

PERFORMANCE OF THE PUBLIC SECTOR'S INTERNAL AUDIT IN THE BALTIC STATES

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Abstract

The development of internal audit in the new EU Member States after the enlargement of the EU in 2004 has a common basis, which is formed by the conditions of the EU Regulations and Directives concerning different fields of public and private sector, as well as under the influence of global economic crisis. Irrespective of the fact that in each national state the development and functioning of internal audit (IA) system may differ, it is emphasized in the research that, on the whole, under the influence of historical, political and economical factors, the development of the public sector's IA possesses certain convergence. The approach of three Baltic States – Latvia, Lithuania and Estonia – towards these issues has been studied in details; there has been performed the comparative analysis of legal conditions and actual data with the aim to identify the best solutions concerning the public sector's IA problem in Latvia after it has faced the economic crisis and in the post-crisis period.

Key words: internal audit, public sector, International standards for the Professional Practice of Internal Auditing, the Baltic States

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Introduction

The EU history faced the second most significant enlargement, and the new Member States included also the three Baltic States – Latvia, Lithuania and Estonia. This historical event could take place thanks to the fact that the new Member States prepared profoundly for the accession to the EU by meeting the set requirements and both modifying the taxation system and improving the state administration, including the development of IA system. The establishment of IA service in the ministries and other state institutions in Latvia was amended and approved in 2002 by the Internal Audit Law. In the same way during this period the IA system was created in Lithuania and Estonia. Although the development of the Baltic States has many common features, the result is not always identical due to the different influential factors and chosen implementation techniques. Therefore, the objective of the

research is on the basis of a comparison of the developmental aspects of IA systems in the Baltic States to detect the most topical problems, as well as to propose options for their prevention in the IA of the public sector institutions in Latvia.

The structure of the research is substantiated with the contents of the manageable tasks – in the first chapter the methodological basis of research is given, the second chapter summarizes results of the analysis regarding the peculiarities of the IA system in the three Baltic States, the third chapter provides summary of the comparison of the activities of the IA in the neighbouring countries and Latvia with the aim to apply the best experience for the improvement of the IA system in Latvia, but the paper ends with conclusions and proposals.

In the research there are applied the methods of general scientific research in economics: economic analysis and synthesis, logically – constructive, qualitative methods, including the methods of the analysis of normative acts. The theoretical and methodological grounds of the paper are the normative acts regulating internal auditing, works produced by Latvian, as well as foreign scientists.

1 Methodological and theoretical basis of research

Since the development of modern IA in 1940-ies, the significant changes have taken place not only concerning the definition and functions of IA, but also regarding its types, approaches, methods and standards to be applied, as well as the perception of public significance. It has been showed in many publications, which initially, from the research on the fundamental issues (Sawyer, 1996) lately places the main emphasis on the studies of different specific aspects related to the IA activities, for example, the efficiency of audit functions (Kinsella, 2010), the interconnection between the internal auditors' specialization and auditing activities (Sarens, 2014), application of agency theory for the research of IA (Adams, 1994), the improvement of IA in the IT environment (Yang, 2011) etc. The topicality of IA is particularly emphasized in the state administration sector, and particularly – in the post-socialism countries (Skoczylas, 2011) (Bota-Avram, 2011).

Understanding the influence of the EU requirements and the international professional organizations, in this case – the influence of IIA – on the development of the IA systems of national countries, it is assumed that, in order to ensure sufficiently transparent state administration system in the countries under research, the best practice of the world has been taken as the basis. Thus, in order to perform the comparative analysis of the development of

the IA of public sector in Latvia, Lithuania and Estonia, the descriptive analysis of national laws and other laws and regulations was used as the research methodology, which was supplemented by the evaluation of available statistical data.

The main research question is how much these relatively different templates resist convergent development in the public sector internal control and auditing and to what extent we can see similar solutions regarding the IA in the public sector in these three Baltic States. The main expectation is that the convergent forces in our globalized world, where public sectors and the managers and audit profession cooperate and bench-mark each other, lead to growing similarity in spite of different basis.

2 The Analysis of the internal audit systems of public sector in the Baltic States

2.1. Case of Latvia

The initial period of IA development in the public sector of Latvia dated back to 1999 when several normative documents were adopted, from which the first was the Regulations of the Cabinet of Ministers No. 342 “Regulations Regarding Internal Audit”, after - the Internal Audit Law (2002). Similar to the other EU member states, Latvia introduced a decentralized IA system. It is characterized by establishing the Internal Audit Council and independent IA unit in each state administration institution. Ministry of Finance (MoF) of Latvia acts as a coordinator in this system. The Internal Audit Council in IA system is a consultative body, which contributes to improving the quality of IA and IA policies and methodologies for the introduction and development of ministries and institutions.

Significant changes in the development and expansion period of the IA system took place in 2002 and 2003 when the need for IA methodology in the public sector created preconditions for drawing up the Internal Audit Law. The Internal Audit Law was primarily based on International Standards for the Professional Practice of Internal Auditing (ISPPA) although the law did not explicitly require comply with these standards. In a way, these normative changes raised the Latvian IA to a higher level of professionalism in comparison with previous periods however one of the problem was the lack of qualified auditors and new high requirements for internal auditors.

Following the approval of these normative acts, the number of IA units significantly grew in the state administration sector. In 2003, 14 ministries and 4 other state institutions had among them a total of 62 IA units, and in 2008, 15 ministries and 5 other state institutions had

83 IA units employing 300 staff. This number was reduced to 29 units in 2012 as the result of cutting costs during economic crises in the state administration. (Ministry of Finance of Latvia, 2012)

The development and expansion stage is also characterized by improvement of the IA methodology. For a better assessment of the development and achievements of IA the MoF performs an assessment of the work of all IA units once every two years. After few years specialists have concluded that the period of two years is too short to assess the development of an IA function. As a result, the MoF introduced the period of five years as required by the ISPPIA. This requirement is introduced via amendments to the Internal Audit Law (2010).

During the period of economic crisis and post-crisis Latvia's adaptation to economic crisis was marked with amendments to the Internal Audit Law introduced on 16 March 2010 and on 28 December 2012. The new Audit Law contains regulations that IA unit should be established only in ministries and institutions directly subordinated to the Prime Minister. The new version of law does not provide the minimum of internal auditors in audit department wherewith the several ministries have only one auditor. The law from 2012, introduced in line with the ISPPIA, includes auditors' objectivity criteria, updating of internal auditor's responsibilities and principles of ethics, specified the objectives of an IA unit. Furthermore, it introduces the basic conditions for establishing an Internal Audit Council and its objectives.

In summary, the increase and decline of IA growth in Latvia during last more than ten years can be explained with the different economic conditions before and after global financial crises and requirements of International Monetary Fund (IMF) as well. IMF required Latvia against loans to develop its control system regarding money usage in the public sector. A number of new regulations of Cabinet of Ministers in 2010 and 2012 (Law of Republic of Latvia, 2012) include measures that set a base for improvement of IA system in Latvia. Thereby, the normative decisions have had a significant impact on IA in Latvia although IA is mandatory only for public sector institutions. Private companies in Latvia have the possibility to voluntarily introduce IA into their organizations.

2.2. Case of Lithuania

Traditionally relying on the centralized public finance management supervision, in Lithuania until 1998 there was no IA function performed. Alongside with the public administration reform there was commenced the development of both public finance planning and public internal control structure. The function of IA in Lithuania was established around 2000 by strengthening it by adopted laws and regulations and policy documents adopted by

the government; thus the basis was laid for the internal control structure in the public sector. The following main legal instruments for IA and financial control were adopted in the Republic of Lithuania:

- Law on Public Administration — on 17 June 1999;
- Government Resolution No 127 on Internal Audit of State Enterprises and Establishments of 7 February 2000 (amended by Resolution No 1098 of 13 September 2001);
- Government Resolution No 1116 on Internal Audit Standards of 19 September 2001;
- Minister for Finance Order No 26 on the Internal Audit Manual for Public Enterprises and Institutions of 31 January 2001 (amended by Order No 22 of 23 January 2002).

The MoF is in charge of the overall methodological guidance on IA and financial control issues. (European Commission, Compendium, 2012)

In 2002 the newly adopted Internal Control and Internal Audit Law enabled to implement in Lithuania the consolidated reforms and the EU conception in this sphere. By 2011 there were established 215 IA units in the state administration, as well as more than 470 workplaces for the internal auditors (Matusevičius, 2011). The important developmental dimension of IA was the formal educational programs for internal auditors, which were supported by the EU, and the development of internal auditors' certification system. Internal auditors were regularly trained under a newly prepared four-module continuous training programme for internal auditors in the training centre of the MoF. In addition, a number of projects comprised training components on IA not only for internal auditors and accountants, but also for the heads of the public institutions. These contributions considerably enhanced the administrative capacities of IA units in the public sector.

In order to implement these reforms, there were two institutions established in Lithuania: 1) Commission for Coordinating the Development of the Internal Audit System in the Public Sector and 2) a Central Harmonization Unit, a new office within the Ministry of Finance tasked with developing standards and guidelines for the new internal control framework. (European Commission, Compendium, 2012).

2.3. Case of Estonia

Having analyzed the development of IA in Estonia, we should point out that before the regaining of independence there was no such IA developed there that would correspond to the international IIA definition, although there were several institutions that ensured the external supervision in the public sector and in different industrial fields. The government of

Estonia in 1999 formed a commission the task of which was to elaborate a plan for the development of the financial and internal control of public sector in Estonia. However, due to different reasons, the work of this commission was not successful. Only in 2000 the parliament of Estonia created an efficient legal basis for the IA system, which had to function at three levels: 1) Ministry of Finance; 2) Ministries and State Chancellery; 3) state agencies. However, the problems regarding the functioning of system were caused by lack of professionally educated internal auditors.

The government of the Republic of Estonia adopted the activities of IA at a larger scale only in the second half of the year 2005. In April 2006 there was approved the IA development conception, where there were defined some fundamental proposals in order to improve the ability of ministries to organize the work of IA, as well as there were indicated four most important problems: 1) the ministers are not entitled to receive information from the IA units of agencies under the subordination of ministries; 2) in some ministries the internal auditors' have a low level of competence; 3) the internal auditors' independence of the small public institutions is exposed to danger, because they perform not only the IA functions, but also other functions; 4) the maintenance of IA system of three levels is cost-consuming. (Linnas, 2008) Only after several years the topicalities indicated in the conception were included into the Auditors Activities Act of Estonia (hereinafter AAAE) which came into force in Estonia on 8 March 2010. By this law there were attempts made in Estonia to relate the common regulation towards the activities of both external and internal auditors, thus causing additional difficulty for the management of processes. It is considered now that in this sphere it is more useful to have the regulation provided by two separate laws. The necessary framework exists for responding to challenges facing IA in Estonia. Still, the IA in Estonia is more similar to the European average with regards to IIA membership history, education, professional training and academic areas of knowledge (The Common Body of Knowledge (CBOK) Europe study report, 2008) (Linnas, 2008).

3. Summary of the comparative analysis

Having summarized the obtained information on the regulation, structure and other parameters of the IA systems of state administration in the Baltic States, we should draw a conclusion that the development of the IA of public sector was relatively similar in all three states, and the initial thesis on the certain convergence has been proved. Certainly, it was facilitated by political and economical factors, the most significant part of which was the fulfilment of the EU requirements during the pre-accession period. However, the detailed

analysis enabled to identify also the differences, and thus the table of comparative analysis was developed (See Table 1), which explicitly showed that the IA systems of states under research have both common and different features.

First of all we should point out the differences in the field of legal acts – in the case of Latvia and Lithuania the IA in the public sector is regulated by special, only for the IA envisaged laws, whereas in Estonia the respective law is applied to the activities of both internal and external auditors, which, to some extent, complicates the application of this law.

Tab.1: Regulation of IA in public sector of Latvia, Estonia and Lithuania

IA characteristics	Latvia	Estonia	Lithuania
<i>Laws regulating internal audit</i>	Separate law for IA in public/state sector 2002 Amended 2010 and 2012	Joint law (Auditors Activities Act, AAA) for IA and EA. Entered into force 8 March 2010	Separate law for internal control and IA Amended several times
<i>Compulsion</i>	State sector: compulsory LG: voluntarily	State sector: compulsory LG: voluntarily	State sector: compulsory LG: voluntarily
<i>Guidance in work</i>	IA Methodology of Cabinet of Ministers	AAA of 2010, regulations of the MoF, The IIA standards for IA.	Methodical guidance in financial control and IA of MoF
<i>Organization mode</i>	State sector: Decentralized, coordinator MoF LG: decentralized	State sector: Decentralized, coordinator MoF LG: decentralized.	State sector: Decentralized, coordinator MoF LG: decentralized
<i>Number of IA units</i>	State sector: 68 (2008), 52 (2009), 29 (2012) Local governments (LG): 17 (118 municipalities)	State sector: IA unit in each ministry and IA units are in 5 of 15 County Governors' Offices LG: only biggest towns	State sector: 215 (2011) LG: 60

Sources: (Law on Internal Control and Audit, Law of Republic of Lithuania, 2002); (Internal Audit Law, 2012; Law of Republic of Latvia, 2012); (Auditors Activities Act, Law of Republic of Estonia, 2010); (European Commission, Compendium, 2012)

There are different solutions found concerning the issue of methodological management, which in Estonia and Lithuania is implemented by the MoF, but in Latvia – by the Cabinet of Ministers, although the organizational form is identical. In all three Baltic countries – Latvia, Lithuania, Estonia, as well as in several other EU countries (Hungary, Poland, Slovakia, the Czech Republic, and Slovenia) decentralized system is chosen as the most acceptable. It is characterized by establishing an independent IA unit in each state administration institution, and the MoF acts as a coordinator in this system.

As a result of analysis it was concluded that concerning some aspects the experience of neighbouring countries is more successful, and therefore it should be recommended for the adoption, thus improving the IA policy and practice of public sector in Latvia. One of the

most important elements of normative regulation, which is included in the laws of both Lithuania and Estonia, is the requirement to implement the activities of internal auditors in conformity with the ISPPIA. This requirement is not present in the Internal Audit Law of Latvia. In total the IA system of the public administration in Latvia has been established in accordance with ISPPIA but there still exist certain deviations. Firstly, the definition of the IA in the Internal Audit Law of Latvia differs from the one expressed in the standards, where it is stated that “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations”. However definition on the goal of the activities within the Internal Audit Law indicates only the examination of the internal monitoring system not including the consulting activities (Internal Audit Law, 2012) . Despite it, regulations foresee that the reviews should also report on the amount of the consulting activities. From the reports it is seen that the amount of the consulting activities increases year by year. It can be explained by the insufficient number of the employees who should carry out not only the current audits in accordance with the annual plan but also provide consultations on several issues that could be related to the system to be audited. Thus in 2012 in 13 IA units there were only 60% of time available for the audit was used for the auditing services (Ministry of Finance of Latvia, 2012). Thus the standard *1100 – Independence and Objectivity* would not be observed. The data of reports of Ministry of Finance of Latvia shows that also observance of the other attribute Standard *1200 – Proficiency and Due Professional Care* can be hindered. Insufficiency of highly qualified internal auditors can serve as a reason for this. The problems related to the high number of free jobs within the IA services create a situation that also several Performance standards would not be observed. Thus, for example, Standard *2010 – Planning* clearly states that „ The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization’s goals.” When determining the most risky systems that should be audited first, the total amount of work can turn out to be too big to be carried out with the help of the current staff. Thus the auditing of very important systems is postponed to the next period. Most of the mentioned problems can be solved by arranging staff issues.

The second example of good practice, which would be useful to introduce also in Latvia, is the education and certification of internal auditors. If in Estonia it is envisaged that since 2013 all internal auditors of the public sector must be certified, then the law of Latvia provides that the heads of all IA units shall be certified starting from the year 2014. The data show that in 2012 only 32% of the total number of auditors had obtained the national

certificate, but in 22 units out of 29 the heads of units had neither the national certificate, nor the international one (Ministry of Finance of Latvia, 2012). The experience of Estonia shall be recognized regarding the improvement of professional qualification, where there were 15 internal auditors educated, who will perform the education of other auditors in the future. In its turn, Lithuania has successfully developed the system of four modules for the education of auditors, where there are involved not only the internal auditors, but also the heads of state administration institutions (European Commission, Compendium, 2012). Unlike to Latvia, in both Lithuania and Estonia the education of auditors is ensured by the Ministry of Finance, thus ensuring the complete platform for the implementation of IA policy.

Conclusions

The development of the IA of public sector in three Baltic States (Latvia, Lithuania and Estonia) is characterized by certain convergence, the basis of which could be found in similar historical development, close economic cooperation, as well as in the observation of the EU requirements during the pre-accession period and when these states became the EU Member States, however, it is difficult to identify the identical developmental periods.

The formal of IA systems – a decentralized system in all states under research is similar, but there exist differences, which manifest in the sphere of the formation of legal basis – the laws with different scope of content, and in ensuring of methodological management. As successful we could point out the Internal Audit Law of Latvia, which regulates the IA activities of public sector, but more uniform approach in the field of IA policy and methodology is ensured by the experience of Estonia and Lithuania.

The performed research and the results of comparative analysis enabled to identify several opportunities regarding the adoption of good practice of neighbouring countries, thus improving the IA system of public sector in Latvia. At this stage the most important aspects of good practice are:

- The supplementation of the Internal Audit Law of Latvia with the condition that the internal auditors shall perform their activities in conformity with the ISPPA could in certain situations increase the auditors' independence and objectivity.
- In order to ensure the fulfilment of the provisions of laws and regulations, in cooperation with the IIA to develop the educational and certification system for the education and certification of the highest level internal auditors of Latvia.

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