risk. These factors are particularly important to consider when delivering major EU funded programmes.

The setting up of a PIFC systems and procedures is a long term process, that should rely on a strategic approach, involving not only the administrative actors starting with the Ministry of Finance, but also the political decision-makers within the ongoing public administration processes.

The major challenge is to a large extent to build an "audit culture" as much as introducing/developing new audit techniques and establishing a legal framework. This implies especially:

- to raise the awareness of managers in the usefulness of solid control system and internal auditing;
- to direct newly established internal audit units to start work effectively in order to establish their legitimacy and demonstrate their usefulness;
- to create a Central Co-ordination Unit for organisation of adequate co-operation and networking activities for internal audit (e.g. within the Ministry of Finance), with the purpose of professional development of internal audit within the public sector and providing a solid basis for independent status of internal auditors.

2. The key components of an ideal financial control system in public sector

For a solid platform of an effective financial control system to be ensured, a number of key components needs to be in place. Ideally, these would include:

⁸ "Managing Public Expenditures – A reference Book for Transition Countries", issued by SIGMA, 2001

⁹ According to the European Commission, DG-Financial Control, April 2000, PIFC covers:

Public, covering all control activities in the public sector.

Internal, covering controls exercised by centralized and decentralized government agencies as opposed to external controls exercised by a body outside the government.

Financial, to stress the financial character of the activities to be checked.

Control, meaning all activities to oversee the entire field of financial management (comprising all control tools such as ex ante control and ex post audit).

Systems, covering organizations, staff training, methodology, reporting, responsibilities, sanctions and penalties.

- a) Management awareness and responsibility to establish sound and efficient financial control system.
- b) A strong central institution/organisation (preferably Ministry responsible for finance) responsible for the direction and co-ordination of public finances.
- c) Centrally established standards (preferably by the same institution/organisation as stated above) for accounting, financial statements and reporting and controls including internal audit.
- d) Clear procedures and transparent lines of responsibility and accountability in internal and external control environment.
- e) Risk assessment based systems and procedures of preventive, detective and directive controls, such as public procurement, countering of fraud and corruption, programming and selection of projects, etc.
- f) Clear and transparent rules for financial and performance reporting by the government and other public sector entities.
- g) An effective internal audit function.
- h) Strong and continuing external oversight (by parliament and supreme audit institutions) and sound professional relationship between internal and external audit.

It is clear that level of success in establishment of such system depends on how it is supported by staff (qualifications, recruitment, and training), IT systems and technical equipment, etc. For effective internal control and risk management it is also important to evaluate the effectiveness of –

- An endorsed risk management strategy for each audited entity (basically an organisational policy towards risk explaining why it has been set and the issues that were considered by management)
- Consideration of the context for risk management – for instance who is involved and what the objectives of the process are
- The identification and evaluation of risk (how were risks identified, and who fed into the process)
- Criteria for evaluating risk (what were the assessment criteria, these could be for instance the scale of the impact of any likely risk, and the likelihood of it happening. This does not need to be an absolute reference, more and objective assessment of high or low, and a relative ranking of the risks identified)
- Risk control mechanisms (what procedures has management put in place to mitigate against the risks that have been identified, these could be additional controls, or stronger monitoring arrangements)
- Review and assurance mechanisms – (what opportunities are there to review the risks identified, and have they been subject to any independent review and validation by internal or external audit) a detailed explanation is provided in Chapter 1 under the definition of Risk Management

Probably a few countries can claim to fully adhere to these processes and standards.

However, high standards related to the development of ICS have been recommended to candidate countries. Effective and well-functioning internal audit arrangements have also been proposed as a key component to provide assurance on the effectiveness of public financial internal control (PIFC) systems.

In a view of the significant progress achieved in a relatively short period since the introduction of reforms in candidate countries, the setting of lesser targets would neither satisfy nor stimulate their ambitions to become equally treated members of EU, nor sufficiently exploit their potentials. Nevertheless it is also important to acknowledge that the development of a full system of internal control and risk management goes much further than pure financial controls. Furthermore, as the capacity of candidate countries for developing their respective systems increases, they will be able to further enhance the procedures they have in place.

Categories and practice of modern Internal Control are shown more in detail in **Annex 8** of the Report.

3. The COSO framework of internal control

As mentioned before, corporate governance's requirement that good internal control should exist in an organization, has led to organizations taking a wider view of the whole control framework for which they are responsible, and using this as a tool to manage and mitigate against risk. This has resulted in a move to providing an overall assessment of an organization's control activities with the aim of giving an assurance as to the effectiveness of its internal control systems. A number of frameworks have been established and adapted according to the individual characteristics of an organisation. Perhaps the one that has attracted the greatest attention and usage is the COSO framework of internal controls developed by the Committee of Sponsoring Organizations of the Tradeway Committee in the USA.

This framework is built around five main control areas:

- control environment;
- identification of risks and priorities for control;
- financial strategy and management;
- control activities and
- monitoring and corrective action.

As such, the COSO framework is providing useful in the elaboration and conceptualisation of internal control standards and could be used in this way in candidate countries. A few of them have prepared standards on this basis already and the European Commission has also made use of its concepts.

The executive summary of integrated COSO framework for internal control is given in the **Annex 11** of this Report, while more information can be found on the following web-site: www.coso.org .

4. The key foundations of internal audit as a part of financial control systems

Historically, internal auditing has focused on financial systems and financial controls within an organization. However, the focus of internal auditing has shifted and is continuing to shift, quite dramatically in modern direction. This is closely associated with the greater understanding and relative importance being placed on internal control, good stewardship and corporate governance.

Some of the key changes that have taken place are:

Historic role

Policemen
Financial focus
Focus on hard controls
Focus on tangible assets
Compliance based
Functional focus
Self-sufficient
Reactive

Modern role

Partners in the organization
Business focus
Focus on soft controls
Focus on intangible assets
Risk based
Process focus
Sharers of best practice
Proactive

In order to achieve internal audit developments mentioned above, the following foundations need to be in place:

- general pre-requisites
- staff conditions
- audit practice development
- professional development and training.

The general prerequisites (implementation varies from country to country):

- The legislative framework in place and consolidated;
- Methodology development unit (preferably within Ministry of Finance) exist;
- Internal audit units exist and large enough to provide efficient audit service;
- Independence of internal audit units putted in place;
- Resources are sufficient;
- Central monitoring exist;
- Ethical base established;
- Management objectives clear and management awareness on satisfactory level;
- Tracking of recommendations and
- Risk management for institution.

Staff conditions

- Specific rules on recruitment of internal auditors settled out;
- The standard professional certification carefully managed (as staff evaporation would be avoided);
- Salary levels relevant to qualifications and responsibilities of internal auditors and
- Career structure for internal auditors developed.

Audit practice

- assessment of audit needs;
- documentation standards;
- organised spread of good practices;
- quality assurance;
- system/risk based approach;
- relationship between internal and external audit;
- follow-up and
- action plans for implementation of recommendations.

Professional development and training

- professional qualifications gained;
- professional networking established;
- skills and training profiles continuously under development and
- manuals developed and introduced in practice.

5. Options for Providing an Internal Audit Service

Several options exist for providing an internal audit service.

The conventional arrangement is to have an internal team which is directly employed by the organisation. Size and cost of providing the service are among the determining factors when considering in-house provision. The in-house team may be reinforced by contractors who can provide specialist skills and additional resources as appropriate.

Alternatively the whole service can be contracted out.

Smaller organisations should consider the use of consortia to take advantage of the flexibility this arrangement can produce. Additional skills or expertise can be brought in on a short or long term basis.

In some countries it is possible that there will be a central strong function, perhaps under the Ministry of Finance, which could be used to provide an internal audit service whilst the in-house facility is being developed. It is also possible that this additional expertise could be called on when an area demands specific expertise, as in some IT Audit situations. In other countries, although the Ministry of Finance is not responsible for the development of a government-wide IAS, the ministry does play the lead role in developing guidance or standards which should be applied when executing internal audit assignments.

6. Benefits of internal auditing

To a great extent, the benefits and need for internal auditing are apparent when examining the profession's purpose and scope of work. However, there are certain additional benefits of internal audit:

- **provides continuity in the monitoring process.** Internal audit's evaluations, recommendations, and reports, being on a continuous basis throughout the year, provide stakeholders with valuable additional comfort. Also, thanks to continuity, management is able to implement corrective measures and improvements on a timely basis;
- **has a considerable insight and knowledge of the organization.** This enables internal auditor's to combine their professional skills with an understanding of the organization's operations in order to make judgements about the effectiveness and efficiency of those operations and management's achievements of defined objectives and goals;
- **contributes to the organization's quality assurance.** The quality of operations, including compliance of policies, procedures, and internal regulations is of fundamental importance if the organization is to achieve its objectives in an economical and efficient manner. Internal auditors have an important role in periodically monitoring compliance with internally defined control procedures and regulations;
- **represents a service to the organization.** Internal auditors are in a unique position to furnish management with necessary analyses, appraisals, and recommendations. As such internal audit provides a service of great value as regards the governance structure.

It is clear that internal audit is an important aspect of internal control structure. The management of public entities should be clearly responsible for defining the role of internal audit and ensuring that it has an appropriate level of authority and independence, including the right to report to the highest level of management.

Therefore, in the document known as the Sydney Statement, INTOSAI stated that SAIs should strongly encourage and support introduction of internal audit where doesn't exist, and strengthen internal audit by appropriate training of internal audit staff.

Practical examples of the development of internal audit in the public administration of candidate countries are given in the Chapter 3 of the Report.

CHAPTER III: DESCRIPTION OF INTERNAL CONTROL SYSTEMS IN CANDIDATE COUNTRIES

1. Introduction

Internal controls are certainly not a new term in candidate countries. They were always presented in functioning of their public administration, in one way or another. But what made things difficult when it came to negotiations for accession to the EU was obligation to introduce internal audit. It used to be one of the most unclear concepts for the public sector of candidate countries. Actually the concept of financial control as such has often been confused with the internal audit, whereas it is only a component of a financial control system. This distinction has been drawn in Chapter 1 of this Report, where we have explained the integral role of Internal Audit within Internal Control, but confirmed clearly that they are not the same, and that Internal Audit is a tool to monitor, assess and improve internal control within audited bodies.

Of course no internal audit capacity was in place amongst candidate countries from the outset, but rather control/inspection bodies tasked in general with a narrow scope of activities; investigation of alleged individual irregularities, or even of complaints of fraudulent behaviour. By definition this activity was not use a pro-active approach based on risk analysis. Moreover, these concept did not allow systematic feedback (recommendations + follow-up), aimed at improving the management and control system and procedures¹⁰.

As financial control is considered as one of the biggest issues in ensuring confidence in the construction of EU, in their preparation for the enlargement process candidate countries started to struggle to convert from that basically transaction-oriented inspection approach to a new structure in which accountability of management and functional independence of internal audit would play key roles.

Evaluation of existing situation and progress made in mentioned area during the last ten years in acceding, remaining and future candidate countries is based on the questionnaire. Replies on questionnaire have been collected during the April 2003. The main outcome of this "research" is that the situation regarding ICSs is still very different from country to country and from SAI to SAI, but regardless of that, shows big efforts and great improvement made in this area at all levels.

Besides giving an opportunity to highlight current situation in candidate countries regarding implementing changes and development of ICSs and SAIs' role in these processes, intention of this Report is to identify good practices and provide some stimulating examples.

2. Internal control structure modelling

In general the term Internal Control System (ICS) are all forms of control exercised at the level of public entity, including internal audit, established by the management. It comprises procedures, methods and responsibilities which aim to assure compliance with regulation, transparency, economy, efficiency and effectiveness of an entity.

European Union

Inside of European Union a couple of different "models" of systems are identified corresponding the internal (management) control and internal audit as a concept which logically flows from internal (management) control.

There is *southern* model system in which the Ministry of Finance does not only play a key role in preparing and allocating the state budget to line ministries, but also carries out ex-ante controls by its own staff in the line ministries. It has the Inspectorate General for Finance which depends directly on the minister of finance and is responsible for financial control of all public revenues and expenditures. In addition, in the line ministries Internal Audit Units exist.

In the *northern* model system, line ministries take full responsibility for spending their own budgets with appropriate checking through their ICSs, which are ex-post checked by Internal Audit. Internal auditors are co-ordinated by the Ministry of Finance and carry out mainly financial audits. They take account of the work of internal auditors at regional level. Their reports are usually received and used by external auditors. Ministries reports on their ICSs to the Parliament annually. The internal audit service of the Ministry of Finance, besides auditing of its own ICS, also provides guidance and co-ordination for the IAUs of the line ministries.

Internal financial control system of European Union, then Austria, France, Netherlands and Portugal as EU Member States, and Canada and USA as examples of non-European practices are described in **Annex 4** of this Report.

Candidate Countries

The preparation for the accession to EU on budgeting and financial control in candidate countries has begun long before acceding with pre-accession aid. In Central and Eastern European Countries it means in the early 90's, after the beginning of the reform processes. During the last decade those countries with a centralized state system in which a uniform and consistent system of internal controls within the public administration was missing and the role of internal controls in the management was very limited, were streamlining to adopt a new institutional approaches and methodologies of the control of public funds, similar to those within the EU.

The main idea was to establish such systems in which managers would be able to trace errors and irregularities in the administering of public funds and to reduce the risk of corruption, what is a good guarantee that public administration units perform their tasks correctly and handle public resources, including EU funds, in a useful and economic way.

¹⁰ R. Cazala: *General considerations on the situation of (internal) financial control in the candidate countries to the European Union in the light of the SIGMA peer reviews*, Seminar on "Evaluation of ICSs", Prague, 26-28 May 2003

Internal Control Systems within the candidate countries today are organized and functioning in different ways (Comparative scheme of ICS models in Candidate Countries is given in **Annex 3**), more close to the *southern* model, but mostly consisted of elements of systems represented in both southern and northern EU Member States, including "classic" external control in a form of supreme audit institution reporting independently to Parliament. Most of them represent combination of an old, "pre-transition" institutional structures and new development requirements.

For example, internal control system of the Czech Republic is currently created on the basis of a "two layer" system consisting of public administration reviews as an "old layer" and internal audit as a "new layer", and is under development.

The public finance system of Slovenia and within it the internal control systems is based on the Public Finance Act. The main role in internal control system is given to the Ministry of Finance, which is responsible for controlling the budget funds also through the Budget inspection function in the Budget Supervisory Service responsible for development, harmonization and co-ordination of Public Internal Financial Control. It supervises implementation of regulations and guidelines for financial management, control and internal audit by on-the-spot checks and based on reports of Internal Audit Services annually submitted to the Ministry of Finance. The external review of existence and operation of internal controls is additionally done by the Slovenian Court of Audit.

*Internal audit services in Slovenia are established in all ministries and in some major bodies within ministries. The budget spending centres with the budget which exceeds 500 million SIT must ensure regular annual internal auditing of their operations by their own Internal Audit Service, joint Internal Audit Service or by external provision of internal auditing (**hiring a private audit company**); in performing internal audit, the private company must comply with the Guidelines for internal audit of budget spending centres.*

The internal control framework in Albania comprises controls exercised by the budget department, the Treasury (in charge of ex-ante controls of budget execution), the Internal Audit Units within the line ministries (in charge of ex-post compliance audit and reporting to the line minister) and the Central Internal Financial Control Department within the Ministry of Finance, which provides oversight of the IAUs within the line ministries. It also carries out internal audit work within the Ministry of Finance and entities under the Ministry's control. In addition, the SAI carries out an independent external audit of budget execution.

*The Albanian Minister of Finance – as person with overall responsibility for ensuring proper internal controls – submits an **annual assurance letter to the Council of Ministers** indicating if effective internal control framework is in place. This enhances the ministers' understanding of the state management and provides positive incentives for ministries to correct any deficiencies reported by internal controls.*

The internal control system in Malta is made up of an intricate system of internal and external financial control checks. The various key players and systems enable the internal and external auditors, as well as management of the entities concerned and other stakeholders, to follow the path of transactions, controls, processes and reporting within a system.

The key players of the System of Controls in Malta:

- The Management of the Ministry/Department concerned;
- The Ministry responsible for Finance;
- The Treasury, headed by the Accountant General;
- The Central Bank of Malta;
- The Department of Contracts, headed by the Director General Contracts;
- The Internal Audit and Investigations Directorate, performing the internal audit function;
- The National Audit Office, performing the external audit (or external financial control) function, and
- "Additional" key players (The National Aid Coordinator; The EU Directorate; The Inter Ministerial Committee; The National Authorising Officer; The Central Financing and Contracting Unit; the Senior Programme Officer; The Implementing Agency; The Joint Monitoring Committee).

In **Cyprus** internal control systems are in place, based on relevant law, financial rules and regulations as well as instructions and circulars issued by the Ministry of Finance and the Treasury. In July 2003 the law pertaining the creation of an Internal Audit Service with a mandate to perform internal audit of Government and report to the Council of Ministers was passed.

In Estonia, the Ministry of Finance is appointed by the Government as the leading ministry in the area of internal control and internal audit in the government sector. Financial Control Department (FCD) of the Ministry of Finance acts as the internal auditor of the Government. It monitors using of the state budget and external funds. Also co-ordinates and analyses implementation of the ICS and organization of internal audit in government institutions and proposes improvements. In major government institution have established internal audit function. Internal control systems and internal audit functions in public sector are evaluated by the SAO during its audits and assessment of their organization is given in the SAO's annual overview on the use and preservation of state assets.

*Each minister, county governor (15 of them) and head of government agency in Estonia had to ensure the establishment of internal control system; they are responsible for its accurate and purposeful implementation. They should ensure the implementation of internal audit and appoint the internal auditor or **if necessary set up the relevant unit**. Internal auditor and the head of the internal audit unit are directly accountable to the head of the institution.*

At the moment about 200 internal auditors are working in government institutions. Reporting system is in place: FCD receives strategic

plans, work schedules and quarterly reports. FCD devises a consolidated report which is submitted to the Minister and the Government.

Internal Control Systems in all candidate countries are based on the relevant laws, which commonly lay down basic requirements for setting up the internal control systems in ministries and institutions, as well as key tasks of an internal audit structure (its head, issues related to internal auditors' independence, responsibilities and rights in conducting an internal control and audit work).

However, the primary legislation concerning internal control system is sometimes not enough supported by necessary secondary legislation. This is certainly an area where, partially because of need for compliance with European practice and partially because of fast changes in living and working environment, constant developments and improvements are needed, what is, for instance, recognized in good Romanian practice.

In 1999 the Romanian Government issued the Ordinance no. 119 on internal audit and preventive financial control. In this context, the Ministry of Public Finance issued in 2000 the Order on the general methodological Norms regarding the organizing and functioning of the internal audit.

In December 2002, the Ordinance no.119/1999 was modified by the Law no. 672 on internal public audit, taking into account the international standards in this field. In application of the provisions of mentioned Law, it was issued the Order of the Minister of Public Finance no.38/2003 for approval the general Norms on internal public audit activity.

Examples from Polish and Lithuanian practice purport on the importance of developing regulations, methodological guidelines and directives for assisting institutions and their management in effective organizing and efficient maintaining of internal controls' functions. Also they show how important can the role of Supreme Audit Institution be in this process.

The Law on Internal Control and Internal Audit adopted by the Lithuanian Parliament in December 2002, it has obliged every public sector entity to introduce and maintain effective IC system. This law defines IC concept, determines management's responsibility for establishment and development of IC system, and states IC objectives and IC efficiency criteria. However in Lithuanian SAI opinion additional efforts are necessary for providing more detail methodological guidance for managers of public sector entities. It is necessary to recommend public sector institutions either to follow IC guidelines that were developed by the INTOSAI Internal Control Standards Committee, or to develop national IC guidelines adapted to local environment. Such document should practically help managers of public sector entities to fulfil functions imposed by the Law on Internal Control and Internal Audit.

During Poland's negotiations with the Commission in Chapter 28 („Financial Control“) the Commission requested Poland to regulate financial control in a uniform way so that it would cover collecting and spending public funds and public assets management in line with internationally acknowledged standards and requirements. Following all those recommendations the Ministry of Finance drafted an amendment of the Public Finance Law, concerning internal controls and audit. The amended law entered into force in January 2002. At the turn of 2001/2002 the Supreme Chamber of Control (SCC) in the Ministry of Finance carried out an audit of internal control of funds from the EU. SCC found that the Minister failed to issue necessary secondary legislation concerning internal audit. In June 2002 the President of SCC and the Minister signed therefore an agreement on harmonisation and co-ordination of financial control and internal and external audit. Following that agreement, the Ministry issued all necessary secondary legislation for the amended Public Finance Law and developed „Internal Audit Manual“, „Financial control standards in the public finance sector“, „Code of Ethics of Internal Auditors“ and „Internal Audit Charter“. While preparing all those documents the Ministry of Finance used the SCC's experience in internal controls auditing and also the SCC Auditing Standards.

Conclusion

According to the "research" described above, we can say in general terms that today in candidate countries legal framework for the ICSs is put in place, new structures in the public administration are introduced, and awareness of importance of their existence raised within both the management structures in public sector institutions and the citizens. But there are still some weaknesses that need to be eliminated in order to ensure more effective operation of ICSs. A number of control procedures and mechanisms that need to be improved are discussed more in detail in chapters below.

When structuring their ICSs the ongoing objective for all candidate countries has to be the development of as harmonized and as common model of the concepts of internal control systems as possible. Process of harmonization implies both: finding similar solutions between candidate countries themselves and in compliance with the best European practices. It is therefore important to keep in view that, while full adaptation to existing EU systems and structures is still in the process, the framework of EU is in constant evolution. This is a fact that at the same time also demands permanent adaptation on the part of the national administration structures in line with European progress.

Therefore, the European Union should have to continue with contributing to this complex and long-term process by providing advices and technical assistance and – what is very important - by offering clear models for relevant public institutions which candidate countries could adopt to their particular traditions and environmental circumstances, based on the best EU practices.

3. Analyses of current situation in candidate countries

Analyses of current situation regarding development of ICSs in candidate countries is mostly based on the SAIs' replies on the Questionnaire prepared by the sub-group and are related to the situation in spring 2003¹¹.

3.1. Legal framework for and role of ICSs

Definition of internal control and internal audit

Common understanding of definition of internal control (and internal audit) and objectives to be achieved can be assured only by legislation.

Based on replies of SAIs of candidate countries, **Internal Control and Internal Audit are legally defined in the great majority (13 of 15) of countries**, in two countries internal control is not defined by law, while in one country both definition are under preparation. However, responses in the questionnaires highlighted **variations between countries and SAIs in the way in which IC and IA are defined** and because of that – plasticized, reflecting administrative culture and tradition. In some countries provision for internal control is purely internal financial control, in others it includes a wider range of responsibilities, as well as playing an important role in the formulation of risk management policies.

Box 1. Various Internationally Used Definitions of Internal Control:

- According to *INTOSAI Guidelines for Internal Control Standards*, Internal Control is a management tool used to provide reasonable assurance that management's objectives are being achieved. It can be organized as:

- a) accounting control – cover the procedures and documentation concerned with the safeguarding of assets and the reliability of financial records;
- b) administrative control – procedures and records concerning the decision making processes that leads employees to carry out authorized activities in achieving the organization's objectives;
- c) management control – all the plans, policies, procedures, and practices needed for employees to achieve entity's objectives.

The intended purpose of Internal Control is to prevent errors, to detect errors, to correct errors that have been detected or to compensate for weak controls where the risk of loss is high and additional controls are needed.

- Following a recommendation in the *INTOSAI Guidelines for Internal Control Standards*, *SIGMA* has decided to use the term "management control" when referring to internal control. This term management control offers the advantage of avoiding confusion with the term internal audit. It also makes it very clear that internal control – management control – is a responsibility of the management.

Management Control may be briefly defined as the organization, policies, and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver those programmes are consistent with the stated aims and objectives of the organizations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported, and used for decision making.¹²

- For use in audits of *European Community* activities Internal Control is defined as all the instruments, procedures, methods and systems arranged by the organization with a view to achieving the following objectives:

- a) adherence to rules, both external and internal;
- b) safeguarding resources against abuses, waste, mismanagement and frauds, international as well as noninternational;
- c) promoting methodical, economical, efficient and effective operations; developing, displaying and maintaining reliable financial and management information and indicators.

¹¹ Questionnaire and country replies – in Volume III of the Report.

¹² Richard Allen in *SIGMA Papers No. 4, Management control in modern government administration*, p. 9

- *The Canadian Institute of Chartered Accountants (CCA):* "Control comprises those elements of an organization (including its resources, systems, processes, culture, structures, and tasks) that, taken together, support people in the achievement of the organization's objectives"¹³

- *The US Committee of Sponsoring Organizations (COSO):* "Internal Control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations".¹⁴

Definitions by countries are given in the **Annex 2** of the Report.

Different definitions (even though in the field of Internal Audit not significant) implicate that models of Internal Control and Internal Audit are various. This variety still limits the standardisation of audit techniques and approaches to ICSs, depending very much on the legal framework the systems are placed.

In respect of that, this Report gives opportunity to compare existing definitions of IC and IA, to highlight main differences and, if necessary, to open "new chapter" for discussion on this matter.

Box 2. Definition of Internal Audit developed by The Institute of Internal Auditors (IIA):

"Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

The INTOSAI Guidelines for Internal Control Standards states that "*a specific authority should be assigned the responsibility for developing and promulgating a government wide definition of an internal control structure... Wherever the authority is assigned, the SAI has a vital role to play in the development of the ICS. This role will be played directly or indirectly, largely depending on the SAI's legal mandate and the organizational structure of the country's management system.*"

According to the responses on the questionnaire, the **responsibility for developing definition of IC and IA is mostly on Ministry of Finance** (Croatia, the Czech republic, Estonia, Hungary, Latvia, Lithuania, Poland – with assistance of General Internal Auditor, Romania, Slovakia, Slovenia) **or some centralized government body** (The Public Internal Financial Agency in Bulgaria, The Internal Audit and Investigation Directorate as centralized government body in Malta). Responsibility for developing definition of IA in Cyprus lies with the Internal Audit Service.

Even though only in the role of external consultants, in some **countries** (Albania, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Turkey) **SAIs have been (or are) involved in the process of definition development**, what shows SAIs' awareness and interest in development of solid and reliable ICSs within the public sector in their countries.

Responsibility for promulgation of definitions is different; somewhere, like for example, in Latvia and Slovakia, it **lies on the Ministry of Finance, somewhere on Parliament** (Estonia, Hungary, Lithuania). Regarding **responsibility for implementing IC/IA in practice**, it is more equal – it is mostly **on Ministry of Finance (occasionally on Treasury or some other MF's Department) and somewhere** (Croatia, the Czech Republic) **also on the heads of the entity**, while in Lithuania this responsibility lies on the head of the legal public entity only.

Standards

INTOSAI guidelines points out that, in establishing the framework for IC structures, a specific authority should be assigned the responsibility for developing and promulgating the standards to be followed when designing an IC structures. This responsibility should be assigned through constitutional or other legal enactment and given to a central organization with authority across various government organizations.

From the SAIs' replies, it is evident that in almost all countries ICSs are based on the relevant professional standards, even though they sometimes refer to the international standards on Internal Audit (Croatia, the Czech Republic, Latvia). Exception is Turkey, whose ICS is not operational at the moment, but proper legal base for setting it up is to be adopted in the near future, and Malta, where the definition of Internal Control is based on international Guidelines and Standards, such as those defined by INTOSAI and IFAC.

Issuing standards and providing technical advice for ICSs in most of countries is in charge of Ministry of Finance (in Poland with assistance of General Internal Auditor). In Bulgaria this is Public Internal Financial Agency, in Slovenia their national Institute of Auditors, while in Albania, it is still not clear which authority should be responsible for this issue.

In 10 countries, SAIs participated/participate in development and promulgation of IC standards, directly or indirectly (mostly in consultative role or by involvement in professional discussions).

Internal control should not be imposed but accepted, established and implemented on voluntary bases by management of each organization. It means that managers at all levels have to provide the proper control environment within the organization.

¹³ The Canadian Institute of Chartered Accountants Criteria of Control (CoCo) Board – Control and Governance – Number 1: Guidance on Control (November 1995)

¹⁴ The Internal Control – Integrated Framework – Committee of Sponsoring Organizations (COSO) US – Executive Summary

Indeed, all SAIs except one have found it helpful to have legislation that establishes an overall requirement and objectives for maintaining effective internal controls, i.e. still recognize the importance of having legislative underpinning to promote effective internal controls.

Important fact in modern audit theory and practice is professional ethics or request for professional auditor's behaviour. Code of Professional Ethics establishes system of general values and rules that should have to be accepted by auditors in their relation to the public, clients and colleagues. Their existence at the same time encourages external audit in relying on professional and honest approach of internal auditors in their work.

Referring to responses on questionnaire, Code of Professional Ethics for Internal Auditors today exist in most of candidate countries.

Role of internal audit in control of public revenue and expenditure

Management often establishes an internal audit unit as a part of its internal control structure.¹⁵ Internal Audit is, therefore, a service to the organization, in unique position to be able to furnish management with necessary analyses, appraisals, and recommendations. As such it provides a service of great value as regards the governance structure. As mentioned in Chapter II, there are also some other needs and benefits for Internal Audit. For instance:

- IA has a considerable knowledge of the organization;
- IA provides continuity in the monitoring process;
- IA contributes to the organization's quality assurance, etc.

The scope and objectives of Internal Audit vary widely depending on size and structure of entity and the requirements of management. However, there is a certain amount of common understanding about the areas of Internal Audit activity in international standards:

- review of accounting systems and related internal controls;
- examination of financial and operating information; and
- examination of the economy, efficiency and effectiveness of operation of all controls.

Referring to replies on questionnaire, **establishment of Internal Audit Units (IAUs) within the public sector is (or will be soon) a legal obligation in all countries**, except in Cyprus and Malta where such obligation doesn't exist. In 9 countries this obligation lies also on all other spending units if they are not served by that in the line ministry (in Lithuania depending on the size of an entity).

Regardless of legal obligation, IAUs are established in most of - or even in all line ministries in 11 countries, in two countries (Bulgaria, Cyprus) only in some of them, while Malta responded negatively because Internal Audit is a centralized function: it falls under the responsibility of the Internal Audit Investigation Directorate.

Further on, regardless of legal obligation, **IAUs are established also in other revenue and spending units**: in Latvia - in all of them, in Albania, Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Poland, Romania and Slovenia - in most of them, and in Bulgaria, Cyprus, Slovakia and Turkey IAUs are established only in some of revenue and spending units if this is not obliged by the law.

In practice the internal audit should cover two main types of audits: financial audit and performance audit, but may also cover a specific analyses of staff resources with the judgement on extent to which they correspond to the objectives of the ministry or other government entity and the tasks it is required to carry out.

In almost all countries internal auditors are today doing their work by looking into how a selection of the transactions have been processed but also by assessing how the systems and procedures that built up the internal control function. In other words, IAUs have a **mandate to carry out all types of audits**, in two countries (Albania and Cyprus) have a mandate for financial and performance audit, while in another two countries (Poland and Turkey) - only for financial audit. In addition, in Poland other internal control units are also responsible for larger scope of audit, including performance audit.

Referring to the mandate of IAUs, in all countries, except Albania where mandate for auditing EU funds are not yet included and in Bulgaria where this mandate is given to the Public Financial Internal Agency, **IAUs have the legal mandate to audit all relevant funds, including EU funds.**

Concerning reporting practice, it varies from one country to another. In some countries, like for example in Estonia, Romania, Slovakia and Slovenia IAUs report directly to the minister. In some others, like Croatia and Lithuania, reports can be sent or given on insight to the other state bodies as well if prescribed by special regulation (e.g. Ministry of Finance). In the Czech Republic reports are sent to the head of public authority, who then report generally on financial control results to the Ministry of Finance. In Latvia, however, IAUs report to the State Secretary of the Ministry and to the IA Department of the Ministry of Finance, while the annual report is also sent to the IA Council and the State Audit Office.

Starting from the basic goals which every Internal Audit should have to wish to accomplish, the basic rule should be that IAUs reports is sent to all members of the organization who can assure consideration of audit results with due care. It means to the persons who are in position to organize corrective actions (heads of departments, head of organization, minister). IAU's report could also be sent to other interested stakeholders, among which are external auditors.

According to Internal Auditing Standards, head of IAU (or Internal Auditor General) is obliged to assure a base for development of manual/instructions for internal audit work. In that manual, procedures, standards for maintenance and managing of internal audit should be described more in detail (concrete instructions to team members on audit planning techniques, collecting of audit evidence and working documentation structuring, preparing of report, etc.).

According to replies, **working methodology of most of IAUs is explained through their own manuals or guides** in big majority of countries.

¹⁵ INTOSAI Guidelines for Internal Control Standards, par. 74.

3.2. Role of SAIs in assessment of Internal Control Systems

Mandate and organization

As stated in the INTOSAI Guidelines for Internal Control Standards, Internal Control is a management tool and therefore responsibility for its adequacy and effectiveness rests with management. But the Supreme Audit Institution is not excluded of responsibility in this part.

SAI should gear its work toward assessing the adequacy in principal and the effectiveness in practice of existing ICs in auditees. It should encourage and support:

- the establishment of detailed organizational internal control structures for each governmental unit based on relevant standards and
- a review of that structure to assure that controls are working as intended and are adequate to achieve the desired results.

The Guidelines also emphasize the SAI's interest in ensuring that strong Internal Audit Units exist "where needed" and cite as problems the nonexistent or weak nature of Internal Audit and the lack of independence. They recommend a number of ways in which SAIs can offer assistance and guidance in order to strengthen Internal Audit function.

The first step for assessing the ICSs of the national administration is the legal right to do so.

Based on SAIs responses to questionnaire, **all SAIs are empowered to audit ICSs** (one SAI will be empowered in very near future). **Besides SAIs**, in 11 countries some **other state agencies or governmental bodies (mainly specific departments within the MF or/and Government Control Office) also have the responsibility to control/assess ICSs.**

The implementation of audits with regard to ICS is not very different from SAI to SAI, which is quite big improvement in comparison with research done in 2000, when three SAIs reported that they had not evaluated ICSs at all. Also, only four SAIs have looked at the ICSs during the regular audits and only two have performed specific audits for the assessment of those systems. **Today all SAIs**, except Turkey who will implement such audits after the relevant draft law pass, **implement audits of ICSs**: 13 of them during the regular audits plus, in 7 SAIs, specific audits, while one SAI perform only specific audits for the assessment of ICS.

In Albanian and Hungarian SAIs **a special department for auditing ICSs was established**. In other SAIs there is no special department, but all auditors or majority of audit staff is involved in audits of ICSs, what is understandable with regard to the fact that review of ICSs is a part of regularity audits.

"Auditing standards" in a form of **specific audit guidelines for ICSs or as a part of general audit manual, do exist in all SAIs** except one. Those manuals/guidelines on audit of ICS developed by the SAIs are a **reflection of existing INTOSAI control standards and European guidelines for their implementation**. They use these guidelines as a tool for evaluating the adequacy and effectiveness of the ICSs of the auditees and made recommendations for improvements on the basis of internationally accepted standards, what implicates that approaches and methodologies are close to be harmonised. As a conclusion, it can be stated that SAIs use INTOSAI and EU requirements and the best European and worldwide practices in the auditing, directly or indirectly – by adapting them to the local or national characteristics, as a framework of reference.

Relationship between Supreme Audit Institution and Internal Audit Units

Internal Audit is important to the well-being of an organization/entity, but it can not and should not substitute for a good Internal Control System. It can only assist management through identification and improvement of internal controls. Also, external auditors have their own role: to review the organization's internal control system, including Internal Audit, and recommend areas of improvement. Therefore, there is a mutual interest for good co-operation between internal and external auditors.

Short description of co-operation in practice is given in **Annex 9** of the Report, while well developed example of *Good Practice Guide on co-operation between internal and external auditors* can be found on the UK National Audit Office's web site: www.nao.gov.uk .

Eight SAIs (Albania, Bulgaria, Croatia, Cyprus, Estonia, Hungary, Lithuania, Romania) reported that they **assist in establishment and development of IAU**, in one way or another. Mostly mentioned ways were:

- *by lending IAUs materials and equipment for education (Albania, Bulgaria, Croatia, Hungary, Lithuania),*
- *by helping in education of IAU's staff within the SAI (Albania, Estonia, Hungary),*
- *by helping in education of IAU's staff through lectures or seminars in IAUs (Albania, Bulgaria, Cyprus, Estonia),*
- *by organizing joint training in working methodology with IAUs (Bulgaria, Croatia, Hungary),*
- *by secondment of its staff (Albania, Estonia),*
- *by providing IAUs with materials for developing methodological guidelines (Hungary),*
- *by providing recommendations for proper establishment of IAUs in public sector entities (Croatia, Lithuania), and in other different ways.*

However, roles of internal and external audit often overlaps and effective co-operation in fact demands willingness from both sides to ensure that work is properly co-ordinated. Eight SAIs (Albania, Bulgaria, Cyprus, Estonia, Hungary, Latvia, Lithuania – partially, and Slovakia) reported that **joint actions to avoid duplication of work have been taken**, such as:

- *frequently contacts, consultations and meetings,*
- *co-ordination of annual audit activities/harmonization of audit plans,*
- *signing of co-operation and assistance agreement between SAI and centralized governmental body on audit related activities, and so on.*

According to the INTOSAI Guidelines for Internal Control Standards, SAIs should ensure that they have access to internal auditors' reports, related working papers, and audit resolution information. Referring to that, **all SAIs reported that have access to all Internal Audit plans, reports and other related working papers.**

Management response to SAI review of Internal Control System

All managers should realize that a strong IC structure, part of which is IA, is fundamental to their control of the organization and its purpose, operations and resources.

SAIs should educate management on its responsibility for IC and to encourage and support management to establish internal control system. SAI should also audit those systems to assure that controls are in place and adequate to achieve desired results.

While three years ago only a few SAIs reported that they had discussed with the ministries how the ICSs could be improved, today all of them **discuss identified weaknesses or failures with the management and**, what is important, **with IAUs** too, and give recommendations for the improvements.

Further on, **all SAIs** responded that they **report and give recommendations on these weaknesses and failures**, either in the audit report or as pointed out in the annual report. **Management mostly or even always** like in Slovakia, Slovenia and Turkey, **follow those recommendations referring to the ICS in their organizations.**

All SAIs stated that have established a sort of **monitoring the auditees' progress in implementation of given recommendations.** From the experience based on those monitoring systems, most SAIs stated that **management of audited entities have a positive and encouraging attitude relating to ICs, and** - what is very important, **actively encourage and support co-operation between internal and external audit.**

In the case of a general conclusion that ICSs are weak in most or in a big number of auditees, **all SAIs reported that they have a mandate to give a sign** (in a form of warning, advice, recommendation for improvement, etc.) **to the responsible authorities**, which - when come to specific experiences - in some countries resulted with significant impact on development of legal regulations and on improvement of ICSs in general (e.g. Hungary and Romania).

Almost all SAIs (except Cyprus and Estonia) reported that **specific barriers or problems during the audit of ICSs arisen.** The most frequent were:

- lack of qualified staff in ICs and IAUs (*Albania, Bulgaria, Croatia, the Czech Republic, Hungary, Lithuania, Poland, Romania, Slovakia, Slovenia*);
- overlapping of work (*Bulgaria, the Czech Republic, Latvia, Malta, Poland, Romania*);
- weak communication (*Latvia, Malta, Poland, Romania, Slovakia*);
- lack of relevant guides and procedures for audit ICS (*Albania, Croatia, Romania, Slovakia*);
- various definitions of IC and IA in public sector (*Croatia, the Czech Republic, Hungary*);
- lack of understanding of ICSs by the staff or management in audited entities (*the Czech Republic, Lithuania, Poland*), but sometimes also the lack of the same understanding by the staff in the SAI (*the Czech Republic, Lithuania, Poland*);
- access to the reports and documents (*the Czech Republic*).

It is evident from the replies that **all SAIs are putting great efforts to deal with problems/barriers** mentioned above. In this respect, following actions have been taken:

- relevant guidance on auditing ICSs developed (*Albania*),
- special publication about IC and IA for managers issued (*Lithuania*),
- consultations regarding development of relevant methodological guidelines held (*Hungary*)
- mutual organization and/or attendance on annual audit seminars or conferences (*Croatia, Slovenia*),
- efforts to highlight the matter in the Parliament and Government (*the Czech Republic*),
- audit meetings (*Croatia, Cyprus, Hungary, Latvia, Poland*),
- Recommendation for improvement given in the audit reports or management letters (*Bulgaria, Croatia, Cyprus, Poland, Slovakia, etc.*),
- training courses for internal and/or SAI's auditors organized (*Hungary, Latvia, Slovenia*),
- part in the improvement of PIFC as advisor taken (*Hungary, Romania*),
- internal rules for SAI developed (*Latvia*),
- education of the top-management and staff of the auditees organized (*Lithuania*),
- web-site for methodology on ICS established (*Lithuania*),
- a Task Force was set up with members from both the SAI and governmental centralized organization for internal audit in order to improve co-operation between the two bodies (*Malta*),
- helping Ministry of Finance in development of education for State Internal Auditor's Certificates (*Slovenia*), etc.

3.3. Recent changes

Several SAIs, like for example Bulgarian, Croatian and Estonian, already made some form of **self-assessment to review their position regarding development of high-quality and effective ICSs in auditees.**

Also, they **recently introduced some changes for the purpose of carrying out audits of ICSs and cooperation with IAUs:** from organization of training courses and seminars for auditors (*Bulgaria, the Czech Republic, Hungary, Lithuania¹⁶, Malta, Romania*), development of manuals/guidelines for auditing ICs (*Bulgaria, Latvia, Lithuania*), organization of discussion forums with IAUs (*Latvia*), carrying out audit on the assessment of the ICs within public sector (*Lithuania*), changes of procedures and workflow (*the Czech Republic*) to establishment of a special unit for auditing ICS, like it has been done in *Hungary*, etc.

Besides within their own organizations, SAIs intend to take certain **serious steps for improvement of IC structures in the public sector.** In this respect, they plan as follows:

- organizing meetings with ministers,
- training and workshops on application of standards,
- developing common audit methodologies,
- supportive training programmes for spreading new knowledge and methods throughout the SAIs,
- developing relevant guidelines,

¹⁶ Example of internal audit training modules developed in one of Candidate Countries (Lithuania) is given in Annex 11 of the Report.

- participate in development of relevant draft laws,
- dissemination of knowledge of the best auditing practice, etc.

3.4. The role of the SAI with regard to EU funds (SAPARD, ISPA, PHARE, OTHER)

The application for EU membership by candidate countries and current provisions of pre-accession funds have rendered more urgent the need for SAIs to improve their organisation by carrying out audits more professionally and by increasing the necessity to adhere the best European practices in state auditing. It is generally agreed that the existence, preparation, dissemination and implementation of appropriate Audit Manuals are essential requisites for the proper functioning of SAIs.

When it comes to the EU perspective, an important cornerstone is a sound and efficient financial management in the execution of the budget. In the Partnership Agreements the governments of applicant countries and the European Commission agreed upon the need for strengthening the chain of management control, including external audit.

The SAI itself has interest in effective management control system so that:

- it can anticipate and prevent errors and omissions, fraud and irregularities in earlier stages than external audit, and
- the reliability and effectiveness of management control systems can save the SAIs resources.

To fulfil this need, it is crucial that the legal mandate of SAIs includes the responsibility to audit and to focus on the quality of management of EU funds.

Mandates

According to the responses on questionnaire, the situation in this area seems to be very positive. Namely, concerning the implementation of active approach with regard to the EU-requirements for external audit, all SAIs, except Albanian, have reached this important stage: **mandate for auditing EU funds** in their countries (although in Malta it is not directly referred to in the SAI's legislation, but it is interpreted as audit of overseas funds administered or held directly or indirectly by Government) - down to the level of the final beneficiary (in Romania only if final beneficiary is not a natural person).

The certification of paying agencies for SAPARD funds is a particular area. Only two SAIs (*Hungarian and Romanian*) have decided to take on this task of being **involved formally in the accreditation of SAPARD Agency**, while four SAIs have been **appointed as the certifying body for pre-accession funds** (Hungary, Lithuania, Romania, Slovakia).

Audits carried out

Twelve SAIs have reported that they have already **carried out audits of EU funds** in their country. Some of these audits were legality or financial audits, some were performance audits, and in some SAIs this was reinforced by carrying out of special investigations. The possibility of **joint or parallel audits with the ECA** or with SAIs from EU member states was also used (*e.g. in Estonia and Romania*).

Replies to how many audits of EU funds have SAIs performed so far, differs very from one SAI to another: from 2 to 35 audits, depending on the fact if auditing EU funds was a part of regular audits.

Referring to the **subject of the audits**: seven SAIs (*Bulgarian, Estonian, Hungarian, Latvian, Lithuanian, Polish and Slovenian*) were auditing both, administrative preparedness to receive EU funds and management of received EU funds. Four other SAIs (*Albanian, Czech, Romanian and Slovakian*) reported that they audited only management of such funds or some other topics (*Romania*).

Reports on auditing EU funds with observations and recommendations were **addressed widely**: mostly to the national authorities such as auditees, Parliament and Ministry of Finance. In 9 cases reports were sent to ECA or EC also, and in some cases also to some other stakeholders such as government (in the Czech Republic), or special investigation services and other ministries involved (Lithuania). In all countries except Romania **those reports have been published** (although in Albania – partially, in Lithuania - only some of reports, and in Slovakia – in the form of brief extraction).

Follow-up on those audits have been made in seven SAIs so far, in following forms:

- auditing of measures taken for implementation of recommendations from previous audits (*Albania, Hungary, Slovakia*),
- reports on the implementation of the recommendations of the audit report (*Bulgaria*),
- monitoring, in some cases repeated or additional audit (*the Czech Republic, Romania*), and
- changes made to legal acts (*Latvia*).

Resources

Concerning the reorganization of the SAIs considering the audit of EU funds, seven SAIs (*Albanian, Bulgarian, Hungarian, Latvian, Lithuanian, Romanian, Slovakian*) have organized a separate unit/department for carrying out such audits, while a few others (e.g. *Croatian SAI*) are in the process of reorganization or intend to do made more efforts in this respect in the near future.

As regards the staff involved in EU matters and requirements related to the audits of pre-accession funds, the **number of auditors involved** in these audits starts from 3 auditors (in Albania and Slovenia for instance). Staff carrying out EU related audits are still higher than the **number of auditors actually trained** for such tasks. Namely, percentage of auditors specifically trained for auditing EU related funds is at present very different. In some countries (*the Czech Republic, Slovakia*) it was hard to precise, because training is still in the process. Stated numbers certainly shows the need for further investments in term of human (and consequently financial) resources development in this area.

Manuals and training

Eleven SAIs reported that they **developed Audit Manuals for auditing EU funds**, either in a form of specific manual or as a part of general Audit Manual. In six of them (*Bulgaria, Hungary, Latvia, Poland, Romania, Slovenia*) development of such manuals was part of TWINNING projects, while Hungarian, Latvian and Slovakian SAI even set up **detailed procedures to audit ICs in connection with EU funded projects. Main sources used for preparation** of manuals were: INTOSAI Auditing Standards, European Implementation Guidelines for INTOSAI Auditing Standards, IFAC Auditing Standards, Reports of WG on AM, various materials developed by SIGMA and SAIs from EU member states, relevant EU and national regulations and guidelines, instructions of experts of European Commission, international agreements, etc.

In SAIs of *Bulgaria, the Czech Republic, Hungary and Slovakia* **training has been organized to assist in the implementation of Audit Manual** for auditing EU funds and in 6 SAIs (*Bulgarian, Estonian, Latvian, Lithuanian, Romanian, Slovakian*) **pilot audit(s) on management of EU funds have been performed**, mostly assisted by the SAIs of member states (Croatian and Slovenian SAI stated that plan to do the same in the near future). Five SAIs **recognized pilot audits as useful tool** in providing the required experience in the implementation of certain audit methodologies and techniques, while two of them also found them good in providing useful input for preparation of Audit Manuals on EU matters.

The application for EU membership by Candidate Countries and current provisions of pre-accession funds, have rendered more urgent the need for SAIs to improve their organization by carrying out audits more professionally and by increasing the necessity to adhere the best European practices in state auditing. In this respect, the existence, preparation, dissemination and implementation of appropriate Audit Manuals are essential requisites for the proper functioning of SAIs.

Totally in compliance with this recommendation based on EU accession requirements, eleven SAIs recognized, mostly based on their practice, importance of developing **a common audit manual for all EU funds**, while Estonian and Polish SAIs stated that there is no need for such Manual. As a rule, they think that it should be based on good practice and experiences, and supplemented by technical guidelines with worked examples and case studies, to help promote practical use of Manual.

All SAIs stressed that Audit Manual and guidelines, once prepared, should be tested in each country to assure that it is applicable to its circumstances and environment (e.g. through the pilot audits).

Future development

When it comes to the question is there **a need to continue with development of ICS's auditing practice**, only one SAI doesn't think that the ICS/PIFC issue should be further developed, while **all others found it desirable**, either through the **establishment of the new sub-group for development of Audit Manuals for EU funds** or through the **establishment of the special Strategic Committee**. Also, there have been some other proposals such as: **on-the-job training in more experienced SAIs, long term advisory work by experts from member countries, learning-by-teaching programmes, web discussions through an electronic network**, etc. This is obviously an area where all SAIs would like to invest more in the future, in one way or another.

Recommendations for improvements of Internal Control Systems in candidate countries and strengthening of SAIs role in that area based on the analysis of replies, are given in the Chapter VI of the Report.

CHAPTER IV: STATEMENT OF PRINCIPLES AND TECHNICAL GUIDELINES

The efforts in streamlining and strengthening of ICSs as an important area of the ongoing enlargement process, should proceed from a solid conceptual basis and specific benchmarks reflecting best practices. Such a framework should be provided by the **a statement of principles governing the way in which this should be addressed, supplemented by a series of technical guidelines** which will capture the standards essential for the effective Internal Control management of EU resources, supported by **a good practice guide**.

As stated in the Chapter III, SAIs of candidate countries have shown interest in and need for development of a common system for the audit of internal control systems, supplemented by the technical guidelines and good practice guide. Such guidance could have a useful additional role in helping the SAIs to easier "switch into" the EU system.

The Statement of principles and/or Guidelines should cover issues such as:

- setting out an audit arrangements for pre-accession and structural funds;
- roles and responsibilities of different bodies involved in the audit of pre-accession and structural funds;
- requirements for Member states' internal control systems;
- standard framework for the audit of internal control systems (methodologies and procedures), including tests of control and questionnaires especially adopted to EU requirements;
- presentation of audit reports;
- a good practice guide as additional part.

It is important to emphasize that these Guidelines:

- a) are based on the using of commonly understood audit terminology;
 - b) are build upon and supplement the INTOSAI Standards and European Implementing Guidelines;
 - c) are communicated to all audit units and to the staff within SAIs as well;
- a) quality assurance measures are set up to assure that the guidance has been:
 - understood by all audit staff and
 - being followed by all audit staff.

The need for establishment of the specific sub-group/committee for development of mentioned document(s) has also been determined. The opportunities of such group/committee to contribute are numerous. It could:

- Organize a workshop with the goal to define type and propose content of Guidance;
- Collect and process the appropriate materials (such as existing manuals - examples of good practice, experts advice and other useful materials) for inclusion in guidance as well as for good practice guide (it is needed to start with this activity as soon as possible);
- Try to unify and to set a framework for guidance;
- Propose relevant supportive trainings;
- Organize seminars where the SAIs from Member States and also from Candidate Countries who have already completed their Audit Manuals in this field or are to finish the process of their preparation, could have presentations with explanation of their approaches in achieving this task.

Development of uniform guidance for all SAIs and all EU funds supported by sufficiently clear and timely documents in a form of technical guidelines and a good practice guides is a complex task. As such, it represents great professional challenge, but also demands more extensive discussions and systematic work.

CHAPTER V: THE PUBLIC SECTOR AUDITING STANDARDS - NEW DEVELOPMENTS?

1. Introduction

The establishment of those demanding internal control standards is necessary, particularly in government, in view of its size; diversity; the volume of transactions; the multiplicity of records and numerous rules, regulations and laws. Because statutory provisions govern the management and control of public resources and public programmes, standards that govern and ensure such compliance are required¹⁷.

As a "living document", auditing standards should reflect, to the extent possible, the current trends, issues and concerns in auditing methodology and practice. In our case: current trends in designing, implementing and evaluating ICSs connected with the EU rules and requirements.

Based on the experience in candidate countries, research done by the PIFC Expert Group and discussions with the members of the Working Group on Audit Manuals, some ideas in the light of the improvement of existing standards have arisen. Ideas are maybe not new, but their presentation as a framework for consideration, however, may be new. Those ideas together with proposals for further consideration are stated in this Chapter.

2. Proposals

2.1. Co-ordination of external and internal auditors

Even though there exist quite significant differences between private sector (commercial) audit, public (state) sector audit and internal audit, external auditors in their work can use work of internal auditors.

External auditor is responsible for his report, as well as for stating the type, time schedule and audit scope of his audit activities. In that work, certain procedures and results of Internal Audit can be useful. This is why external auditor has to understand purpose (role), procedures and methods of internal audit's work, what can help in audit planning and can enable efficient audit approach.

Because of the significance of good co-operation between internal and external auditors in both directions, the Internal Audit Standards gives special attention to mentioned co-operation, while in the INTOSAI Auditing Standards this is not a case - they refers only to the co-operation with internal controls:

Internal Control Standards

The Internal Audit standards of the Institute of Internal Auditors presently in force are systematized in the following main areas:

Attribute Standards:

- 1000 – Purpose, Authority, and Responsibility
- 1100 – Independence and Objectivity
- 1200 – Proficiency and Due Professional Care
- 1300 – Quality Assurance and Improvement Program

Performance Standards:

- 2000 – Managing the Internal Audit Activity
- 2100 – Nature of Work
- 2200 – Engagement Planning
- 2300 – Performing the Engagement
- 2400 – Communicating Results
- 2500 – Monitoring Progress
- 2600 – Resolution of Management's Acceptance of Risks.

Detailed information on what does internal auditor's independence mean, how should the internal audit service be organized, which professional qualification and skills of internal auditors are desirable, what activities should audit work consisted of, who and how should manage the Internal Audit Service's work, co-ordinate work of internal auditors, communicate with external auditors, etc. is given.

As concerning the relationship between internal and external auditors, the following standard has to be mentioned:

2050 – Coordination

The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

INTOSAI Auditing Standards

INTOSAI Auditing Standards are consisted of four parts:

- a) Basic Postulates,
- b) General Standards,
- c) Field Standards and
- d) Reporting Standards.

Field Standards includes that the auditor, in determining the extent and scope of the audit, should study and evaluate the reliability of internal control¹⁸. The study and evaluation of internal control should be carried out according to the type of audit undertaken¹⁹. The extent of the study and evaluation depends on the objectives of the audit and on the degree of reliance intended²⁰.

¹⁷ INTOSAI Guidelines for Internal Control Standards, Chapter III, par. 16.

¹⁸ INTOSAI Auditing Standards, Chapter III – Field Standards, par. 131 (c).

¹⁹ INTOSAI Auditing Standards, Chapter III – Field Standards, par. 142.

²⁰ INTOSAI Auditing Standards, Chapter III – Field Standards, par. 143.

As mentioned above, Field Standards explain the issue of examination and evaluation of assurance of internal control systems. However, those Standards don't directly look over neither in practical sense explains co-operation with internal auditor. Moreover, internal audit is not directly mentioned at all.

Even though it hasn't been stated explicitly, those activities should be referred to Internal Audit as well.

Referring to the fact that INTOSAI Auditing Standards constitute the criteria or yardstick against which the audit results are evaluated, **significance and importance of good relations and effective co-operation of external and internal auditors for achievement of good results, should be stated in them more specifically.**

Co-operation of external (public) auditors and internal auditors would be more effective if, in conducting of common activities, they would use similar techniques, methods and terminology. In respect of that, **harmonization of part of Standards common to private sector (commercial) audit, state audit and internal audit** is also possible.

2.2. Definition of internal Audit

Management organizes internal audit as a "supervision" under the organization's internal control system and connection between management, stakeholders and external audit. In its modern perception, internal audit can help in realization of the basic goals of an organization. This result from the new definition of Internal Audit (1999): Internal audit is independent, objective, assurance and consulting activity designed to add value and improve effectiveness of risk management, control and governance processes".²¹

Concerning the INTOSAI Auditing Standards, there is no standard defining internal audit. It is only mentioned in the INTOSAI Guidelines for Internal Control Standards (par. 84.) as an important element of internal control by providing a continuous means for improving an organization's operations.

If the external auditor is to understand purpose procedures and methods of internal audit and use this in audit planning and establishing of audit approach, he has to know its definition. Namely, definition - as substantial determination or description of the concept - should show which role does Internal Audit have in the organizational structure and what is their intended purpose.

As the general framework for public audit work in most of the countries, INTOSAI Auditing Standards, in accordance with growing importance and development of internal audit in public sector, should provide a definition of internal audit function and its relation to external (public) auditor's work.

Therefore, **definition of Internal Audit should be embedded in INTOSAI Auditing Standards.** Also, definition should, to the maximum possible extent, be harmonized with definitions determined and used in private sector's and in internal audit's field.

2.3. Other possibilities

In consideration of possible modifications or even expanding of existing Standards and Guidelines for their implementation, it would be important to also include issues arisen during the last year's workshops and meetings, like is:

- the need to emphasize the importance and impact of Information Technology and Computer Assisted Auditing Techniques,
- to include the concept of quality assurance,
- to pay attention to auditing external aid,
- judicial process (in the case of Court structures),
- detailed and specific contradiction procedures for public sector,
- to develop comprehensive performance audit standards,
- more detailed Audit Sampling Standards, etc.

For most of these last detailed areas the EU Implementing Guidelines (EUIG) for the INTOSAI Standards provide more detailed, relevant guidance, although the EUIG also could benefit from updating and extension on certain aspects. Active consideration needs to be given as to how the EUIG can be further developed and made even more relevant and useful.

In the preparatory phase, a questionnaire to both SAIs from this Working Group and from EU Member States could be created in order to:

- do a survey on the situation and problems related to the implementation of the INTOSAI Auditing Standards, INTOSAI Guidelines for Internal Control Standards and European Implementing Guidelines for INTOSAI Auditing Standards in the individual states and
- to determine the expectations and the possible needs for their development, and whether they consider it necessary to amend them in any possible direction, especially when it comes to the control of EU funds and the relative detailed control procedures.

Report on the results of survey should be followed by discussions regarding the possible development of currently accepted standards and guidelines. On the basis of the survey, if significant ideas arise, recommendations could be prepared. In that case, Working Group on Audit Manuals should liaise with the INTOSAI Auditing Standards Committee and the INTOSAI Internal Standards Committee (whose major project at the moment is a revision and updating of existing Guidelines for Internal Control Standards adopted by INTOSAI in 1992) as well as with other relevant institutions and organizations responsible for development of standards/guidelines for analyzing.

²¹ www.theiia.org

CHAPTER VI: THE GENERAL CONCLUSION

Most of conclusions presented here are not new ideas. Many of them are already incorporated in some countries. However, their presentation as a framework for improvement may be new in countries where they are not fully incorporated. Nevertheless, it is evident that the SAIs of the Candidate countries, have already taken concrete measures to improve their situation regarding the improvement and development of effective internal control and risk management systems in their countries - either by efforts made by themselves or through the co-operation with ECA, SAIs from EU member states or SIGMA – and achieved a significant progress in this area. The present situation shows constantly improving situation and development in the direction to meet the EU requirements. All countries are obviously eager to ensure that audit methodologies are in line with INTOSAI audit and other related standards, thus being acceptable to the ECA, the EC and other EU bodies. In this respect, additional actions for further improvements are planned to be implemented.

In short, one can conclude that degree of satisfaction that the EU wishes to derive from the CCs in establishment of sound financial management and control systems for their national income and spending, including EU-funds, based on economy, efficiency and effectiveness, everyday is getting closer to the expectations.

However, the review of progress, current position and experiences gained to date by SAIs of all countries has revealed number of issues that still need to be improved and addressed by the SAIs. The most important needs were summarized in the following recommendations:

- Recommendation 1:** ***Definitions of "internal control" and "internal audit" need to be clearly understood and applied consistently.***
- Recommendation 2:** ***SAIs should continue to focus on the development of effective and efficient ICSs in public sector entities and, where an internal audit function does not exist, to strongly encourage and support its introduction.***
- Recommendation 3:** ***SAIs should persuade management of auditees of the importance of internal audit functions undertaking the full scope of its role, where this is not currently the case.***
- Recommendation 4:** ***SAIs should encourage management to share internal audit reports with all stakeholders that have some influence on the recommendations made and corrective actions that may be taken thereon.***
- Recommendation 5:** ***SAIs should continuously endeavour to develop good working relations and effective coordination with internal audit units (IAUs) and that common practices, carefully taking into account SAI's independence, could be developed.***
- Recommendation 6:** ***In the light of the audit of EU funds, further investment in human resource development should be undertaken by both SAIs and IAUs.***
- Recommendation 7:** ***Training practice through pilot or other test audits in specific audit areas (particularly to those related to EU funds), should be undertaken by both SAIs and IAUs, and that the experience gained should be translated into technical guidelines and procedures for guiding future audits.***
- Recommendation 8:** ***Technical guidelines and good practice guides on specific EU-related areas (such as Structural and Cohesion Funds, VAT and Customs "Own Resources", etc) should continue to be developed and further discussed.***
- Recommendation 9:** ***SAIs should cooperate on determining the needs for improvement and development of current international standards and guidelines in the area of internal control system, particularly in terms of undertaking risk and materiality assessments.***

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- The European Commission's bibliographic database
(<http://www.europa.eu.int/scad>)
- The International Federation of Accountants (IFAC)
(<http://www.ifac.org>)
- The Committee of Sponsoring Organizations of the Treadway Commission (COSO)
(<http://www.coso.org>)
- The Canadian Institute of Chartered Accountants (CICA)
(<http://www.cica.ca>)
- The American Institute of Certified Public Accountants (AICPA)
(<http://www.aicpa.org/index.htm>)
- The Institute of Chartered Accountants in England & Wales
(<http://www.icaew.co.uk>)
- CIRCA, European Commission
(<http://www.forum.europa.eu.int>)