



SIGMA

Support for Improvement in Governance and Management

A joint initiative of the OECD and the European Union, principally financed by the EU

SIGMA PEER ASSISTANCE FOR THE STATE INTERNAL AUDIT SYSTEM IN LATVIA

Detailed Report of the Peers

February – April, 2005

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SECTION 1: OVERVIEW, INTRODUCTION AND BACKGROUND

A. Overview

1. SIGMA and the peers acknowledge the excellent development of the Internal Audit (IA) at the central government level in Latvia which has occurred during the EU accession period. Latvia has established an effective and modern internal audit service at this level. The drive and energy devoted to this, particularly by the Ministry of Finance, has been considerable. This has been rewarded by the levels of progress seen by the peers during the peer assistance review. It is also clear that there is an aim to deliver the best of international (ie the Institute of Internal Auditors (IIA) standards) and European Union internal audit good practices. There is recognition that the further development and sustainability of the IA system in order to maintain the work of IA to these standards is a never ending process that will need constant monitoring, hard work and vigilance.

2. The peers are impressed by the leadership, competence and motivation of the Ministry of Finance in its efforts to improve and further develop the performance of internal audit. The request of an open collaboration and partnership with SIGMA for peer assistance is an excellent example in itself of the ambition and well founded confidence prevailing today in Latvia's IA system, and in the Ministry of Finance in particular. The sound base for IA established over a number of years does provide a good platform and an opportunity to make further advances in introducing international standards and good practice.

3. When the Latvian IA system is being examined, five key factors need to be taken into consideration:

- The technical concepts for IA are difficult and still relatively new to Latvia.
- It is not easy to establish and then maintain the required new IA standards, practices and concepts to an acceptably high standard.
- The control environment is highly complex, and effective control systems are still being developed.
- Resources for the development of IA are scarce in the public sector.
- The Ministry of Finance's Central Harmonisation Unit for IA (the CHU) has done some very good work in a relatively short period of time.

4. The peers note that many of their recommendations set out below, if implemented, would represent some further complex and significant developments and changes to current working practices and procedures for IA Units. They may also require: some amendments to existing manuals and regulations; some significant investment of additional resources into IA; and greater appreciation by managers of the issues involved – particularly concerning risks of less than adequate IA cover and the need for managers, especially senior managers, to also be knowledgeable in risk management and assessment. We consider, however, that these recommendations will help senior financial management decide on priorities for developing and enhancing internal audit and also risk management systems. These changes cannot all be made overnight. Our recommendations on adopting and implementing and developing a formal planning process and detailed action plans (for the relevant components of the review) with defined objectives, targets and deadlines for achievement need to be considered in this context. The maintenance of the high

standards of IA needs to be properly controlled and implemented by the CHU. In setting high standards as the basis for this review, the peers are conscious of the fact that not all Member State internal audit systems and arrangements can claim to fully effective and fully apply the relevant standards. The peers consider, nonetheless, that in view of Latvia's good ambition to maintain effective progress in the IA area, the setting of less demanding criteria for the peer assistance review would neither satisfy Latvia's ambitions nor sufficiently exploit its potential.

5. The peers have made many detailed, and hopefully useful and helpful, recommendations. They are set out below in the three main sections of the report covering:

- a) The current state of Government level IA;
- b) The CHU and other important issues;
- c) Some recommendations by the peers for making IA better and stronger.

6. In more general terms the peers have made recommendations in the following key areas for action:

- Internal audit resource shortcomings have been clearly identified (some 30% of IA posts are vacant, and only 75% of planned IA work is completed each year) by IAUs and the CHU. The CHU needs to explain more clearly, assertively and urgently the risks this situation poses to financial management and control for the Government. This is a significant failing in the corporate governance and control arrangements for the State and needs high level actions from senior managers who are accountable to the public for sound financial management. There should be a plan made for a sensible strategy to reduce and then eliminate the gap in IA work.
- Many IA Units are of a very small size (2-4 persons) which makes it difficult for them to be operationally efficient. A sensible strategy should be developed by the CHU for ways and means of providing an IA service to small budget institutions in a more cost effective way.
- Changes need to be made to the methodology in the manual to reflect some significant changes that have occurred in IA methods in the last two years. The IIA Practice Advisories need to be translated into Latvian (as have the IIA standards) and used as a base for continued methodological understanding and development. The manual should be expanded with an Introduction Section on IA principles. All definitions in the manual need to be changed to reflect current standards and practice.
- As and when IA is developed as a legal requirement in the Local Government area the national Manuals, Guidance and methods developed by the CHU should be applied. As was successfully done for State level IA, the CHU should be asked to develop a policy paper on IA for the local government area as a necessary precursor to legislative development. This policy paper could helpfully also consider accountability, corporate governance, internal control and external audit requirements for local government.
- The CHU should be asked to take the lead in the government wide development of national standards and detailed procedures for Enterprise Risk Management. The CHU should be asked to report annually on the risks identified by these systems and discuss and consider the government wide issue identified and ensure the quality of systems operated.

- The lack of IT audit capacity capability should be tackled with some urgency. Specialised audit software should be available for all internal audit units (eg Winidea or ACL).
- Training arrangements have been developed well and competently delivered. But, training needs should be examined regularly and incorporated into fully financed training plans at the state and ministry levels making use of all training delivery methods. The IA government Certification scheme needs extending and linked to national and international professional certification schemes.
- Salaries need to reflect the importance and specialist nature of the internal audit position in ensuring a good internal control environment.
- The recruitment pool for internal auditors needs to be broadened by a more proactive policy from the Ministry of Finance towards the development of an IA profession in Latvia. Transfers, promotions, staff development, conditions of service are all key HRM areas on which the CHU should help develop policy and advice.
- The scope of audits should be extended to cover recent IIA developments. Independent consultancy advice and support for developing systems are all part of a modern role for IA.
- Good networking between IAUs is taking place, but should be further encouraged with the HIA networks further developed and used by the CHU for developing methodology and good practices.
- The establishment of audit committees should become a priority. IA needs to lead the effort to persuade management of this modern and effective corporate governance tool.
- Audit risk assessment processes should be re-examined in the light of recent technical developments and Standards changes, and in particular IA should actively support Ministerial objective setting and Enterprise Risk Management processes.
- A more comprehensive range of performance measures for IAUs should be introduced.
- Professionalism should be encouraged through active support for an IIA Chapter in Latvia, and financial support provided for this. Assistance from the international section of the IIA should be requested. Membership of the IIA in Latvia should be more actively and positively encouraged.
- English language training needs to be developed in order for auditors to have more direct access to technical developments and research; and also for interaction with other EU colleagues.
- Quality assurance processes are on a sound basis, but still need to be improved and brought in line with all IIA Standards requirements. Unit level quality improvement plans need further development and actions. The CHU should continue to develop its quality assurance fully in line with IIA standards requirements.
- Whilst the relationship and understanding of the separate and very different roles of IA and the State Audit Office (SAO) are now better understood than ever before the relationships with the SAO could be much better organised and co-ordinated. It is important that

procedures are introduced to facilitate more extensive reliance on IA work by the SAO, and to encourage the SAO to follow the International Auditing Standar 610 approach.

7. The peers consider the foregoing as perhaps the highest general priority areas, which should be tackled at the earliest possible date. In addition it would be sensible to use and spread the many good practices they have seen at individual Internal Audit Units during the detailed review. In the following 3 Sections a significant number of further detailed recommendations are provided. Recommendations were also provided to individual Internal Audit Units visited by the peers.

B. Introduction and Background

8. Following a request in 2001 from the EU Council of Ministers for SIGMA to carry out peer assistance reviews for all central and eastern European candidate countries the Ministry of Finance with practical support from DG Budget and DG Elarge, has asked SIGMA to arrange this external independent review (the peer assistance review) of internal audit. The purpose of the review is to provide the Ministry and the Commission with observations and recommendations for possible changes and improvements in order to help further develop and improve internal audit in a practical and effective way.

9. A peer assistance team of senior and independent expert IA practitioners from other EU Member States was brought together by SIGMA to work in a cooperative, practical and collaborative way with their Latvian IA peers (see **Appendix A** attached to this Report). The SIGMA team consisted of:

- Member State Peers: Sten Bjelke, Sweden; Gareth Evans, UK; Darius Matusevicius, Lithuania; and Gunther Meggeneder of Austria.
- SIGMA¹ provided technical and organisational support for the peer review.

10. The purpose of this peer assistance was to make an external independent expert analysis of internal audit in Latvia using as a basis of the evaluation the professional knowledge and experience of SIGMA and EU specialists in internal audit. Some of the yardsticks used by the peers are internationally acknowledged internal auditing (IIA) standards and good practices as applied in the EU Member States. The peers have made many recommendations based on these benchmarks as well as on their knowledge and experience of national, international and EU systems and good practices. The team was composed with this in mind, representing different types of nationalities and experiences.

11. It has to be emphasised that SIGMA peer assistance is not an audit, and by its very nature it concentrates largely on challenges and problem areas confronting IA in Latvia currently. A contradiction procedure with Latvian colleagues at the end of the review has been used as a means of clarifying the peers' findings, and to ensure that the understanding of the peers in the relevant areas is not significantly incorrect or resulting in misleading recommendations from the peers. On some issues the peers have found it useful to give examples of solutions applied in the EU Member States or other suggested practices. Such examples are illustrated in the several **Annexes** attached to this report.

12. The peers carried out the fieldwork in Riga over two separate weeks in February 2005. The SIGMA peers gathered information through extensive discussion and collaboration with their Latvian peers, and also analysed relevant laws, guidelines and official files and papers. A special team from the Ministry of Finance greatly and enthusiastically supported the SIGMA and the peers, who wish to express their sincere thanks on both an organisational and technical level, and especially to Dace Nulle (Director of

¹ **Nick Treen** SIGMA Team Leader (Senior Advisor for Audit and Financial Control to SIGMA); **Gareth Evans** SIGMA IA expert responsible for the QAR approach; and **Esther Bright**, SIGMA Project Assistant

the CHU at the time of the peer review) and Inguna Zvane (Deputy Director of the CHU at the time of the peer review, and now Director of the CHU) whose dedication, professionalism, drive and determination has done so much to set the basis for an effective IA system in Latvia, and the CHU team who ensured the efficient logistics of the visits and data collection.

13. The peer assistance has resulted in the production of many documents, annexes and technical notes and papers; one is this detailed report by the peers. Other documents including facts sheets on the Internal Audit Units visited and the resulting Quality Assurance measurement Reviews and reports by Unit by the peers are collected on a series of zip files and presented on a CD Rom of all the materials collected and generated by the peers. Also in the CD Rom is a zip file of **Annexes** with details of all peers both Latvian and SIGMA and technical advices and other reference documents that the peers thought may be useful. It is hoped that all these documents will be used as a reference guide for some time to come and as a basis for considering and developing detailed, further actions to implement actively and effectively the recommendations of the peers.

SECTION 2: THE CURRENT STATE OF INTERNAL AUDIT

General description of arrangements for IA

14. In accordance with the Internal Audit Law and the Cabinet of Ministers Regulation No. 306 the Ministry of Finance is responsible for overall co-ordination of internal audit. The role of the Ministry's Central Harmonization Unit (CHU) covers training and development, the development of a legal foundation, methodology and the improvement and sustainability of internal audit in the ministries.

15. Regulations of the Cabinet of Ministers provide for:-

- i. The procedure for internal auditing in an institution
- ii. The procedure for the certification of internal auditors

16. Internal audit units have been established and operate successfully at all ministries and subordinate institutions generally are included in their internal audit system. From the opinions on internal control systems included in the most recent reports submitted by the internal audit units it can be concluded that in general there is an established and operational system of internal control although there are a number of shortcomings which have been identified and for which recommendations have been made.

17. Before looking at issues which impact directly on the internal audit community it may be of value to first consider why the role of internal audit carries with it such an importance and potential value for ministers and senior managers. Internal audit is a cornerstone of good corporate governance in any organisation. It is, moreover, seen as a fundamental factor by the EC. In Latvia there is a well educated, enthusiastic and proficient group of internal auditors within the Ministries who have the capability of providing a modern internal auditing service, but who still need the injection of time, training, professional support and proper direction of their efforts if their future contribution is to be used to maximum effect

18. Even though there has been positive support it is still unlikely that the significance is fully appreciated of what can be the impact on the Latvian Government when the European Commission auditors start their missions to the country now that accession has been achieved. The EC auditors will be seeking to ensure that effective internal control exists across government and that EU money is being properly administered and accounted for. Where there is evidence that this is not the case then stringent financial penalties can and will be laid on the member state.

19. One of the best defences against the possible outflow of funds in the form of penalties is the existence of a fully effective internal audit service. Having a professional organisation capable of reviewing systems before the arrival of EU auditors, identifying problems and suggesting how they can be remedied, (provided it is coupled with a determination by the government to eliminate the weaknesses), is one of the best insurance policies available to a member state. Although not all ministries and subordinate organisations will all have the same involvement, if any, with the EC, nonetheless, the practices and standards which are necessary to safeguard EU monies should be seen as equally necessary to effectively protect national finances. Without an effective internal audit service there is also a risk going to be run that a situation will be created where fraud finds an environment in which to flourish.

20. The sooner this is understood and acted upon the less unpalatable will be any future dealings with the European Commission. It follows therefore that any organisation which provides such a potential safeguard must be treated as a vital asset. Recruitment, pay and conditions must reflect this. Good calibre people are fundamental to a successful internal audit capability. If the conditions are not right to attract and keep its internal auditors then the member state has only itself to blame for any consequences. One of the most vital roles internal audit can play is in the support and assurance it can give to the head of any organisation. With an honest, objective approach coupled with operational independence, internal audit is well placed to tell the Minister or State Secretary what is really happening in the Ministry and not what officials would like the Minister to know. When so much of good governance is dependent on the Minister having a realistic idea of what is involved in certain courses of action or having unbiased facts on a particular case or situation then the internal auditor can really prove his or her value

Explanation of approach

21. The starting point for Sigma was the general recognition of Latvia as one of the internal audit leaders of the new members of the EU having an already well-developed internal audit function operating in the government sector. This influenced the focus of the peer review approach which has been directed at assessing the comparative maturity of internal audit in Latvia and what can be done to push these boundaries even further forward. What we have clearly experienced is that people are highly motivated to do a good job and to improve and get even better.

22. The model used for this part of the peer review has taken the form of a 5 part Quality Assurance Review (QAR) evaluating and embracing the elements of:-

- The internal audit environment
- Standards
- Organisation
- Human resources
- Services.

23. Each of the internal audit units has been reviewed to assess their position in respect of development and capability. The five levels of evolution are:-

- 1) Entry level – no standards
- 2) Function generally operating along the lines of management's directions
- 3) Meeting some IIA Standards
- 4) Meeting most IIA Standards
- 5) Mature – world class incorporating the recognised elements of best practice

24. Basically the lowest level is a new starter unit whilst the highest level is a mature, experienced, well-resourced unit where best practice is the norm. A key point to bear in mind is that it is necessary to achieve effective implementation of all the elements at each level before it is possible to support development to the next level or to claim to have progressed to the higher level. It should also be understood that an internal audit unit does not have to strive for the ultimate level of competency

described. The process can however help an organisation determine the ideal level and focus of its internal audit function.

25. The final product of the peer review therefore tries:

- To provide a picture of where internal audit has reached in Latvia;
- Identify areas of strength, and also point to areas where further development is desirable and possible.

26. Interviews and paper and file examinations were carried out with the CHU and the following internal audit units:-

- Ministry of Finance core department (2 units)
- State Treasury
- Ministry of Transport
- Corruption Prevention and Combating Bureau
- Ministry of Interior
- Ministry of Economy
- Ministry of Agriculture
- Ministry of Environment
- State Revenue Service
- Rural Support Service
- Social Insurance Agency
- Ministry of Finance EU Financed Programs
- Ministry of Defence
- Ministry of Health
- Public Health Agency

27. Each of the 16 internal audit units visited by the peers has been the subject of a review covering 26 different areas in the 5 elements detailed above. A summary two to three page report for each has been completed and a spreadsheet incorporating the total QAR findings has been produced. The package of these three products can be found in the CD Rom containing all the materials provided by the SIGMA peers. The summary spreadsheet of the QAR scores is attached at **Appendix B** to this report.

28. In summary the peer's evaluation showed overall that IA in Latvia was well into group 4 – meeting most IIA standards, with scope for rapid development to group 5 with effort and resources applied

correctly. Scores for individual IAUs ranged from group 3 to group 4. Best elements overall were the IA Environment and IA Organisation. Most attention needs to be made to the Human Resources element and in particular to the following specific areas:

- IT audit capacity and capability
- Audit Committee use
- Professional membership
- Designations and qualifications

29. Many of the findings and views of the peers have been also identified by Heads of Internal Audit in their own self assessment procedures and in the CHUs own quality assurance work.

30. Further main messages emanating from this work of the peers under the five major elements are:-

1. THE INTERNAL AUDIT ENVIRONMENT

This is one of the strengths for Latvia. Internal audit units (IAUs) have a solid base provided for their activities within their charters. These, however, do not generally reflect the current direction set out in the IIA Standards towards risk management and corporate governance. There are strong reporting lines to senior management and the State Secretaries but within the limitations for some smaller ministries and agencies the introduction of audit committees will be of long term benefit.

2. STANDARDS

IAUs work to a well prepared and implemented central methodology adapted as appropriate to the individual circumstances within ministries. The Practice Advisories developed by the IIA as part of its Professional Practices Framework were rarely in evidence and need to be adopted and followed to ensure best practice prevails. Quality assurance needs to be developed particularly with regard to the need for independent external reviews. Performance measures are limited at present and a more comprehensive and progressive set needs to be adopted. Membership of the IIA is woefully low for a number of reasons not least the cost and the lack of incentive and recognition for becoming more professional in approach and attitude. This is a major point to be addressed if future improvement is to occur.

3. ORGANISATION

Heads of Internal Audit are generally graded at an appropriate level but scope exists for the all round position to be improved. The scope of work for IAUs is not limited and this is a very good sign. IAUs are well integrated into the work and structure of ministries and are seen as an important part of the organisation. Reporting relations are very effective. This aspect was found by the peers to be the most satisfactory part of their reviews. Many IAUs are small in size (2-4 persons) which makes it hard for the Unit to be cost effective and provide all audit expertise necessary ie IT audit.

4. HUMAN RESOURCES

Staffing levels are barely adequate and there is a significant shortfall overall particularly when staff absences and a high turnover rate are brought into the equation. Skills are at a reasonable level for core audit and financial work but need development in the wider areas of auditing and especially in consulting. Professional designations and qualifications would benefit from a closer proximity to the IIA. Professional

development is mixed with some units well placed but others need more involvement. Generally tools and technology for carrying out internal audit work need to be upgraded.

5. SERVICES

Work is generally focused on the financial controls and business processes and solutions. Planning is generally of good quality but could be made more relevant if ministries themselves had a clear plan of their own risks, priorities and activities. Assurance and consulting activities are still at a formative stage but a number of very good examples exist. Access to outside specialists is not a problem from a budgetary or theoretical perspective but in practice not much use of this resource has been witnessed. IT audit capability is an area which needs to be developed and in most cases this is also applicable to relations with the SAO which in many cases does not seem to fully understand or acknowledge the role of internal audit. Reports are presented at a suitably senior level whilst access to information is freely obtained. Overall the perception of internal audit is good and improving consistently with the development of a more consultative pro-active approach.

Overall Message

If there is one overriding message as to what internal audit in Latvia needs to do if it is to steadily progress further from where it currently rests it is that professionalism must be firmly embraced. The implications involve staffing, pay, training, modern internal auditing, corporate governance, professional qualifications and a general recognition that internal audit has a lot to offer senior management in Latvia if it is supported in reaching for a more sustainable and professional basis. Without that, the risk remains that internal audit in Latvia will become insular and start to fall behind those EU member states which are more pro-active in encouraging and forcing through professional initiatives.

SECTION 3: CENTRAL HARMONISATION AND OTHER ISSUES

A. THE CENTRAL HARMONISATION UNIT (CHU)

Introduction

31. Whilst this peer assistance devoted most of its expert assistance to the evaluation of the work and organisation of the Internal Audit Units (Section 2 above) the peers did review the role and work of the CHU because of its important and central role in the development and progress of internal audit. A number of main issues relating specifically to the CHU were discussed.

32. In general terms the peers noted that the CHU has a well deserved high profile nationally and internationally. Its work in helping achieve for Latvia the successful negotiation of the so called Chapter 28: Public Internal Financial Control (PIFC) area has been very useful and effective. The peers regarded the work and efforts of the CHU of high standard that was comparable to the best practice of EU Member States. The peers are hopeful that the resources and status of the CHU will remain important for the Ministry of Finance during a coming period where consolidation and further development of IA in Latvia remains very important. It is note worthy at the start of this Section to record the excellent efforts of our Lithuanian peer - Darius Matusevicius, who is head of their CHU for Internal Control and Internal Audit for all the Public Sector - for his assistance on this Section of the report.

33. Effort and resource has already been committed towards providing the CHU with an acceptable level of internal audit expertise and coverage. The right direction towards the new methods of working on internal audit has been and is continuing to take place. To maintain progress in making the most effective use of resources for the country it will always be necessary to enhance and improve the modern approach to internal auditing as the profession itself develops internationally and nationally and continue to improve the effectiveness of the government internal audit network.

Quality assurance role

34. The activities of the internal audit units are being assessed by themselves and the CHU in an ongoing effort to improve the internal audit activity and to determine whether the performed internal audits comply with internal audit standards approved by Government and other regulatory legal acts. The supervision (local peer review) of the internal audit activity contains:

- The internal (self-) assessment, i.e. regular revision of the activity performed by the Internal Audit Unit and carried out by the Internal Audit Unit itself, seeking to ensure the achievement of internal audit objectives, accuracy of data of the internal audit report and to assess proper implementation of other functions. This has been good in identifying some key deficiencies;
- The external assessment, i.e. periodic revision of the activity performed by the CHU or by the superior institution, on receipt of any information of the activity of the Internal Audit Unit and by on-the-spot-checks. The CHU needs to maintain frequency laid down in decree,

but this is time consuming so the peers question whether it has the resources to cope with this important demand demands. The current review is very dependent on self-assessment.

- Specific quality improvement plans need to be better developed and implemented as part of the existing long term development planning process monitored by the CHU.

35. In the view of the peers all ministries and agencies should have an independent external QAR at least every five years which rigorously measures IAU performance against IIA standards. This is a policy of the CHU.

Role of CHU in establishing an effective control environment

36. The financial/internal control component is the most important part of the PIFC system and in the majority of the new member states is considered to be a part of the CHU's responsibilities. The control environment:

- Are the overall attitude, awareness and actions of management regarding internal controls and their importance in the entity (the state administration as a total, ministries or individual budget spenders)?
- Encompasses the management style; and working cultures and values shared in the organisation at stake.
- Provides the background against which various controls are operated.
- Must be based on the rule of law, and an implemented system (integrity framework).
- It shall contribute to maintaining reliable accounting and reliable routines, which reveal and prevent material errors and irregularities. This is also the basis of secure administration of assets and good economical use of central government funds.
- It depends to a great extent on the ethics and integrity of management and this has a direct effect on the effectiveness of internal controls. Any management whose ethics and integrity can be questioned usually has considerable problems in guaranteeing satisfactory internal control of operations.
- An important part of the control environment, are the issues relating to the organisation and general management of work staff. Formal organisation is often of decisive importance for the efficiency of the internal controls in individual processes and routines.

37. Whilst the Peer Review has not been specifically focused towards these kinds of questions as the arrangements in Latvia are somewhat different to other new member states the impression has nevertheless been gained that there is some room for improvement of the overall control environment. A very important issue is related to the setting of clear objectives for this control component, ensuring an adequate implementation process and sufficient level of assurance. The purpose of this assurance is to give the top management of the public institutions and PIFC authorities the benefit of a checklist and format for analysing the current situation and to measure the progress achieved on a yearly basis. It is important to ensure that the format of the document should be understandable, well structured, accessible and transparent, focusing on major issues and bottle-necks, avoiding too much diverting detail; where necessary supported by statistical evidence, but not overburdened by details of tables and diagrams, thus

drawing away the attention from the purpose of the report. The format should be as far as possible problem-solving oriented and operational, facilitating the production of a report to make recommendations for actions towards further improvement.

Framework for future evaluation of CHUs

38. A practical exercise was organised by SIGMA during the SIGMA peer review mission in Riga with the close participation of the Lithuanian Head of CHU, Darius Matusevicius, and his direct Latvian peer Dace Nulle. It presented a unique formula for getting together government organisations that are responsible for the harmonised implementation of PIFC principles. The peers explored opportunities for further cooperation between the CHUs of Latvia and Lithuania facilitating the sharing of experience, analysis, evaluation and discussion of various PIFC situations. New ideas were also obtained on possible alternatives to move forward and further develop in Lithuania based on the relevant issues discussed (especially: risk management initiatives, quality assurance techniques, simplification, EU audit coordination, etc.). Both peers gained much valuable and interesting experience and exchanged documentation of use to each other.

CHU Benchmarking and good practices

39. CHU evaluation is an important issue within the whole PIFC framework. Its main objective is to develop and maintain procedures for quality assurance and improvement that cover all aspects of the CHU responsibilities within public internal audit and internal control activities so as to ensure an adequate/sufficient level of continuous monitoring of PIFC effectiveness. There are different approaches to such a kind of evaluation: - internally by self-assessment of the CHU and externally by any or all of the internal audit unit, Supreme Audit Institution, institutional managerial review process, international peer review mission, auditors from European Commission etc.–.

40. A CHU evaluation framework should be developed to help the CHU activity add value and improve its operations in order to provide assurance that CHU activity is in conformity with the objectives stated in national legislation and in line with the best professional practices and international standards.

41. Evaluating performance is not easy but nevertheless an efficient system of performance measurement and indicators needs to be established to allow better monitoring of performance and also benchmarking across government. CHU evaluation and related quality assurance and improvement and particularly the supervision of CHU differ under the way the PIFC in government is currently structured and what objectives are ascribed to. A harmonised and effective system of performance measurement and indicators for quality assurance needs to be ensured.

42. The principal CHU evaluation points could be considered as:

- The role of the CHU (staffing and resources, training, public relations, planning and reporting, networking, etc.);
- Internal audit system development;
- Financial Management and Control (FMC) system development;
- Coordination of EU financial aid control / audit activities.

43. The principal purposes of the CHU evaluation are to:

- assess the effectiveness and efficiency of CHU activity;
- assess the conformance to the legislative and other requirements;
- identify opportunities and offer recommendations for improvements.

44. At the preliminary discussion between the CHUs of Latvia, Lithuania and SIGMA, it was agreed that in order to provide the proposals for the harmonised CHU evaluation framework, first, benchmarking of the existing situation in all new member states in relation to the current CHU objectives is important. The CHUs of Latvia and Lithuania agreed to take the initiative in this benchmarking process. SIGMA will provide support to the preparation of information and proposals for this to the annual Meeting of NMS and CC CHUs organised by DG Budget based on:

- The methodology developed and used by SIGMA “Evaluation of central harmonisation and the drive for quality in the assessment of elements of role of CHU” (see **Appendice** attached) is one of the best examples to be used in developing and strengthening the CHU evaluation framework in different EU national authorities.
- After the benchmarking and relative considerations, the methodology is to be circulated among EU member states as a possible CHU evaluation framework.
- The role and objectives of the Lithuanian CHU are set out in an **Appendice** attached to this report for information. It is proposed that work be undertaken together with SIGMA on refining and developing a framework of model “objectives” for a CHU.

CHU Annual Report on Performance

45. The annual report of the CHU (a consolidation of the annual reporting process of the IAUs) is good and provides much information on the work and organisation of IA. The Internal Audit Council appreciated this work and relies on it to report and advise the Council of Ministers on IA. It is the view of the peers that the CHU should more actively use the report to draw conclusions and make recommendations for actions that in their view will help develop IA in any areas they seem fit. This expert diagnostic advice will be helpful to the Committee in its deliberations, and help the CHU have a mandate for its activities and programmes.

Consultancy Activities of the CHU

46. The CHU provides advice to HIAs, and the Heads of Internal Audit have begun to provide independent consultancy advice to managers in a practical and useful way and in line with IIA standards advice on this area. This is much to be welcomed as a modern and useful aspect of regular CHU and IA work and as such needs to feature in CHU and IA plans. Particularly useful work for IA in this area is to develop its support for the development of new systems (particularly new IT systems) in order to ensure effective controls are built into systems from the start. Audit Charters need to reflect the scope and purpose of the work area clearly.

CHU Conclusion

47. The CHU is strong, technically competent and has accomplished all its basic tasks. More work is still needed to keep standards, guidance and advice updated to constantly developing international standards and good practices, but the CHU is capable to meet this ongoing challenge. The CHU should consider the scope for performing its functions in the other areas of the PIFC system eg for Risk

Management and Internal Control issues. The human resources provided to the CHU appear just adequate at present, but the resources and scope for the CHU to contract specialist advice and other services in a flexible and efficient way needs to be more developed.

B. OTHER ISSUES

Introduction

48. A number of issues were considered and discussed by the peers that affect the general well being of the state of the IA nation in Latvia. These are set out below.

The IA profession and the IIA

49. The profession of IA and in particular the Institute of Internal Audit (IIA) is not well developed in Latvia. Unlike many New EU Member States there is as yet no national certification scheme for IA. The IIA itself has only 107 members of which less than 30 are from the central Government sector – although it is apparent that for some years the senior members and leaders of the profession have been from the public sector.

50. The support system and sheer extent of information and guidance available to members of a professional body is a very important issue. The IIA association in Latvia should have a target to welcome public sector auditors and grow the local body into a membership of more significant numbers, and develop an examination process capable of achieving recognition by the IIA. Staff should be encouraged to join the IIA and take attestation exams as a prelude to achieving full qualification. The payment of IIA subscription fees could be considered as an effective way of ensuring participation by the individuals in the IIA, and a way of Government obtaining influence over IIA activities. It may be useful to explore with other MS including Lithuania how to make a common public/private sector certification scheme. It may also be necessary to review the role of IIA to determine what's needed to inject some life and energy into it to make it something to which internal auditors will wish to subscribe.

Relations with the State Audit Office

51. During the last few years IA relations with the SAO have developed and improved considerably – to the great credit of both parties. These business relations still need to be improved and a key indicator of actual success in this area will be when the SAO actually is able and does rely on some of the work of IA. An **Appendix** is attached with some basic advice on building this relationship and further advice is contained in the Annexes in the CD Rom connected with the report. The IA and International Auditing Standards are clear on the steps and provisions both sets of auditors should take for this relationship and cooperation to flourish and be useful to both parties. It is recommended that the CHU take a lead in this area.

Local Government and State Industries

52. IA for Local Government and State Owned Companies is not a legal requirement – but should be. When a legal requirement is established the standards, manuals advices and guidance developed by the CHU on IA should be applied to these areas as well. Thought should be given as to how to extend the role of the CHU and the Internal Audit Council to these areas. This could be developed through the medium of a policy paper approach for the whole of PIFC, and include internal control, financial management and accountability issues, as well as external audit arrangements – so as to ensure maximum quality, efficiency and effectiveness of the system; whilst removing all unnecessary duplications.

Training and Certification for IA

53. It is vital that there is a concentration and strong focus on developing a sound approach to the subject of internal audit in its own right as a profession. Trained internal auditors should be proficient in applying internal audit methods, procedures and techniques without extensive management and be able to recognise significant deviations from good management practice. Internal auditors also need to appreciate the fundamentals of relevant specialist subjects so that they can identify problems or potential problems and judge when to seek assistance if required. This broader and richer mix of knowledge and skills and the giving of a wider, more intellectual and considered focus to audit issue would, in its course, lead to internal auditors being better equipped to achieve professional qualifications which test for those types of skills and qualities. Linking training to professional qualifications adds value, increases commitment and provides reward. A basic audit training qualification, which may have as its formal assessment the passing of professional examinations, whether in full or in modules, can be well directed way of motivating internal auditors and ensuring training is well focused. There would probably be a progression based on experience and capability through from the self-determined and influenced government qualification to an externally recognised qualification. It follows therefore that the existing process needs to be fully tied in with achieving an established, pre-determined government training qualification. Training needs to be linked to the achievement of professional qualifications. The good Latvian government public sector internal audit-training organisation and a certification programme needs to be further developed and enforced. The training modules and methods for internal audit of IIA should be analysed by to ensure compatibility and avoid duplication. Staff should be proactively encouraged to join the IIA and take attestation exams as a prelude to achieving full professional qualifications.

Internal Audit Council

54. The role of the Council has been crucial to the effective and good implementation of effective internal audit across the central government sector. The membership is of sufficient standing and covers a sufficiently wide range of skills and interests to enable it to exercise its responsibilities effectively. Nevertheless the effectiveness of the decision making process should be analysed. The Council, whilst carrying out its legislated commitments, should ensure internal audit development matters be progressed without any unnecessary delay. In particular it needs to be proactive in:

- Solving the unsatisfactory staffing/resources issue with IA (see Section 4 below).
- Taking a lead in providing a good solution for the need for IA in local government and the wider public sector.
- Promote the role of the CHU in providing standards and advice on risk management.
- Develop the use of audit committees and statements of assurance from senior managers on the adequacy of internal controls at ministries.
- Strongly support the professionalisation of IA.

SECTION 4: MAKING IA STRONGER

Background

55. The short reports the SIGMA peers have made on each of the 16 Internal Audit Units visited by them are contained in the CD Rom of all the peer assistance materials (see SECTION 2 above also refers). These contain many specific recommendations for the Unit concerned. The peers have also developed a series of more general and horizontal issue and recommendations for consideration, and these are set out below in the following categories:

- Pre-requisites for good IA
- Pay and conditions of service
- Practice improvement
- Professionalism for IA

56. There have been a number of big issues which the peers have considered and faced when discussing and analysing the position of IA in Latvia with their Latvian peers. These, together with some of lesser importance but which are still essential issues to be tackled, are briefly presented below:-

A. PRE-REQUISITES

Resource deficiencies

57. Most of the internal audit units are running below the necessary staffing levels necessary to carry out their work. The latest figures point to a shortfall of over 100 audit staff across the central government sector. This represents a shortfall of some 30% of IA staff, which carries significant risks for internal control and sound financial management of which senior management must be aware and take responsibility.

Recommendation

An Audit Needs Assessment exercise is carried out across the government internal audit sector to establish the resource deficiencies. These shortfalls in resources and the risks they pose need to be more forcefully presented to senior managers and the dangers to good corporate governance and sound financial management fully explained.

Satisfying internal auditors

58. Efforts are being made to produce committed professional auditors with enthusiasm and skills to create a professional internal audit service. The best performing internal auditors, in the profession globally are generally in a position where they have good self esteem and are also held in high regard by others. The

very best tend to be in the category of self-actualisation that is with an inner drive to realise their full potential and to maximise the impact of their internal audit profession. This follows Maslow's classical hierarchy of needs in which he identified that certain low level but basic needs like sufficient income, security and acceptance by others needed to be reached before people can push on to the higher levels. At present in Latvia there seems to be a real danger of reduced commitment by internal auditors who are still to have their basic issues of salaries, status and security catered for.

Recommendation

The classical management 'satisfiers' under the hierarchy of need should first be addressed as a prelude to providing the route to 'self-actualisation' for internal auditors

Potential internal audit talent

59. A view seems to exist that internal auditors should come from an educational background in accountancy, economics or something similar. When there is great difficulty in recruiting sufficient numbers of good calibre candidates it may be a luxury to stick to these fairly rigid requirements. Someone from a field different to these may be no less capable of making a good impact as an internal auditor and it is often the sign of a well rounded internal audit unit that their staff has a wide mix of experience and backgrounds.

Recommendation

Consideration should be given to broadening the pool of potential internal audit talent by positively welcoming and encouraging applicants from a wider background than accounting and economics. As an example, management experience is highly valuable when addressing governance issues and performing operational audits.

Shortage of IT expertise

60. Many internal audit departments do not have an appropriate level of IT expertise. Most audit departments are able to "in source" IT experts but with an ever increasing use of IT in the administration, the internal audit departments will need "in house" experts to be able to fulfil their duties.

Recommendation

Internal audit departments should be encouraged, where needed, to train or hire their own IT auditors to cover the need for increasing day-to-day support of the audit work needed in this area. Specialized experts should also, in the future, be "in sourced" where necessary.

Training anywhere other than with the Administration School is difficult without external funding.

61. Many internal audit units have explained that it is almost impossible for an internal auditor to participate in professional training which is not organized by the Administration School unless it is funded from some external source. Continuous training is one of the most important activities for an active and developing internal auditor. There is a lot of professional training that the School can't realistically hope to deliver. Thus it is important that there is a possibility for internal auditors to participate in training outside the Administration School without having to find a source of external funding.

Recommendation

There should be a budget for internal audit training external to the Administration School. Initially that budget could be administered by the CHU.

No specialized IT tools for audit

62. Audit Software (ACL, IDEA) is not used by or available to many internal audit units. These tools are very useful and easy to use by auditors who are not necessarily IT specialists. These tools facilitate considerable possibilities to rationalize the audit work without having to make a big investment.

Recommendation

CHU should negotiate with the national dealers of ACL and IDEA about purchasing at least one license for every IAD (governmental license)

Laptops

63. A number of internal auditors visit auditees, take notes and then transfer those notes on to their computers when they return to their office. It has been suggested that the provision of laptops (possibly to replace existing desk tops) which could be used to directly input information at the auditees' premises would provide for a more efficient way of working

Recommendation

The provision of laptops to internal auditors as a means of creating greater efficiencies in working practices should be considered.

B. PAY AND CONDITIONS

Low pay for junior staff

64. Pay is set at different levels across internal audit units and is dependent on how successful their ministries have been in achieving their budget allocations. Pay is a decisive factor in achieving the right resources to produce an effective internal audit unit. Aside from the disparity between public and private sector pay for internal auditors the pay levels for junior staff are insufficient to recruit people or retain those who have acquired any knowledge and experience. This is demonstrated by the high turnover rates and the scramble between ministries themselves to attract staff.

Recommendation

Salaries should be established on a national level and be set so as to recognise the specialist nature of internal audit and the need to attract and retain junior level staff.

Internal audit as a specialist

65. Currently internal auditors, particularly at the junior levels receive the same terms and conditions as any other desk officer. The demands made on them to train and become professional in their approach are significantly greater than the general administrative function and this should be recognised. Internal audit is a recognised specialist and should be accorded that status together with the benefits and expectations that go with that position

Recommendation

Internal auditors should be classed as specialists to distinguish the nature of the expectations upon them from those of general administrative desk officers

C. PRACTICES

Internal quality assurance

66. Within the Ministry of Finance there are a number of units carrying out internal audit work. This would seem to be an ideal situation for meeting the internal peer review requirements of the IIA Standards

Recommendation

Peer assessments should be carried out on a regular basis within the MoF by the three IAUs situated therein. This could be extended to the ST within the MoF and also to other ministries with similar type structures and relationships.

Performance Indicators

67. Currently there are a limited number of measures reported on by IAUs. Some units have already recognised the need to extend the scope of these measures examples of which can be found in Annex.

Recommendation

PIs and performance measures need to be developed to improve the management information process.

Performance measures sometimes not understood

68. The Internal Audit Manual prescribes three different performance measures that should be periodically reported to the CHU. Some units do not always follow these measures, whilst other units have developed these measures even further. During our interviews we have found that there are misunderstandings and sometimes objections to these measures. Performance measures are of vital importance to an audit unit if it is to develop the quality of its services.

Recommendation

The CHU should address the issue of performance measures with the HIAs and if needed take the initiative to revise the set of minimum measures demanded.

Representation on IS project board

69. Modern internal auditing recognises and champions the role that internal audit can play in ensuring that new and developing systems, whether they be IT or non-IT, embody effective internal controls. There is an issue of independence and conflict of interests with which many internal auditors are uneasy as their advanced involvement could place them in a difficult position if and when they come to subsequently review the implemented system. Current wisdom accepts this as a risk which must be taken and therefore it becomes imperative that internal audit is involved in new developments as an absolute right and not one where internal audit has to receive an invitation

Recommendation

Internal audit must be provided with the absolute right to representation on project boards set up to oversee and direct the development of new systems

Scope of audits

70. There is still a natural bias towards traditional internal audit work which looks at an organisation in a 'vertical' way where the individual functions are seen as the systems. This approach could usefully be developed to cover horizontal work of an overlapping nature eg. management information, risk management arrangements, human resource management systems, full systems eg payments through a full global life cycle, linkages with the trails in other ministries. Reviews of this nature may be particularly helpful and informative to top management

Recommendation

The scope of audits should evolve to one of including a 'horizontal' approach to identifying systems which extend beyond any one particular function or part of an organisation

Education of managers

71. The internal control and internal audit message needs to be disseminated widely to managers. Education of managers is vital if the importance of public internal financial control is to be understood and, equally importantly, acted upon.

Recommendations

- A series of seminars/ discussion groups should be arranged as a means of explaining and spreading the message of good internal control and the role which internal audit can play in achieving this.
- Regular and effective communication between State Secretaries/senior managers and their Heads of Internal Audit should be actively sought and encouraged

Compulsory annual management internal control assurance statements

72. Developments in corporate governance are increasingly requiring that internal auditors provide their senior management with an annual statement of assurance on the effectiveness of internal control within the organisation. Internal audit units in Latvia are in a position of development where they should be capable of providing such assurance statements.

Recommendation

Internal audit units should provide annual control assurance statements to their senior managers.

Shadowing

73. Where internal auditors join a small unit of only one or two auditors it can be difficult to gain experience of general practices and to fall into a closed mind set of how internal audit should be carried out. In these circumstances once a basic proficiency has been achieved it could be highly beneficial for internal auditors to shadow their counterparts in other longer established and larger units.

Recommendation

Internal auditors from small units should be encouraged to spend time shadowing their counterparts in larger units

Reporting routines are not congruent through all units.

74. Most internal audit units address their audit reports to the State Secretary or Director (Agencies) with copies to the direct responsible managers. Some internal audit units address the audit report to the responsible manager with copies to the State Secretary or Director. The biggest value added by internal audit is that management implements the auditors' recommendations. Usually a report addressed direct to the responsible manager and only copied to the State Secretary or equivalent encourages that.

Recommendation

Internal audit reports should normally be addressed to the directly responsible manager/director. Exceptions must be possible for instance reports with suspected irregularities or fraud.

Ministry Audit Committees

75. Very few Ministries have considered establishing an Audit Committee. An Audit Committee will be a very helpful initiative to support Risk Management and help the Ministry to increase the value added to its activities by the internal Audit. The peers strongly recommend the use of Audit Committees, and set out in the Appendices some descriptive materials on their operations and functions.

Recommendation

All authorities and agencies under the government should consider establishing an Audit Committee.

The Risk Assessment Method described in the Internal Audit Manual is not reliable

76. The result of the Risk Assessment Method described in the Internal Audit Manual is reliable only when used in an environment where all possible effects from all possible events are known and can be calculated. This is not the situation in a public authority or an agency. For further details see **Appendices** to this report.

Recommendation

The CHU should consider whether the Risk Assessment section in the Manual should be revised to allow and promote the use of scenario methods when assessing risk and to allow authorities and agencies to customize the methods to their environment and needs. The management of the public institutions in Latvia are responsible for the organisation's system of internal control and should set appropriate policies on internal control and seek assurance that will enable it to satisfy itself that the system is functioning effectively. Management must ensure that the system of internal control includes 'early warnings' to avoid being caught by unexpected issues that might have a negative impact on important objectives. Management needs to consider:

- The nature and extent of the risks facing the institution;
- the extent and categories of risk which it considers acceptable for the institution to bear;

- the ability of the institution to reduce the incidence and impact of the risks that might materialise;
- the cost of operating particular controls relative to the benefit thereby gained in managing the related risks.

The aims and objectives of an effective internal audit service should:

- a) include the provision of independent and objective assurance to ministers of the existence and effectiveness of a sound system of internal control and risk management as part of the wider application of good corporate governance; and
- b) Provide advice and assistance to management in the establishment and maintenance of corporate governance and risk management structures and processes.

In Latvia internal audit's role will need to strengthen focus on how institutions are developing in the setting up of risk management. Strengthening of the guidelines for this work and monitoring progress are important. Training will need to be provided before this can be started but as the subject matter is widely available and understood the selection of a suitable source of training should not be too difficult.)

The Internal Audit Strategy prescribed by the Internal Audit Manual is not optimal

77. The direct consequences of the strategy prescribed by the Internal Audit Manual is that audit resources are spent on all systems within a five year period, also on systems that are of less importance to the unit's objectives. Today internal audit is expected to be risk based and to allocate resources to the areas of greatest importance to the organisation's objectives regardless of whether there may be some areas which are not audited at all.

Recommendation

Subject to restrictions imposed by EU auditor requirements the strategy in the Internal Audit Manual should be changed and the requirement of repetitive, cyclical audits removed.

Management involvement in internal audit

78. The management involvement in internal audit differs rather much from unit to unit. In some units the management is much engaged in the internal audit activities, in others almost not at all. Internal audit is basically a service to management and is established to help the organisation achieve important objectives. To be able to deliver work of a good quality, then internal audit needs the management's participation to audit work.

Recommendation

The Internal Audit Manual should emphasise the need of direct management involvement in the work of the internal audit unit while preserving the functional independence of the HIA.

Strategic Planning

79. According to the Internal Audit Manual the strategic plan should comprise 1) all systems to be audited ranked according to the risk assessment, 2) frequency of audits for each system, and 3) resources

necessary for the internal audit unit. Usually a strategy is expected to comprise objectives of the future expressed in functional terms, not in operational terms.

Recommendation

The terminology in the Internal Audit Manual regarding planning should be changed to better reflect established professional practice.

Customer Satisfaction Questionnaires

80. Some internal audit units have started to use Customer Satisfaction Questionnaires covering the last year's audits. Customer satisfaction is of vital importance in the internal audit unit's efforts identify the needs of the organisation and to add value to the administration.

Recommendation

Customer Satisfaction Questionnaires should be used after all or at least a sample of finished audits. An example of such a questionnaire which has been for used many years with very good effect in both public and private sector entities is in the attached **Appendices**.

EU internal audit co-ordination

81. It is important at IADs with EU related functions and audit responsibilities that a very active role is played before, during and after EC audits.

Recommendation

The relevant IAUs should actively participate at all meetings and on the spot-controls during an external EU audit. There should be regular meetings between IAUs and external internal auditors to co-ordinate the planning and inform and consider audit results with management.

Review of the Internal Audit Manual

82. We have reviewed the Internal Audit Manual in order to evaluate if the content is in line with international accepted auditing practice. The Manual in general is well prepared and covering all phase of the audit process. Though there are some parts of the manual that could be further developed to make the Manual even more useful for the internal audit function. The parts commented under other headlines in this report are excluded here.

Recommendations

- The Manual does not have an Introduction Section explaining the principles on which the internal audit process and methods are based. It is suggested that an Introduction Section is added at the beginning of the Manual.
- The IIA produces and sells a product called "Internal Audit Manual, Shell on CD". It is a very useful tool when producing or updating an Internal Audit Manual.
- The internal auditor unit's communication with its customers is advised to be primarily in a written form. This needs to change. The auditors should meet with and communicate as much as possible with the customers before and during the audit. There should at the very least be an Opening Meeting at the beginning of an audit discussing the key issues of the opening

statement and a Closing Meeting at the end discussing the draft audit report and the audit findings supporting the auditors' conclusions and recommendations. The Audit Manual should be updated to meet these requirements.

- The Opening Statement (Audit Task Work Plan) does not refer to which Business Objective(s) the audit is addressing, only to the internal control. The Opening Statement form should be updated to modern practice. (See also Standard 2201)

Sampling

83. The section on sampling could mislead the auditors. The IA Manual chapter XVI Examinations, figure 2 gives an overview of sampling methods and explains the difference between statistical methods and non- statistical methods. All commonly used methods are not shown and the explanations of the differences are not fully in line with modern requirements and approaches.

Recommendation

The section on sampling should be rewritten to further elaborate on this useful technique.

Opinion on the internal control system

84. The head of the internal audit formulates an opinion on the internal control system established in an institution or ministry. To be able to give such an opinion on the entire system of control, the audit must each year cover all important parts of the control system. Sometimes internal audit departments have insufficient resources at its disposal to carry out this function.

Recommendation

If the internal audit unit has not been able to carry out the audit needed to be able to formulate such an opinion there should be a possibility not to do so.

Internal control definition

85. Internal control is defined as “a set of certain measures taken to prevent or decrease the possibility of risks”. This definition is not in accordance to current international Standards.

Recommendation

The definition should be changed to the current definition used by the IIA:

Control - Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Training schedules

86. The Manual includes just the good requirement for a training schedule for internal auditors for the year or half a year.

Recommendation

The IAD, and centrally the Ministry of Finance, should also develop a longer term-training plan and should develop and maintain a competence matrix for the whole department(s). This matrix should it make easier to verify if the internal audit unit collectively possesses the knowledge, skills and other competencies needed to perform its responsibilities (Standard 1210) and help longer term consideration of training needs – which is particularly important if staff turnover is high and qualified professional internal auditors are few.

Draft audit report

87. The Manual states that the draft audit report should be sent to the auditee “to be audited for appraisal”. This may be an unfortunate translation of the need for factual contradiction of the reports. The HIA needs to remain free to express in firm terms his conclusions from his work. The peers advise that more attention be given to making material recommendations for making management and control systems work better. An approach focused on matters helping to prevent control failures is desirable, as is a move away from purely compliance with rules activities.

Recommendation

The auditee’s views about conclusions, opinions or recommendations may be included in the report. This does not include an ”audit” of the draft report by the auditee. This point (115) in the Manual should be changed or explained further. For IA reporting the approach should be based on readability and making things better.

D PROFESSIONALISM

Professionalism.

88. Embarking down a professional route for the internal auditors in the Latvian public sector will bring benefit to the profession, the individual and the country as a whole. Encouraging and supporting internal auditors to join a professional body brings both direct and indirect benefits

Recommendation

People need to be made more aware of the advantages of being a professional and joining the organisation which provides their Standards

English language training

89. Professional internal audit material in Latvian or Russian is very limited. The fact remains that the vast majority of the profession and its material and examination processes carries with it a need to have a good working knowledge of English. At present many internal audit staff are handicapped by not having that capability. Whilst it is possible to ensure a certain number of key documents are translated into Latvian there can be no denying that the way forward is to obtain a proficiency in English.

Recommendation

English language training and proficiency needs to be accentuated and developed to allow better access to IIA material and change of attitude to taking CIA qualification Training for professional examinations

Technical Training

90. Training is geared at present to achievement of the certification program. This is a good start but must be seen in terms of preparing staff to progress onto taking a globally recognised internal audit qualification such as the Certificate in Internal Audit (CIA) issued by the IIA

Recommendation

Training needs to be developed to enable people to take the CIA exam route

Pool of professional resources.

91. Unless effort and money is put into establishing a sound and well supported professional base for internal auditors to be trained and developed there will always remain a strong risk of inadequate numbers and quality of staff. The Ministry of Finance should develop a policy and strategy to encourage and facilitate the development of the IIA in Latvia and encourage staff to obtain national and international professional certification.

Recommendation

Professionalism needs to be developed to increase the pool of available resource for future internal auditors

Financial support for the encouragement of professionalism

92. In Latvia the majority of internal auditors are not supported in joining the IIA or for taking examinations. This financial outlay is significant in terms of the salary received by staff, particularly those at junior levels, but in terms of a valuable investment the outlay on a ministerial or centrally funded basis would provide a significant return on its investment.

Recommendation

People need assistance to ease the financial burden of taking professional examinations

Networking

93. Networking is considered to be one of the most effective ways of extending one's knowledge in a specific area and of making contacts whose help and advice can be particularly crucial. Little of this currently exists in Latvia outside of the regular IAU meetings organised by the CHU. Opportunities to link with opposite numbers and particular subject experts in other countries, particularly in an EU context, should be encouraged.

Recommendation

Networking should be encouraged within and outside Latvia. Particularly useful is the attendance and active participation at EU Homolog meetings organised by the Member States.

IIA Professional Advisories

94. The Practice Advisories are a non mandatory part of the international Professional Practices framework that offers a lot of useful advice on how to observe the principles of the Standards in practice.

Recommendation

The Practice Advisories need to be translated into Latvian. All IAUs should use the Practice Advisories when developing their audit routines and practice.

Quality assurance practices

95. International internal audit Standards requires both internal and external quality assurance activities. The internal assurance process is usually very well established. The peer reviews by the CHU only partly covers the requirements for external assurance reviews prescribed by the Standards.

Recommendation

The CHU peer review routine should be expanded to a more regular activity and the scope of the review should be developed to cover as much as possible of a total external quality assurance review.

Membership of professional organisations.

96. Most of the entities today see the internal auditors' membership to professional organisations as a private issue. Professional organisations are established exclusively to foster professionals' ability to serve their customers/employers. Thus it is of great importance to the institutions that their internal auditors are active members of a professional organisation.

Recommendation

All institutions should encourage internal auditors to be active members of a professional organisation. To facilitate this, the institutions should pay the fees for such a membership.

CIA certification

97. The international internal audit certificate, the Certified Internal Auditor (CIA) certificate, is not seen as an option by the internal auditors. This might be a result of a general attitude to certification among internal auditors but also from insufficient support from the CHU and Senior Management.

Recommendation

Auditors that have passed the level 2 of the Latvian Certification process should be encouraged to sit for the CIA exam. As the CIA is an international designation the administration will have a "receipt" that the public sector internal auditors have the skills and experience needed to perform internal audit in accordance to international Standards.

Liaison with State Auditors and/or the External Auditors

98. Many of the internal audit units do not communicate with the state auditors and/or the external auditors to coordinate their audit activities. Also when the internal auditors don't do any audit work for the state auditors or the external auditors it is important to coordinate the audit activities to avoid unnecessary disturbance of the audited units' productivity, unnecessary overlaps or other mistakes that might influence the auditee perception of the audit or the auditors.

Recommendation

The internal auditors should take the initiative to coordinate the audit planning regularly with the state auditors and/or the external auditors.

OVERALL CONCLUSION of the SIGMA PEERS:

99. The review of internal audit in Latvia has confirmed the peers' views that a lot has been achieved and there is a very strong basis to build on for the future. There is a challenge still to be faced and that is how to become fully professional in outlook and actuality. Professionalism and how to achieve that situation must now be the objective for everyone. The human talent, knowledge and ability are present, but this must be continued and further supported in monetary, training and development terms.

APPENDIX A

Names and titles of the Latvian Peers who were present at the interviews with the SIGMA Peers

No.	Ministry / Institution	Participant name	Position
1	Ministry of Defence	<ul style="list-style-type: none"> • Harijs Haru • Zinaīda Jundule • Juzefa Dzalbo 	<ul style="list-style-type: none"> • Director of the Internal Audit Department • Head of the Internal Audit Division of the National Armed Forces • Head of the Internal Audit Division of the Internal Audit Department
2	Social Security Agency	<ul style="list-style-type: none"> • Inta Bergmane 	<ul style="list-style-type: none"> • Head of the Internal Audit Division
3	Ministry of Health	<ul style="list-style-type: none"> • Gita Stūrīte • Dzintra Reinalde • Boriss Kņigins 	<ul style="list-style-type: none"> • Head of the Internal Audit Division • Senior Officer • Senior Officer
4	Ministry of Economy	<ul style="list-style-type: none"> • Velta Feodorova • Kaspars Gerhards 	<ul style="list-style-type: none"> • Director of the Internal Audit Department • State Secretary
5	Ministry of Interior	<ul style="list-style-type: none"> • Malda Šteinberga 	<ul style="list-style-type: none"> • Director of the Internal Audit Department
6	Rural Support Service	<ul style="list-style-type: none"> • Andis Rukmanis • Nata Lasmane • Uldis Širaks 	<ul style="list-style-type: none"> • Deputy Director of the Service (dealing with the EU issues) • Director of the Internal Audit Department • Deputy Director of the Department
7	Ministry of Environment	<ul style="list-style-type: none"> • Santa Mince • Renārs Volks 	<ul style="list-style-type: none"> • Director of the Internal Audit Department • Deputy Director of the Department
8	State Audit Office	<ul style="list-style-type: none"> • Inguna Sudraba • Inta Fiļipova 	<ul style="list-style-type: none"> • Auditor General • Director of the Internal Audit Department
9	State Treasury	<ul style="list-style-type: none"> • Irēna Rečicka • Irēna Krūmane 	<ul style="list-style-type: none"> • Director of the Internal Audit Department • Treasury Manager
10	Public Health Agency	<ul style="list-style-type: none"> • Gita Kūkoja 	<ul style="list-style-type: none"> • Discharge of duties of the Head of Internal Audit

		<ul style="list-style-type: none"> • Artā Puikēvica • Dace Sideļska 	<ul style="list-style-type: none"> • Division • Internal Auditor • Internal auditor
11	Riga's Municipality	<ul style="list-style-type: none"> • Ervīns Lenšs 	<ul style="list-style-type: none"> • Head of the Riga's Municipality Audit and Revision Department Internal Audit Division
12	Ministry of Transport	<ul style="list-style-type: none"> • Daiga Jurēvica • Elita Grante 	<ul style="list-style-type: none"> • Director of Internal Audit Department • Deputy Director of the Internal Audit Department, Head of the EU Financed Projects Audit Division
13	State Revenue Service	<ul style="list-style-type: none"> • Ārija Sīpola • Armands Ābelis 	<ul style="list-style-type: none"> • Director of Internal Audit Administration • Deputy Director of the Internal Audit Administration
14	Ministry of Agriculture	<ul style="list-style-type: none"> • Pēteris Lībietis • Lelde Veidemane 	<ul style="list-style-type: none"> • Director of Internal Audit Department • Deputy Director
15	Anti Corruption and Combating Bureau	<ul style="list-style-type: none"> • Sintija Štelmahere • Aleksejs Loskutovs 	<ul style="list-style-type: none"> • Head of Internal Audit Division • Head of the Bureau
16	Ministry of Education and Science	<ul style="list-style-type: none"> • Leonīds Mankovs 	<ul style="list-style-type: none"> • Director of Internal Audit Department
17	Public Administration School	<ul style="list-style-type: none"> • Uģis Rusmanis 	<ul style="list-style-type: none"> • Director of the School
18	IA CHU of the M of Finance	<ul style="list-style-type: none"> • Dace Nulle • Inguna Zvane • Lolita Lune 	<ul style="list-style-type: none"> • Director • Deputy Director • Project Assistant

APPENDIX B

Spreadsheet of Individual QA scores for the Internal Audit Units reviewed

		MEd	PC	MI	PHA	MEc	MA	MH	MF/1	MF/2	ME _n	SSA	MoT	MD	SRS	ST	RSS	Avge.	
ENVIRONMENT	Charter	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4.00
	CAE – rep./admin	5	5	5	5	5	5	5	4	4	5	5	5	5	5	5	5	5	4.88
	functional	4	4	4	4	4	4	4	4	4	4	4	4	4	4.5	4	4	4.5	4.06
	Aud. committee	1	1	1	1	1	1	1	1	1	1	1	1	1	3	1	4	1	1.31
		3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.3	3.3	3.5	3.5	3.5	4.1	3.5	4.3	3.6	3.56
STANDARDS	PPF	3	2.5	2.5	3.5	2.5	2.5	3	3	3	3	3	3	3	3	3	3.5	5	3.06
	QA	2	2.5	3	3.5	3.5	3	3.5	3	3	3.5	3.5	4	3.5	3.5	3.5	3.5	5	3.34
	Perf. Measures	2	2	2	3.5	2	2.5	2	2	4.5	3	3	3	4	4	4.5	3.5	3.5	2.97
	Prof. Membership	2	1	1	2	1	2	2	1	2	2.5	2	1	2	3	1	3	3	1.78
		2.3	2.0	2.1	3.1	2.3	2.5	2.6	2.3	3.1	3.0	2.9	2.8	3.1	3.4	3.1	4.1	4.1	2.79
ORGANISATION	CAE	3	4	3	3	3	4	3	3	3	4	3	4	3	3	4	4	4	3.38
	Scope	4	5	4	4	5	4.5	4	5	5	5	5	5	5	5	5	5	5	4.72
	Integration	5	5	5	5	5	5	5	5	5	5	5	5	4	5	5	5	5	4.94
	Rep.relationship	3	5	5	3.5	5	4	4.5	4	3	4.5	4	5	5	4	5	4	4	4.28
		3.8	4.8	4.3	3.9	4.5	4.4	4.1	4.3	4.0	4.6	4.3	4.8	4.3	4.3	4.8	4.5	4.5	4.33
HUMAN RESOURCE	Staffing	2	2.5	2.5	3	3	3	3	3	2	3.5	4	3	3	3	3	3	3.5	2.94
	Skill levels	1	2	2	2	2	2	2	2	2	2.5	4	3	3	4	2.5	3.5	3.5	2.47
	Designations	1	1.5	2	2	2	2	1	2	2	2	2.5	2	2	1	2	2.5	2.5	1.84

	Prof.Dev	3	2	1.5	2	2	2	3	2	4.5	2	4	2	4	4	3	4	2.81
	Tools/ Technology	3	2.5	2	2	2	2	2	2.5	3	2	3	2.5	3	3	3	3.5	2.56
		2.0	2.1	2.0	2.2	2.2	2.2	2.2	2.3	2.7	2.4	3.5	2.5	3.0	3.0	2.7	3.4	2.53
SERVICES	Focus	2	2	2.5	3	3	3	3	3	3	2.5	3	3.5	3	3	3	3	2.84
	Planning	1	3	3	3	3	3	3	3.5	3	3.5	3	5	3	3	4	3	3.13
	Types	2	1	3	2	2	2.5	2	3	2	3	2	3.5	3	3	3	2.5	2.47
	Outsource access	3	2	2	3	2	3	3	3	3	4	3	3	3	3	3	4	2.94
	IT capability	1	2	1.5	1	2	2	2	2	2	2	2	2.5	2	3	2	2.5	1.97
	Ext.Aud. co-ordn.	1	2	2.5	1	2.5	3	3	3	3	2.5	3	3.5	1	4	3	1.5	2.47
	Reporting results	4	4	3.5	3	4	4	4	3.5	4	4	4	3.5	5	4	5	4.5	4.00
	Access to inf.	5	5	5	5	4	3	5	5	5	4	5	4	5	5	4	4	4.56
	Auditee perception	1	4	3	2	4	2.5	3	4	3	3	3	4	4	4.5	4	3.5	3.28
			2.2	2.8	2.9	2.6	2.9	2.9	3.1	3.3	3.1	3.2	3.1	3.6	3.2	3.6	3.4	3.2
TOTAL	Average scoring	2.6	2.9	2.9	2.9	3.0	3.0	3.1	3.1	3.2	3.3	3.4	3.4	3.5	3.5	3.6	3.6	3.19
	Score	68.0	76.5	75.5	76.0	78.5	78.5	80.0	80.5	83.0	85.0	88.0	89.0	90.0	92.0	93.0	94.5	83.00
	Grouping	3	3	3	3	4	4	4	4	4	4	4	4	4	4	4	4	3.75

Groupings

- 1 26 - Entry
- 2 26,5 - 52 management controlled
- 3 52,5 - 78 meets some IIA standards
- 4 78,5 - 104 meets most IIA standards
- 5 104,5 - 130 world class best practice

APPENDIX C

SIGMA PAPER ON MODERN ARRANGEMENTS FOR INTERNAL AUDIT

Introduction

The Institute of Internal Auditors defines internal audit as an:

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

This is a definition that recognises the increasingly widening and important role which internal audit has to play in any organisation. The elements of independence and objectivity are vital in giving an assurance on the state of internal control in transition countries and have always been an essential feature of any effective internal audit activity. The definition in addition focuses for the first time on an organisation's corporate governance and risk management processes.

Thus internal audit is positioned quite clearly in the forefront of ensuring transition countries develop and implement sound practices and processes for the custody of EU and national funds, a position totally underpinned by the European Commission's support and expectations of the benefits an effective internal audit service can bring to transition countries.

Where is IA Generally in Countries Seeking Accession?

Most candidate countries have little or no tradition of modern internal auditing as it is widely practised throughout many parts of the world. Instead there is the tradition of a "government control office" or "control activity" based on the practice of the pre-independence regime. These units investigate complaints received about staff from members of the public and may also investigate allegations of irregularity or fraud before turning the cases over to the fiscal or criminal police. There is thus a very large element of "the policeman" associated with this type of activity, something not uncommon with the role and perception of internal audit in other parts of the world in its earlier "pioneering" days.

In each transition country, it is likely that there will be different levels of capability. Currently those units in the SAPARD and ISPA agencies, together with the internal audit units of the National Fund, associated and supplying the agencies with EU money will have had to meet criteria for internal audit as a condition of accreditation of the agency. They will have received considerable external support in achieving this position and will probably be the leaders in the field in their particular country.

Following that, will be pockets of very good practice in individual ministries but generally the picture throughout the public sector will be one of being very much in the developmental stage with internal audit units struggling to create a different environment from the traditional "control" culture.

Where IA needs to get to

This is most definitely not the case for modern internal audit globally. Internal audit these days is generally recognised as being positioned to promote good practice and act in a positive proactive way without the negative connotations associated with a "control" or "checker" type of approach. The best

internal audit units have a very positive role to play in the running of an organisation and their value in helping to keep the organisation out of trouble is being increasingly recognised by management and staff alike.

Nowhere could the need for good internal audit be more evident than for transition countries in preparing for and after achieving accession to the European Union. The European Commission auditors have clear views of the standard of organisational stewardship they demand from countries receiving EU funds. These are heavily biased towards sound internal control and good governance. Who could be better than well-trained and professional internal auditors to provide guidance and advice in these circumstances? Existing Member States and the Commission have long recognised the role internal audit can and should play. It is essential that new countries coming into the Union are equally committed.

Need to Adopt and Execute Internationally Accepted Standards for Internal Audit

At the forefront of the drive to provide effective internal audit throughout the EU is the recognition that internal audit must recognise and follow standards for internal audit which are laid down and practised globally. These are in two parts and cover:

Attribute Standards

- Purpose Authority and Responsibility.
- Independence and Objectivity.
- Proficiency and Due Professional Care.
- Quality Assurance and Improvement Programme.

Performance Standards

- Managing the Internal Audit Activity.
- Nature of Work.
- Engagement Planning.
- Performing the Engagement.
- Communicating Results.
- Monitoring Progress.
- Management's Acceptance of Risks.

Need to move from Traditional Emphasis on “control” to Modern Internal Auditing

Historically, internal auditing has focused on financial systems and financial controls within an organisation and it is certainly true within transition countries that what would be classed as "internal auditing". This is auditing inside the organisation, comes from the offices of controllers by people generally trained more in line with external auditing work-business continuity.

The focus of internal auditing has shifted, and is continuing to shift, quite dramatically. This is also closely associated with the greater understanding and relative importance being placed on internal control, good stewardship and corporate governance.

Table 1. KEY CHANGES WHICH TOOK PLACE ARE:

Historic Role	Modern Role
Policemen	Partners in the organisation
Financial focus	Business focus
Focus on hard controls	Focus on soft controls
Focus on tangible assets	Focus on intangible assets
Compliance based	Risk based
Functional focus	Process focus
Self-sufficient	Shares of the best practice
Reactive	Proactive

Overall objectives for IA-internal control

What does Internal Audit do?

Ultimately, management is responsible for managing risk and establishing an effective control framework. Internal audit can assist management in this and can also provide advice to management on what it needs to do to establish appropriate policies, systems of control, and procedures necessary to manage risk effectively and efficiently.

The scope of work of any internal audit function will invariably need to be agreed with management but nevertheless the following list, drawn in part from the IIA Standards, is a commonly pursued range of work for internal auditors:

- Understanding the key business risks and reviewing the adequacy and effectiveness of the processes in place to manage the risks.
- Reviewing the controls which ensure the reliability and integrity of management information and the means used to identify, measure, classify and report such information.
- Reviewing the processes and systems established by management to ensure adherence with those policies, plans, procedures, laws and regulations which could have an impact on operations and determine whether the organisation is in compliance.
- Reviewing the means of safeguarding assets (including both tangible and intangible assets such as people and information).
- Appraising the economy, efficiency and effectiveness with which resources are employed.
- Reviewing operations and projects to establish whether results are consistent with established objectives and whether the projects are being carried out as planned.

- Monitoring corrective action plans to ensure they are implemented effectively and promptly.

What is key to the success and contribution of internal audit is that it must focus on the critical risks to the organisation and review the adequacy of the underlying activities to manage those risks. This will add value to the organisation and strengthen its ability to deal with the issues and risks facing it.

The understanding and evaluation of the risks will generally come together in to an audit needs assessment which identifies those aspects of the organisation which should form part of the overall strategic and annual plans for internal audit. From these plans comes the day-to-day work of internal audit.

Structure-Viable Critical Mass

At present the establishment of internal audit in ministries is minimal. There is little by way of meaningful capacity to provide internal audit services. In effect there are many one-man audit units, each of which has to provide an effective service:

- Over a whole range of tasks.
- Generally provide information to the MoF.
- Carry out certain laid down pieces of work.

It may be in the early stages of the development of internal audit units, but not in the longer term, that benefit could be gained if resources were centralised. This would also have the effect of:

- Creating a critical mass of auditors which would enable a wide range of skills to be acquired.
- Ensuring the service could continue in the absence or in the event of the departure of individual officers.
- Enabling a structure for the unit to be created which could provide a career progression for auditors.
- Ensuring experience is built up and passed on so as to enable a better quality and more effective end product.

The thin spread/dissipation of resources which exists at present, whilst possibly understandable in the overriding need to provide internal audit functions, is not necessarily the most effective use of scarce resources.

Need for Independence

The internal auditor should be responsible to the minister or the Secretary-General of a ministry or agency, giving technical advice on the efficient management of resources without becoming involved in political questions. It is important to be clear about the nature of the internal auditor's independence. It should not be compared with the independence of the external auditor (*e.g.* the supreme audit institution) who reports directly to the parliament or budgetary authority and whose independence is normally reinforced by the tenure and security of his appointment and safeguards against unjustified dismissal. The internal auditor is responsible to the head of the ministry and is part of the staff of the ministry or agency.

The Institute of Internal Auditors requires that the head of internal audit should have organisational independence and “should report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities”.

The IIA also lays down that “The internal audit activity should be free from interference in determining the scope of internal auditing, performing work and communicating results”. Since the internal auditor is not completely independent of the ministry or organisation in which he functions it is essential that the internal audit function achieves an appropriate status and weight in the organisation.

Relationship with Management and the Organisation

One of the most vital roles internal audit can play is in the support and assurance it can give to the head of any organisation. With an honest, objective approach coupled with operational independence, internal audit is well placed to tell the minister what is really happening in the ministry and not what officials would like the minister to know. When so much of good governance is dependent upon the minister having a realistic idea of what is involved in certain courses of action, or having unbiased facts on a particular case or situation, then the internal auditor can really prove his value.

In order to establish awareness of, and gain support for, good governance, internal control and risk issues, it is good practice to establish regular contact with the minister/state secretary.

Pillars on which IA should be constructed:

These can be summed up as the four P's:

Pre-requisites – things such as:

- HIA independence.
- Effective audit committee.
- ANA.
- Strategic plans.
- Annual and assignment plans.
- Audit charter.

Pay and conditions

- Adequate salary levels.
- Career structure for internal auditors.
- Working conditions which take account of the specific needs of internal auditors such as confidentiality.
- Security etc.

Professionalism

- Working to internationally accepted standards.
- Professional training and qualifications.
- Membership of IIA.
- Attitude of mind.

Practices

- Good planning.
- Risk analysis.
- Documentation/manuals.
- Quality assurance.
- Effective reporting.
- Good communication skills.
- Systems/risk based approach.
- Performance indicators.
- Follow-up systems.
- Internal/external audit communication.

The Need for Internal Audit

Over the last 10 to 15 years in areas where internal audit has had solid foundations, there has been a change to internal auditors becoming advisers to management, helping them to deal with risk and to establish an effective framework of internal control. This has been a concerted move from internal financial control to internal control through to risk management activities.

This more modern role for internal audit assists management at all levels to carry out their duties and meet their responsibilities more effectively. It also helps to ensure:

- The business of an organisation is conducted in an orderly and efficient manner.
- Assets are protected.
- Accuracy of records.
- Minimisation of opportunities for fraud.

This is the role that for transitional countries is largely aspirational in their early days in joining the EU but which must be the goal.

Benefits of Internal Audit

An effective internal organisation can give the following benefits to an organisation:

Assurance regarding the adequacy and effectiveness of the organisational control framework in the context of the organisation's critical business risks.

Identification of major control weaknesses and recommendations to reduce risk exposure.

Advice on and facilitation of best practice in risk management and internal control.

Value for money performance reviews looking at economy efficiency and effectiveness.

Education of line management and their staff in elements of risk management and control.

Advice on the most appropriate controls to be implemented in projects and new systems.

The potential deterrence of fraud and other illegal activities across the organisation.

An early warning of potential problem areas.

Making Internal Audit Effective

Internal audit needs to be set up and managed in the best way to ensure that it assists in the achievement of organisational objectives and that it operates in an effective manner within the organisation. Internal audit can be most effective if the following are in place:

- The objectives of internal audit are agreed at the highest level in the organisation and are clearly understood across all levels of management and staff. This may be partially achieved by the production and circulation of an internal charter or terms of reference but there will also need to be a continuing and concerted educational process to ensure the message is properly spread.
- The scope of internal audit work should cover the entire organisation, not simply the financial aspects or those systems or processes which management decides are appropriate for audit review.
- Internal audit must have totally unrestricted access across the entire organisation, endorsed by the minister or other head of an organisation.
- The head of internal audit must have a direct reporting line to the minister/ head of the organisation and where one exists, the Chair of the Audit Committee.
- Internal audit must be, and must be seen to be, completely independent from the day to day operations of the organisation.
- Internal audit should not undertake non-audit work, but where it is absolutely essential, it is understood that they are not operating as internal audit.
- The results of internal audit work must be effectively communicated and be seen to be acted upon.

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.

Is the Internal Audit Function Adding Value?

Although we have spoken in a previous section of the ways of making internal audit effective, the other side of the coin is that internal audit needs to demonstrate the value it adds to an organisation. The questions you may wish to ask in determining whether or not your internal audit unit is delivering the value that you both want and need might include:

- Does the internal audit plan focus on the achievement of the organisation's objectives?
- Does internal audit provide you with adequate assurance on the state of risk and control within your organisation?
- Does your internal audit function have the correct blend of skills, knowledge and experience of your business?
- Is internal audit invited to become involved in all major projects that the organisation sets up?
- Is internal audit responsive to changes in the business and does it offer constructive advice in relation to those changes?
- Is there a constant demand for internal audit staff to move into line management positions within the organisation?
- Does internal audit enjoy good and strong relationships at the most senior levels within the organisation?

The Institute of Internal Auditors also recommends that each internal audit function should have an independent peer review on a regular basis. Such a review will also inform you of the value added by your internal audit function and will enable comparison with best practices from other organisations.

It is also important to develop a set of performance measures for your internal audit function.

The Internal/External Audit Relationship

Although internal and external auditors have different end result objectives and, to some degree, different reporting lines, their work is complementary.

External auditors have a wide experience of a number of different organisations and related systems and controls whilst internal auditors have an unparalleled knowledge of their own organisation and an understanding that outsiders are never ever likely to have.

Both sets of auditors should be striving to work for the public good to ensure that systems and controls are strong, to ensure that fraud does not happen, or where it does, that it is picked up at the earliest opportunity and that lessons are learnt and immediately put into practice.

Many of the recent corporate governance initiatives should virtually “force” auditors to focus on clarifying what controls need to exist within an organisation and defining the most efficient way for senior management to satisfy themselves that controls are working effectively. The following issues will certainly need to be addressed as part of this process:

- How should an organisation define its control standards?
- How can line management be motivated to take on their responsibilities for managing risk and internal controls?
- What is the right split of responsibilities between internal and external audit work?
- How can the value of the work be maximised?

Where there has been an internal audit function, historically external auditors have used it to carry out a range of its own work. This is not a course to be recommended or continued.

- The aims and purposes of the two are different although complementary.
- It is not in an organisation’s interest to have an internal audit function that spends considerable time carrying out external audit work.
- Many organisations use internal audit as a training ground for future.
- Organisation managers.

The two sets of auditors need to communicate on a regular basis. Frequent communication will lead to:

- More effective working for both parties.
- Lack of duplication of work.
- Stronger reports leading to better implementation of recommendations and a stronger control environment.

What internal audit is not responsible for:

- It cannot ensure the success of the organisation.
- It cannot ensure the survival of the organisation.
- It cannot ensure the effectiveness of internal control.
- It cannot ensure the reliability of financial reporting and accounts.
- It cannot ensure the absence of fraud or other irregularities or that they are detected.

All of the above remain, as they always have been, clearly the responsibility of management.

APPENDIX D

SIGMA PAPER ON INTERNAL CONTROL - CATEGORIES AND PRACTICE

Introduction

In European public sector circles great attention is paid to control. It is often placed into categories such as “ongoing”, *ex ante*, *ex post* etc. To the uninitiated, this placement can all seem a little mysterious, not to say mystifying. In the modern risk-based world of business, both in the public and private sectors, internal control is seen as a total concept with a common language throughout the world. Control is not limited to certain phases of activity but, rather, is present throughout the operation and functioning of an organisation. Every function is subject to internal control and can no longer be seen in isolation from other parts of the organisation. Concentrating solely on certain phases of work, *e.g. ex ante* and using these rather historic terms, is not necessarily the most effective or transparent of ways of working. This paper attempts to bring together some thoughts and guidance on internal control as it is practised generally.

Importance of Control

Every activity within an organisation works on two levels within two systems. One is the operating system, which is designed to accomplish stated objectives like processing 200 payments per day without error and within EU requirements. The other is the control system, which is overlaid on the operating system. It is made up of procedures, rules, and instructions that are designed to make sure that the operating system’s objectives will be met. Control enhances the probability that management’s wishes will be met.

Control is especially important in large organisations where managers are unable to personally oversee everything for which they will be held accountable.

Benefits of Control

Controls need not be exclusively restrictive. Modern management philosophy regards control as an aid rather than a constriction. It is a means of helping people meet their goals. Controls become the means of auto-control and not only protect the organisation but also the employee. Further, by establishing an appropriate system of control managers can provide assurances to their stakeholders as to the acceptable conduct of their business.

Types of Control

Controls may be divided into different types. For example:

Preventative - designed to prevent the occurrence of inefficiencies, errors or irregularities. These cannot guarantee that the controlled factor will not occur but reduce the chance of it occurring. Examples include division of duties and authorisation controls.

Detective - designed to detect and correct errors, inefficiencies or irregularities. They may not give absolute assurance since they operate after an event has occurred or an output has been produced but they should reduce the risk of undesirable consequences as they enable remedial action to be taken. Detective

controls are most effective when they form part of a feedback loop in which their results are monitored and used to improve procedures or preventive controls. Examples include post payment check, stock verification and bank reconciliations.

Directive - designed to cause or encourage events necessary to the achievement of objectives. Examples include clear definition of policies, the setting of targets and adequate training and staffing.

In practice, the above categories may not be clearly distinguished and a single control may operate to cover two or more functions. Supervision for example, covers all three categories.

Internal Control Standards

Operating standards may be key elements in the control process as they establish the kind of performance expected. These standards can come from various sources such as:

- Mandated standards.
- Industry standards.
- Cost accounting standards.
- EU standards/guidelines.
- Historical standards.
- Best-estimate standards.

Apart from these there is a body of standards to which the control systems themselves should conform. These are

General

- Reasonable assurance - that the objective will be achieved.
- Supportive attitude - by managers and employees.
- Integrity and competence - of those involved in the system.
- Control objectives - for each activity.
- Monitoring controls - managers to continually monitor output.

Detailed

- Documentation-adequate documentation readily available.
- Prompt and proper recording of transactions and events.
- Authorisation and execution of transactions and events-by properly designated persons.
- Separation of duties.

- Supervision.
- Access to and accountability for resources/and records – to be limited to authorised individuals.

Table 2. GENERAL CHARACTERISTICS OF CONTROLS

Timely	Detect problems early enough to limit costly exposures.
Economic	Provide “reasonable” assurance of achieving intended results at a minimum cost and with fewest undesirable side effects.
Accountable	Help people demonstrate their accountability for assigned tasks.
Well-placed	Positioned where they are most effective.
Flexible	Will accommodate changes to procedures without themselves needing to be changed.
Identify cause	Identify not only the problem but also the cause.
Appropriate	Meet management’s needs.

Problems with Controls

- Over-emphasis on controls can make them an end in themselves rather than the means towards the end.
- Can become obsolete.
- People generally resist controls.

Means of Achieving Control

Some of the means by which managers can control functions in an organisation are:

Organisation

Organisation as a means of control, is an approved intentional structuring of roles assigned to people within the organisation so that the organisation can achieve its objectives efficiently and economically.

Policies

Stated principles that require guides or restricts actions.

Procedures

Means employed to carry out activities in line with prescribed policies.

Personnel

People employed should be qualified to do their jobs. The best form of control over the performance of individuals is supervision. Hence, high standards of supervision should be established.

Accounting

Accounting is the indispensable means of financial control over activities and resources. It furnishes a framework that can be fitted to assignments of responsibility. Moreover, it is the financial scorekeeper of the organisation. The problem lies in which scores to keep!

Budgeting

A budget is a statement of expected results expressed in numerical terms. As a control it sets a standard for input of resources and what should be achieved as output and outcome.

Reporting

In most organisations management functions and makes decisions on the basis of reports it receives. Therefore, reports should be timely, accurate, meaningful and economical.

Some Examples of Controls in Practice

Planning

- The setting of aims, objectives and targets.
- Forecasts of activity.
- Specification of desired levels of control.
- Setting standards of performance.
- Definition of outputs of a system and criteria for measuring them.
- Anticipation of contingencies and the action to take in response.

Organisation

- Clear and documented definition of the responsibilities of individuals and groups for resources, activities, objectives and targets.
- Establishing clear reporting lines.
- Establishing the best split of work between different groups in the organisation.
- Establishing the most effective spans of command.
- Establishing the most effective means of communication throughout the organisation.
- Separating duties to avoid conflicts of interest.
- Avoiding undue reliance on any one individual.
- Giving managers the necessary authority to do their jobs effectively.
- Organisation charts and manuals.

Accounting

- The organisation must keep adequate financial and other information to allow it to produce accounts in the form prescribed.
- Accounting that fits the needs of the organisation and allows managers to make rational decisions.
- Based on lines of responsibility.
- Financial reports of results which parallel the organisational units which carry out operations.
- Accounting which allows controllable costs to be identified.

Monitoring of Performance

- Quality control built into systems.
- Clear management information requirements.
- Performance measures and indicators.

Authorisation

- Clear definition of the authorisation requirements for activities and transactions.
- Allocation of authority to appropriate individuals or groups.
- Separation of responsibility for authorisation from activities which could lead to a conflict of interest.
- Checks that relevant activities and transactions have been properly authorised.

Budgeting

- Matching of resources and costs to responsibility for objectives and outputs.
- Realistic but sufficiently tight to encourage economical use of resources.
- Closely linked to planning to ensure proposed expenditure is necessary.
- Subsidiary budgets should tie into the overall budget.

Segregation of Duties

- Preparation, authorisation and despatch of payments to be done by different people.
- More than one person to be involved in a transaction that can lead to an actual gain or benefit (fraud).

Staffing

- Identification and continuing review of numbers, grades, experience and expertise levels.
- Recruiting staff to meet the needs.
- Monitoring performance.
- Adequate training.
- Employees investigated for honesty and reliability.
- Effective recruitment practices.

Completeness and Accuracy

- Transactions should be recorded as close to their origin as possible.
- Transactions checked at appropriate times.

- Checks by staff independent of those performing the activities.
- Sequence checks on pre-numbered documents.
- Comparison of one set of documents or accounting records with another *e.g.* orders and goods received notes.
- Control totals.
- Re-performance checks by management on a sample basis.

Policies

- Clearly stated in writing.
- Systematically communicated to all employees.
- Must conform with applicable laws and regulations.
- Periodically reviewed.

Written Guidance/Procedures

- Operations manuals.
- Financial guidance and regulations covering income, expenditure, cash, banking, general accounting, contracts and related matters.
- Staff handbook.
- Purchasing code of practice.
- Code of personal conduct with guidance on gifts and hospitality.
- Computer standards on the use of computer hardware and software.

Systems Development

- Authorisation of project/change.
- Project management.
- Stage reporting.
- Quality assurance.
- Testing.
- Post-implementation review.

Physical

- Access controls such as passwords, identity cards, guards, computer logging.
- Stocktaking, security inspections.
- Secure custody of assets and records.

Supervision

Staff observed, checked and helped by their line managers.

Compliance Checks

Control teams carrying out regular compliance checks.

Output Inspection

Reviewing reconciliations, working papers, reports, physical products, and achievements against a defined standard.

Documentation

- Good standards laid down.
- Auditable, able to be reviewed by audit management.

Inter-Relationships of Controls

Controls should not be viewed singly because they inter-relate, either in a hierarchy or in the consecutive flow of operations. A hierarchy may be represented by controls at various levels within a system, or be imposed by a higher level system (e.g. budgetary control). In the consecutive flow of operations, controls at one stage of processing may act to achieve similar objectives to others at different stages. Weaknesses in one control may therefore be compensated for by other controls. Appraisal of the adequacy of internal controls should therefore be made in relation to the objectives of control in the system as a whole.

Corporate/Organisational Control

So far we have looked at control primarily in terms of individual or groups of controls to cover certain conditions. Corporate governance, and its requirements that good internal control should exist in an organisation, has led to organisations taking a wider view of the whole control framework for which they are responsible. This has resulted in a move to providing an overall assessment of an organisation'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 which has attracted the greatest following is the COSO framework of controls developed by a Committee of Sponsoring Organisations 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.
- Monitoring and corrective action.

This grouping provides a combination of “soft” controls such as establishing an environment in which control can survive and flourish alongside stricter more traditional types of “hard” controls over accounting and financial transactions. The main issues to be considered would be along the following lines.

Control Environment

- A commitment by ministers, directors, management and staff to competence and integrity.
- The communication of ethical values and control consciousness to managers and employees.
- An appropriate organisational structure within which business can be planned, executed controlled and monitored to achieve the organisation's objectives.
- Appropriate delegation of authority which has regard to acceptable levels of risk.
- A professional approach to financial reporting that complies with accounting practice.

Identification of Risk and Priorities for Control

- Identification of key organisational risks in a timely manner.
- Consideration of the likelihood of risks occurring and the significance of the likely impact on the organisation.
- Establishment of priorities for the allocation of resources available for control and the setting of clear control objectives.

Financial Strategy and Management

- Performance indicators that allow management to monitor the key business and financial activities and risks, and the progress towards objectives, and to identify developments that require intervention.
- Information systems that provide on-going identification and capture of relevant, reliable and up to date financial and operational information from internal and external sources.
- Systems that communicate relevant information to the right people at the right time in a way that identifies variance from plans and allows a prompt response.

Control Activities

- Procedures to ensure complete and accurate accounting for claims and financial transactions.
- Appropriate authorisation limits for claims and transactions.
- Procedures to ensure the reliability of data processing and information reports generated.
- Controls that limit exposure to loss of assets/records or to fraud and the risk of disallowance.
- Procedures to ensure compliance with laws and regulations that have significant operational and financial implications.

Monitoring and corrective action

- A monitoring process that provides reasonable assurance to directors and managers that there are appropriate control procedures in place for all significant business activities and that these procedures are being followed.
- Identification of change in the business and its environment that may require changes to internal control systems.
- Formal procedures for reporting weaknesses and for ensuring appropriate corrective action.
- The provision of adequate support for public statements on internal control.

A more detailed example of how this works in practice is attached as an appendix to this paper.

Suitability of control(s)

In terms of assessing the suitability of systems of internal control, there are some danger signs that should be looked for that might lower the efficiency of the control environment:

Table 3. SUITABILITY OF CONTROLS

Ability of senior managers to over-ride accepted controls	Particularly a problem where staff are intimidated or feel unable to challenge senior managers who choose to bypass a standard control.
Lack of staff and vacant posts	Authorisation, internal check segregation and supervision suffer when there aren't enough staff to carry out the procedures
Poor control culture	Depends on managers and staff being committed to doing the job properly.
Staff collusion	Virtually all systems can be by-passed if dishonest staff choose to conclude. This is the nightmare scenario for control!
Reliance on a single performance indicator	The temptation is to concentrate on the one issue to the detriment of achieving good overall practice.
Reliance on memory	Lack of formal procedures leads to certain experienced individuals becoming indispensable – a classic breeding ground for fraud.
Retrospective recording of transactions	Bureaucracy can be given as a cause for delay justifying the non or late completion of necessary documentation.
Uncontrolled delegation of tasks	Delegation can be abused to the point that no one knows who is responsible for what.

Controls in computer based systems

This is a specialised area in its own right covering security, installation and application controls. Guidelines for computer security have been produced by the European Commission and give a useful overview of best practice. The main features are included as Appendix B.

ANNEX 1 OF SHORT SIGMA PAPER ON INTERNAL CONTROL – CATEGORIES AND PRACTICE

ORGANISATIONAL/CORPORATE GOVERNANCE CONTROL FRAMEWORK

Control Environment

- A commitment by ministers, directors, management and staff to competence and integrity.
- The communication of ethical values and control consciousness to managers and employees.
- An appropriate organisational structure within which business can be planned, executed controlled and monitored to achieve the organisation’s objectives.
- Appropriate delegation of authority which has regard to acceptable levels of risk.
- A professional approach to financial reporting that complies with accounting practice.

Identification of Risk and Priorities for Control

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- Formal procedures for reporting weaknesses and for ensuring appropriate corrective action.
- The provision of adequate support for public statements on internal control.

ANNEX 2 OF SHORT SIGMA PAPER ON INTERNAL CONTROL – CATEGORIES AND PRACTICE

CONTROLS IN COMPUTER BASED SYSTEMS

General Organisation and Management

IT strategy and overall management
 Approved and steered by top management
 Development plan on a two to three year cycle

Based on corporate or business plan

Policies, Standards and Procedures

Policies agreed by senior management
Standards and procedures set on basis of policies
Compliance with national and European legislation and in line with international standards

Segregation of Functions

IT units have an independent place in the organisation
Functional separation between users and developers

Personnel Policy

Defines responsibility for information security
Security training and awareness policy in operation

IT Audit

Specified in the internal audit charter
Plans and reports supervised by Board or Audit Committee
Independent reporting
Appropriate qualifications and experience
Appropriate involvement in control and audit aspects of developing new systems

Physical Security

Physical access
Supervised access to buildings
Restricted access to IT installation
Access of non-IT staff to critical installations is logged

Fire prevention/Detection/Protection

Centre located away from combustible materials
Minimisation of accumulation of flammable goods
Thermal boundary around central computer room
Detectors
Fire extinguisher systems
Emergency procedures

Flood Prevention/Detection/Protection

Centre located away from areas susceptible to flooding
Water detectors
Pumping equipment

Power Supply Protection

Un-interruptible power supply or standby generator
Tested at least annually

Logical Security for Data or Applications Server

Logical Access Security

- Security Administrator
- Access rights
- Audit trails

Logical Security-Programmes

- Separate libraries for production from test and development

Logical Security-Personnel

- Users do not share passwords
- Audit logging

Logical Security-Data

- Non-production and utility programs only run against data files when run is authorised

Logical security-Systems Software

- Security features installed
- Audit trails

Systems Development, Programming and Maintenance

Project Management

- Systems development standards
- Procedures at specific project stages
- Project initiation
- Feasibility study
- Analysis and design
- Construction testing and implementation

Change Management

- System for monitoring changes
- Retention of source code
- Audit trail of all changes
- Recovery procedures from unsuccessful changes
- Separation of development and production

Routine Operations of Central Facilities

- Equipment maintenance
- Separation and rotation of duties
- Operator actions logged
- Job execution and scheduling
- Monitoring of activities

Audit trail of activities
Library controls
Distribution of output

Telecommunications

Networks closed to unauthorised external access
Encryption
Authentication
Non-repudiation
Steps against malicious code

Microcomputers

Standardisation of hardware and software in organisation
Back-up procedures
Protection of data
Virus policy
Application development subject to proper systems development and change management procedures

Contingency Planning

Disaster recovery plan
Plan tested annually
Back-ups

APPENDIX E

THE INTERNAL/EXTERNAL AUDITOR RELATIONSHIP

Background

Internal and external auditors pursue different objectives, have different lines of accountability, possess different qualifications, and engage in different activities. But they have mutual interests that call for co-ordination of their talents and resources for the benefit of an organisation.

The internal auditor's objective is determined by management and professional standards: usually that objective is to review the efficiency and effectiveness of the operation, compliance, and the adequacy and effectiveness of internal control throughout the organisation. The external auditor's objective is that which is required by law and is usually to express an opinion on the fairness with which financial statements have been prepared.

Internal auditors are accountable to management. The external auditors in the public sector are accountable in general to the governing body and/or the parliament.

Internal auditors' qualifications are generally those that management thinks appropriate and range from certification to nothing more than on the job training. The qualifications for external auditors are generally set by law and require membership of a professional body.

Internal auditors are concerned with all aspects of an organisation's activities – both financial and non-financial. External auditors are concerned primarily with the financial aspects of the organisation.

Co-ordination

Co-ordination between internal and external auditors is important because it increases the economy, efficiency and effectiveness of the total audit activity for an organisation. Neither form of auditing can replace the other. However, in many ways they impinge on each other, and if the two types of audits are uncoordinated there will be overlaps and duplications that unnecessarily increase audit costs and create inefficiency and unnecessary demands on the time of the people/organisation being audited.

Co-ordination must be based on mutual respect and integrity. Each group must be able to regard the other as professionals of equal competence. Trust must be the keystone of the co-operative bridge. Neither should try any tricks on the other. Neither should be ashamed or reluctant to admit to not having been especially clever in the way they handled a particular task. With the feeling of mutual respect and trust, they can soundly construct that all-important bridge.

Benefits of Co-operation

Here are some of the benefits which co-operation can bring:

- More effective audit based on a clearer understanding of respective audit roles and requirements.
- A reduced audit burden resulting in less disruption.

- A better informed exchange of views on the risks facing the organisation leading to more effective focusing of audit effort and consequently to more useful advice to management.
- Better co-ordinated internal and external audit activity based on joint planning and communication of needs.
- A better understanding by each group of auditors of the results arising from each other's work which may inform respective future work plans and programmes.
- Increased scope for use by both internal and external auditors of each other's work.
- The opportunity for each party to draw on a wider and more flexible skills base.

Achievement of Co-operation

This can be assisted in a number of ways:

- Senior management actively encourages and supports co-operation.
- Opportunities for co-operation are identified from respective audit plans, and documented along with the agreed procedures for co-operation.
- Regular and structured dialogue between interested parties.
- Both sets of auditors adopt an active role in seeking opportunities for co-operation.

Building effective co-operation – the four C's

Effective co-operation demands:

- Commitment
- Consultation
- Communications
- Confidence

Commitment. Commitment is an attitude of mind in which both parties understand and embrace the value of co-operation in developing co-ordinated and effective audit services and are prepared to be flexible and understanding to achieve that end.

Consultation. Regular consultation between internal and external auditors provides the basis for identifying opportunities for beneficial co-operation and the mechanism for helping to bring it about. Even where internal and external auditors are not working together in a particular area there may be circumstances where they wish to consult with each other on particular issues or on specific audit findings.

Communication. This is a two-way process. Regular and open communications between internal and external auditors is essential, for example, in regular meetings to look at future plans to identify opportunities for co-operation. There should also be a desire and recognition of the value of being able to communicate informally when issues of mutual interest arise.

Confidence. This is founded on the recognition that internal and external audits are conducted in accordance with appropriate professional standards. There also needs to be confidence that any information exchanged is treated professionally and with integrity.

Co-operation in practice

Internal Control

Measuring and evaluating effectiveness of the system of internal control is the primary objective of internal audit. External auditors are required to make a preliminary assessment of the adequacy of the accounting system and the control environment as a basis for the preparation of the financial statements and the design of audit procedures. Exchange of information about internal control is therefore important. When internal audit can provide positive assurance that internal control is adequate, external audit can use that information in determining the extent of its audit procedures.

Reporting and Financial Statements

Parts of internal audit work can help external audit when reporting on financial statements. In addition to internal audit's opinion on control, any relevant specific testing work undertaken will be of use. There may also be opportunities to conduct joint testing work which can serve the purposes of both internal and external audit.

Compliance with Laws and Regulations

Internal auditors will invariably consider controls over compliance with laws and regulations as part of their compliance and systems based audit work. This will be of use to external auditors who may have to give a view on the regularity of transactions and whether or not activities have been carried out in accordance with laws and regulations passed by the country's parliament.

Fraud and Corruption

Internal and external audit both have an interest in the prevention and detection of fraud. External audit should consider the work of internal audit when assessing the risks of fraud in the context of the financial statements.

Developing Systems and Major New Initiatives

Internal auditors may review the development of new systems. This work will be particularly important to external audit when new accounting systems are reviewed.

Testing Programmes

The interrogation of computerised systems for testing purposes can be expensive both in the preparation of the testing techniques and in the running of the testing programmes on computer systems. When there is an overlap in testing plans, co-operation can allow more economic approaches to meet the needs of both parties.

Audit of Regional Organisations

If the audited organisation has regional/functions or offices there is obvious scope for co-ordinating the planning of visits. Chances to work in joint teams or for one party to carry out work on the other's behalf is more economical and limits disruption.

Audits by European Commission Officials

The EC auditors will often choose to derive much of their assurance that European funds have been dispersed in line with regulations, by examining the work of both internal and external auditors. The two parties can usefully liaise to provide essential background information; assurances on the basis of work carried out or indicate a willingness to put resource into areas where the Commission auditors consider there is a need for further activity.

Conclusion

Effective co-operation between internal and external audit leads to a range of benefits for both sides, and also for the organisation being audited. Whilst their respective roles are different, co-operation helps both parties achieve their objectives and also helps them provide a more effective, efficient and economical service to the organisation they work for and ultimately to parliament and the public.

APPENDIX F

SIGMA PAPER: PILOT INTERNAL AUDITS: A DEVELOPMENTAL TOOL

Introduction

SIGMA has developed the use of pilot audits as a very useful and practical tool in assisting auditors of all types to develop and implement their audit methodologies and practices.

A pilot audit may be defined as an audit undertaken which includes the objective of testing new working procedures, practices or techniques. In the circumstance where a new audit methodology is being developed, a pilot audit may be devoted solely to furthering that development. It will take place in a real work environment and will have the twin objectives of audit development and of informing the principal stakeholders of the changes taking place. It may be carried out in conjunction with a third party (e.g. SIGMA or another Internal Auditor), but still have the main aims as stated above. The pilot audit is a particularly good way of field testing methodology before it is prescribed in audit manuals or audit procedures documentation.

Why Carry Out Pilot Audits?

When it is decided to introduce a new audit methodology or to revise significantly an existing methodology (revising both practice and documentation re. audit manuals) it is always best practice to test the new working procedures, practices and techniques before implementing them for all audits. This will help to ensure that as many shortcomings or problems as possible are identified so that appropriate remedial action can be taken. Without such testing, and pilot audits are an effective way of undertaking such testing, the quality and the credibility of the new audit methodology will be at risk.

Pilot audits set up an arena where there are meaningful opportunities to identify, discuss and resolve issues concerning the new methodology. When implementing a strategy in co-operation with experts from other countries, the use of pilot audits provides a practical, hands-on way to ensure that full implementation will proceed as smoothly as possible.

By using pilot audits, staff training can be introduced in a more focussed manner and the experiences of the staff involved can be disseminated to all staff as “real life” examples. The staff used for pilot audits might also be used as “trainers” as the audit methodology is introduced throughout the organisation. It provides a clear opportunity to demonstrate the utility and benefits of new audit approaches in a practical environment.

Pilot audits require only a relatively small number of audit staff to undertake the work required, the risk of wasting scarce human resources is therefore kept to a minimum.

When are Pilot Audits Appropriate?

Developmental activities are normally most effective when they are undertaken within the framework of strategic development plan (often the outcome of a peer review type exercise supporting a process of self-assessment). Such plans are based on analyses of desired states and will identify the key areas where change is needed and they will also establish priorities. They may be prepared with the co-operation of experts from other countries with broad experience of international auditing standards and working practices but their knowledge of the situation and culture of the host audit organisation and the

environment in which it works is likely to be, at best, superficial. In these circumstances and before proceeding too far with the implementation of a new or revised audit methodology, it is prudent to test the changes by means of a series of pilot audits.

Implementing development plans is a huge challenge and they need considerable resources to ensure that they progress smoothly and successfully. It is likely that, given limits to the staff resources available, the outputs from the existing activities and responsibilities will reduce. In some countries this may lead to criticism from important stakeholders. It is vital therefore that the mix between audit development activities and the fulfilment of the continuing responsibilities is balanced so that quality of outputs from both areas is not jeopardised. The use of pilot audits helps to keep that mix of responsibilities at the appropriate level.

The use of pilot audits is also appropriate when auditors need the understanding and acceptance of their stakeholders to the changes being proposed. Maintaining the auditors standing and credibility can be difficult when changes are being introduced that are not fully explained or understood. Pilot audits provide a useful means to “test the water” with key stakeholders to help establish their concerns and ensure that they can be addressed for the future.

In some countries the changes being made, require changes to the legal framework and changes to major governmental processes (such as the budgetary process, financial management processes, the introduction of internal audit). It is vital to ensure that the changes being introduced by the auditor are fully compatible with the changes being made elsewhere in government. Pilot audits will address such issues and enable the auditor to contribute to the changes in the broader financial accountability area.

Development plans often cover a four or five year time span for the successful implementation of a new audit methodology. Pilot audits provide, at a very early stage in the life of these plans, an excellent mechanism to provide quality feedback about how the changes are working in practice, at the same time using only minimal resources.

How can it be done?

SIGMA experience with pilot audits throughout Central and Eastern Europe suggests that the following minimum requirements will provide a good basis for successful pilot audits:

- Pilot audits are a part of the Development Plan process for implementing desired change. It is important for the implementation team — senior audit staff — to ensure that the plan progresses.
- Pilot audit staff — experienced audit staff with potential to train other staff.
- Audit Methodology staff — core audit staff to develop or revise the audit methodology and/or the audit manual in the light of experience (pilot audits) and research.
- External expert(s) — considerable experience of internal audit to assist in reviewing progress of pilot audits at key stages. This may be facilitated through joint audits with other audit organisations or other experts.
- Internal workshops — to provide regular feedback at key stages of each pilot audit (Planning, Fieldwork, Review, Reporting, and Lessons Learned).
- Seminars for all internal audit staff — using pilot audit staff as trainers.
- Discussions with stakeholders — to clarify the changing role of the audit and the basis of the audit methodology.

Some Lessons Learned

- Select an audit area of substance and importance. Pilot audits provide a rare opportunity to demonstrate clearly the changes being made and the added value and contribution they make to the stakeholders' own development. The reporting of the new type of audit findings and conclusions can therefore be used in the wider perspective of public accountability.
- Keep the number of pilot audits at a manageable level. Over-enthusiasm for change can reduce the benefits of using pilot audits as a tool in the first place.
- Ensure that the expert(s) obtain(s) as good an understanding as possible of the audit environment, in general and in relation to the specific area under the pilot audit.
- Define expressions used. Do not under-estimate potential language problems, not only the translation of the technical terminology but also dealing with the detailed working papers of the audit and unfamiliar (to the expert) papers of the audited body.
- Select pilot audits that are priorities under the Strategic Development Plan and also priorities under the annual work plan. Conflicting priorities will affect the quality of the outcomes.
- Ensure that the legal basis of the audit is sound to minimise the risk of challenges to the reports being made.
- Do not under-estimate the difficulty of dealing with audited bodies who may not understand what is required of the under the new audit approach. It is important for the expert/s, on some occasions, to be part of the audit team visiting the client. This helps all parties understand what is actually taking place.
- Make sure that audit findings and reports to management add value as regards the development of the audited body. The ways in which the findings are expressed is vital, as this is likely to be a new experience for the participants.
- The outcomes of the pilot audits need to be fed back into the audit development process. The staff of the pilot audits should be separate from those of the audit methodology team so that independent thought can be given to the impact of findings on the development of audit methodology.
- Ensure that the results of the pilot audits are spread effectively. Pressures of "the next audit" often result in the knowledge gained from the audits is disseminated fully or effectively. Seminars are a good mechanism, particularly as a dialogue between the expert and the audit team can make the experiences more interesting.
- At the completion of each pilot audit ensure that team members are appointed to senior positions in new pilot audits so that their experience is not "lost". This makes the most effective use of limited resources.
- Ensure that most team members have the potential to "train" and lead seminars so that, again, limited resources can be used effectively.

Conclusion

SIGMA experience has found that pilot internal audits are an effective tool for testing new working procedures, practices and techniques. This in turn facilitates the development and preparation of audit manuals. Staff resources are invariably scarce and this type of approach helps with the implementation of a new methodology in a very effective way. It is vital that these audits, along with other tools used in the developmental process, are applied in conjunction with an agreed Strategic Development Plan so as to ensure that progress can be monitored and controlled satisfactorily.

The support and co-operation of IAs' stakeholders is vital, these include not just the audited bodies but also relevant parliamentarians and bodies with oversight responsibilities such as the Ministry of Finance. External experts are a valuable addition to pilot audits; they are able to bring their experience of internal auditing standards to bear on real audits rather than simply from a theoretical perspective which may not always take into account local culture and practices. Joint audits with other auditors can also be a good way of experiencing and testing new methodology.

The outcomes of pilot audits also have the potential to identify shortcomings in audit methodologies. If used effectively, it can contribute to the future development of improvements in methodology or the introduction of new auditing practices and approaches.

APPENDIX G

INTERNAL AUDIT COMMITTEES - SUMMARY ADVICE FROM THE (CIPFA)

General

Ministries and Public sector bodies and Institutions should establish an Audit Committee, comprising non-executive members, with responsibility for the independent review of the systems of internal control, internal audit and of the external audit process.

Establishment

The Audit Committee should be independent of the organisation's executive management. It should be established as a high level committee, constituted formally as a sub-committee of the main executive board. Membership should be confined to non-executives, although committee members need not all be members of the main board.

Composition

The chair of the Audit Committee should not be the chairman of the board or have an executive role in the organisation. However, he/she should be a member of the board, although other members may be independent of the board. The chair of the board should not normally be a member of the committee.

The responsible finance officer or director of finance, the chief internal auditor and the external auditors should normally attend meetings of the committee and should have direct access to the committee at any time.

Responsibilities

The functions of the Audit Committee should include the following:

To review with management the:

- Adequacy of the internal controls system.
- Adequacy of policies and practices to ensure compliance with relevant statutes, directions, guidance and policy.
- Compliance with relevant standards or codes of corporate governance.
- Financial statements.
- Risk assessment and management process.

To ensure that the internal audit function is effective, is properly resourced and has appropriate standing within the body.

To review the activities of the internal audit function, including its annual work programme, co-ordination with the external auditors, the reports of significant investigation and the responses of executive management to specific recommendations.

To manage on behalf of the board all aspects of body's relationship with the external Audit Office (ASZ).

APPENDIX H

SIGMA SHORT PAPER - MANAGEMENT OF INSTITUTIONAL RISK

The running of any organisation is primarily concerned with achieving its objectives. Whatever the purpose of the organisation, whether it be government or private sector, it will face all manner of risks. The job of management is to respond to these risks so as to maximise the likelihood of the organisation doing what it is set up for.

Risk can be defined as “an outcome or event which could have a material effect on the objectives of an organisation”.

The primary causes of risk are closely inter-related:

- The random nature of events.
- Imperfect or incomplete knowledge and information.
- Lack of control and/or control weaknesses in the organisation.

There is a continuous “cycle” to the risk management process:

- Identify the risks and define a framework within which risk is to be identified.
- Evaluate the risks.
- Assess risk appetite.
- Identify suitable responses to risks.
- Gain assurance about the effectiveness of the responses.
- Embed and review.

A strategic approach to risk management depends on identifying risks against key organisational objectives. Two of the most common approaches to identifying risk are to commission a risk review, or risk self-assessment.

An alternative but unsystematic approach is to rely on intuition. This may be the most pragmatic in getting risk management off the ground. It simply involves management identifying risks using their “gut feelings”.

Essential to the process is that the organisation has a well defined hierarchy of objectives starting with high level, strategic objectives, and working down to lower level, day to day objectives (*e.g.* objective for payroll, purchasing etc.) against which risks can be identified.

Categories of risk (not comprehensive) with examples.

Organisations will probably be able to identify other categories of risk applicable to their work. Issues can arise which can be an external source of risk to an organisation or can occur as an effect of an organisation's own activity or lack of it. Some examples:

Table 4. RISK MANAGEMENT

EXTERNAL RISKS	
Infrastructure	Infrastructure failure prevents normal functioning e.g. overload of e-mail system, computer networks, power supply systems. Transport systems for bringing staff to work may go on strike
Economic	Interest rates, exchange rates, inflation may adversely affect plans.
Legal and regulatory	Laws and regulations may limit scope to act as desired. Inappropriate constraint through regulation may be imposed.
Environmental	Pollution, fuel consumption may have a damaging effect on the environment. The constraints of the environment in which the organisation is located may limit possible action.
Political	Change of government may require change of objectives. Organisation's actions may attract a political response/reaction.
Market	Developments with competitors and suppliers of goods adversely affect plans.
"Act of God"	Ability to act as desired affected by fire, flood etc. Contingency plans against disasters prove inadequate
FINANCIAL RISKS	
Budgetary	Availability of resources insufficient to carry out desirable actions. Inability to control or direct resources
Fraud or theft	Loss of assets. Resources not available to carry out desirable preventative actions.
Insurable	Insurance not obtainable at acceptable cost. Failure to insure.
Capital investment	Inappropriate investment decisions being made.
Liability	The organisation is adversely affected by others actions, leading to the organisation gaining a right to seek damages. The reverse can apply.
ACTIVITY RISKS	
Policy	Inappropriate policies being pursued. Policies based on inadequate or inaccurate information.
Operational	Unachievable/impractical objectives. Objectives inadequately achieved.
Information	Inadequacy of information for decision making leads to decisions being made without sufficient knowledge.
Reputation	Development of poor public reputation and consequent effects. Ethical reputation, for example, may limit scope to act as desired.
Transferable	Risks which could be transferred are retained or are transferred at the wrong price.
Technological	Need to improve/replace technology technology to remain effective. Failure of technology disables the organisation's operations.
Project	Projects developed without the risks being properly assessed. Projects failing to deliver in time budget or functionality.
Innovation	Exploitation of opportunities for innovation missed. Using new approaches without properly assessing risks.
HUMAN RESOURCES RISKS	
Personnel	Lack of sufficient staff with appropriate skills limits ability to operate effectively, or at all. Poor morale affects staff.
Health and safety	People unable to perform their responsibilities due to neglect of well being of employees.

Assign ownership of risks

Risk management is most effective when a senior official is allocated ownership of particular risks, normally those within his area of responsibility. The risk owners can be formed into a Risk Management Committee that would identify the areas of greatest risk to the organisation, and decide how to respond to those risks. A re-evaluation of risk would take place at regular intervals and the Committee would also have a monitoring role to determine how risks are being managed.

Evaluate

Some types of risk lend themselves to a numerical diagnosis, particularly financial risk. For other risks, for example reputation risk, a much more subjective view is all that is possible. It will be necessary, however, to develop some framework for categorising risks into, *e.g.* high/medium/low.

Assess Appetite for Risk

Decisions about response to risk have to be taken in conjunction with the identification of the amount of risk that can be tolerated.

Response to Risk

Mitigation/control strategies

- Avoid the risk by suggesting alternative strategies.
- Eliminate the cause(s) of the risk.
- Reduce the likelihood of the risk occurring.
- Reduce the direct consequences of the risk.
- Minimise its impact in business terms.
- Transfer the risk (insurance).
- Instigate further investigation to gather further information before a final decision is made.
- Accept the risk as unavoidable.

Flowing from this the organisation should draw up a corporate risk register. The register should contain details of the risks. For each risk the register will show:

- Importance.
- Proposed action to deal with the risk.
- Responsible officer.
- Whether there are controls in place to achieve the organisation's objectives.
- If the controls are inadequate, what the organisation is doing about it.

Gain Assurance that Risk is being Properly Managed

It is vital that assurance is obtained as to the effectiveness of management actions. This can be provided by management periodically reporting on the work they have done to keep risk and control procedures appropriate and up to date. Internal Audit can also provide assurances about management's risk and control mechanisms.

Embed and review

The risk environment doesn't stand still and it is important that the risk process is regularly re-visited to have an assurance that the risk profile for the organisation continues to be valid.

Useful steps for implementing the risk management process:

- A memo from the "boss" to all members of management and staff to "kick off" the process.
- Circulation of a risk management policy document.
- Workshops at different levels on risk management.
- Re-allocation of some of the training budget specifically to risk training.
- Dissemination of key business objectives and significant risks.
- Clear policy communicated on how significant risks are to be managed.

Rather than developing separate risk reporting systems it is better if possible to build early warning mechanisms into existing management information systems. Cumbersome databases can be a major distraction from the key point which is that each person in the organisation becomes more focussed on meeting the business objectives and in managing the significant risks which relate to the task which he or she performs.

The message is that risk management is not simply a process to be gone through to satisfy external parties. It is a highly practical management tool and should be a fundamental part of planning and decision making. Therefore top management should work to embed risk management within every process and to ensure all staff understand the value of risk management.

Anyone wishing to go further on this topic may wish to refer to the UK Treasury's risk support home page:

http://www.hm-treasury.gov.uk/documents/public_spending_and_services/risk/pss_risk_index.cfm

Or look into the newly issued standard on risk management prepared in the UK:

<http://www.theirm.org/publications/PUstandard.html>

APPENDIX I

© QUALITY ASSESSMENT MANUAL/INSTITUTE OF INTERNAL AUDITORS

Internal Audit Activity

Measurement Criteria

The following are some of the significant measurements that may be tracked by internal auditing activities:

Human Resources

- Average years of audit experience
- Hours of training per auditor
- Percent training plan achieved
- Percent staff certified
- Auditor turnover
- Staff rotated to and from operations departments
- Staff satisfaction survey

Effectiveness

- Balanced Scorecard
- Number of major audit findings/recommendations
- Percent recommendations accepted
- Amount of audit savings
- Number of repeat findings
- Number of process improvements

Quality

- Number of management requests
- Average response time — management requests
- Level of customer satisfaction — by survey
- Number of complaints about audits

Cost/Productivity

- Number of auditors per 1,000 employee.
- Number of auditors per million dollars of revenue/million dollars of assets
- Staff utilization — direct vs. indirect time
- Completed audits per auditor
- Completed vs. planned audits
- Actual hours vs. budgeted hour
- Cost savings as a percent of department budget.

Reporting

- Number of audit reports issued.
- Elapsed time — opening conference to field completion.
- Elapsed time — field completion to final report.
- Number of “unsatisfactory” audit opinions.

APPENDIX J

REVIEW OF THE INTERNAL AUDIT MANUAL.

We have reviewed the Internal Audit Manual in order to evaluate if the content is in line with international accepted auditing practice.

The Manual in general is well prepared and covering all phase of the audit process. Though there are some parts of the manual that could be further developed to make the Manual even more useful for the internal audit function. The parts commented under other headlines in this report are excluded here.

Recommendations for future development

The Manual do not have an Introduction Section explaining the principles on which the internal audit process and methods are based.

Recommendation

That an Introduction Section is added at the beginning of the Manual. The IIA produce and sell a product called "Internal Audit Manual, Shell on CD". It is a very useful tool when producing or updating an Internal Audit Manual.

The auditors communication with the customers is recommended to primarily be in written. The auditors should meet with and communicate as much as possible with the customers before and during the audit. At least there should be an Opening Meeting at the beginning of an audit discussing the key issues of the opening statement and a Closing Meeting at the end discussing the draft audit report and the audit findings supporting the auditors conclusions and recommendations.

Recommendation

The Audit Manual should be updated to meet these requirements.

The Opening Statement (Audit Task Work Plan) do not refers to which Business Objective(s) the audit is addressing, only to the internal controls.

Recommendation

The Opening Statement form should be updated to modern practice.

The section on sampling is not correct and could be misleading the auditors.

Recommendation

The section on sampling should be rewritten.

The head of the internal audit formulates an opinion on the internal control system established in an institution or ministry. To be able to give such an opinion on the entire system of control, the audit must each year cover all important parts of the control system. Usually internal audit departments never have that big recourse to its disposal.

APPENDICE K

POST AUDIT SURVEY QUESTIONS

The effectiveness of the audit process is rated by checking the appropriate responses for each item.

1. You were given reasonable notice of the audit to allow your staff to be adequately prepared to minimize disruption to your operation
2. The purpose and scope of the audit were clearly communicated in writing, and you were advised of the expected length of the auditors' stay.
3. You were given an opportunity to discuss with the auditors your concerns about your operations for possible inclusion in the scope of audit.
4. The auditors had an appropriate level of knowledge of the operations prior to starting the audit, so that undue management time was not wasted communicating the basics. 4/93.
FIELDWORK
1. The purpose of questions asked of you or your staff was always made clear by the auditors.
2. Auditors attempted to cover several questions or topics in their meetings with management in order to efficiently use management's time.
3. The auditors periodically informed management of audit's progress.
4. The auditors provided responsible supervisors and managers with written audit recommendations as the audit progressed.
5. The "agreed to" solutions to each audit findings in the final audit report was the best available solution for the given circumstances, and you were given the opportunity to contribute to developing it.
6. All original documents used by the auditors were returned
CLOSING CONFERENCE
1. The date and time of the closing conference was arranged well in advance with all appropriate managers.
2. The purpose of the closing conference was fully explained.
3. The Draft Audit Report was received at least 24 hours before the closing conference.
4. The auditors were well prepared and had a good knowledge of the areas being discussed at the closing conference.
5. The audit recommendations were discussed openly and objectively, and the auditors were receptive to management's comments.
AUDIT REPORT

1. The final Audit Report adequately reflected the results of the audit and the closing conference.
2. The Audit Report was written in a fair manner and reflected all pertinent facts.
STATUS REPORT
1. The written instructions for preparing the follow-up status report were clear, given to you with the final Audit Report and explained where necessary.
GENERAL
1. The audit was a useful service.
2. The auditors were professional. Courteous and objective.
3. The audit was thorough and well-balanced, not dwelling on minor areas.
4. The auditors were receptive to concerns or questions raised by management.
MANAGEMENT'S COMMENTS
1. Was there anything about the audit that you particularly liked?
2. Was there anything about the audit that you disliked?
3. If you felt that the audit disrupted operations, how could the disruption be reduced in the future?
4. How could the next audit of your area be improved?
5. Please add any other comments.

APPENDICE L

OBJECTIVES OF THE CHU – LITHUANIA²

PRINCIPAL ROLE OF THE CHU

The CHU is responsible for the development and promotion of harmonised internal audit and control legislation and methodologies, as well as for the coordinating the implementation of it in the global public (state and municipal) sector.

The principal role of the CHU includes:

- Raising the awareness of all public sector shareholders (i.e. all management, control and audit levels) towards the PIFC.
- Developing and maintaining a network for an adequate exchange of relevant information between its participants. The networking itself is carried out by e.g. regularly organised meetings within the profession, the use of a website and other electronic facilities to disseminate the latest information and discussions on common issues raised. ensuring help – desk, consulting for the internal auditors and officials responsible for certain control functions.
- Drafting framework or primary legislation to provide the government with a legal basis to introduce the various elements of PIFC.
- Developing and implementing primary and secondary law. Providing basic methodological guidance and tertiary regulations like the Sample internal audit methodology, the Financial control manual, etc.; also the templates like the Internal Audit Charter and the Code of Ethics, etc. to be used and refined by the relevant services inside line ministries and other budget agencies.
- Monitoring PIFC implementation aspects, ensuring the compliance and quality assurance checks on whether its recommendations are being properly carried out and find out how to overcome any bottlenecks in the implementation of the adopted policies.
- Analysing the annual internal audit reports from each of the budgetary income or spending centres, which facilitate the reporting role of the CHU to the Ministry of Finance on the progress of PIFC throughout the public sector.
- Participating at the nomination committee of the HIAU;
- Coordinating and supervising of the establishment of sustainable training facilities for the professions and improving the relevant administrative capacities. Also ensuring close co-ordination and co-operation with the State Audit Office, professional private organisations (like the local IIA) and academic circles;

² Financial Control Methodology Department of the Ministry of Finance of the Republic of Lithuania

- Coordinating internal audit of the EU funds and ensuring appropriate cooperation with the European Commission services.

OBJECTIVES OF THE CHU³

The principal objectives of the CHU are the following:

- To participate in improvement of financial control and internal audit systems at public institutions, bodies and enterprises as well as public legal entities those that manage, use or dispose of state and municipal assets (hereinafter referred to as the public legal entity);
- To draft and elaborate standard legal acts and methodical guidelines for financial control in public legal entities and those on matters related to internal audit, that of funds disbursed to Lithuania under EU financial assistance programmes, from the Structural Funds and the Cohesion Fund included, in public legal entities as well as co-ordinate application thereof;
- To co-ordinate the draft standard legislation on financial control and internal audit matters developed by other public institutions;
- To analyse and assess the functioning of internal audit units in public legal entities;
- To co-ordinate internal audits of EU financial assistance funds carried out by EU institutions and institutions, as well as implementation of internal audit related recommendations in co-operation with EU institutions and institutions of the Republic of Lithuania.

³ According to the Regulations of the CHU, approved by the Minister of Finance

APPENDICE M

PEERS COMMENTS ON RISK ASSESSMENT AND INTERNAL AUDIT STRATEGY

The risk assessment method prescribed in the Internal Audit Manual is a traditional Matrix Method using mathematically derived weights of risk factors and system components and matrices to describe risk and define control points.

The Internal Audit Strategy in the Internal Audit Manual prescribe:

- systems at high risk should be audited at least every 3 years,
- systems at medium risk at least every 4 years, and
- systems at low risk at least every 5 years.

This strategy makes the risk assessment a tool to classify the *frequency* of the audits instead of allocating audit resources to areas of significant importance to the organisation. The direct consequence of the strategy is that audit resources are spent on *all* systems within a period of five years, also those of less importance to the organisations objectives.

Matrix Methods are inexpensive and easy to use and it is easy to transform the result from the assessment into an audit plan. The disadvantage is that these methods call for a very specific assessment environment. The result from such an assessment is reliable *only* when all possible effects from all possible events are known and can be calculated. Such a situation appears in the insurance and gambling industry but rarely in other professional activities.

When there are possible events and effects that are unknown risk cannot be calculated. Then risk assessment and risk management can do nothing but *prepare the organisation for the unexpected*. This call for the use of Risk Scenario Methods instead of Matrix Methods. Scenario Methods are more flexible but also more complex and more expensive to administrate. The big benefit is that the assessment will help the organisation to prepare for the unknown and unexpected.

One group of Scenario Methods that have been developing rapidly and been very popular during the last years are the so called Risk or Risk & Control Self Assessment Methods. There are about 70 different Self Assessment Methods on the global market today. We believe that the Latvian Administration and Internal Audit today have reached such a maturity that they would be able to benefit from one of these methods. The Institute of Internal Auditors have more information about this.

A modern handbook “Implementing the Professional Practices Framework” written by Christy Chapman and Urton Anderson PhD, CIA, CISA, CGAP (The IIA Handbook Series) recommend in the Exhibit 12, Best practice in value-added auditing,

Risk Assessment and Audit Planning

- Minimize or eliminate repetitive, cycle audits.

- Use qualitative, participative risk assessment.
- An automated risk model is of secondary importance.
 - If you use one, emphasize qualitative factors.
 - If you use one, use it as the starting point only.
- Management participation is primary.

We propose

- the current internal audit strategy to be changed to allow authorities and agencies to use risk assessment results to allocate audit resources to sensitive areas of importance for the organisation without demand for repetitive, cycle audits and
- the risk assessment sections of Internal Audit Manual to be revised to allow and promote the use of scenario methods and to allow authorities and agencies to customize the risk assessment methods to fit their specific environment and needs.

An example from an Internal Audit Manual text on annual risk assessment:

Annual Risk Assessment

Risk management should be a central part of each Budget Organisation's strategic management. It is a Management responsibility and is significant to the achievement of performance and objectives. Effective Risk management adds value to all activities by increasing the probability of success and mitigating against the possibility of failure.

A Risk assessment is important to internal audit since it will provide an indication as how best to employ scarce resources.

The Risk assessment firstly sets out to define systems which cover all of the Budget Organisation's objectives and activities and their associated risks. The Risk Assessment goes on to prioritise these systems in accordance with a risk ranking of High, Medium or Low (See Figure No 1 on next page).

- **Low** – the assessed possible negative impact is low and the assessed probability low;
- **Medium** – the assessed possible negative impact is low and the assessed probability high;
- **High** – the assessed possible impact is not acceptable.

The internal auditors shall stress on the significance of the **impact**. The answer to the question whether the impact of a given risk should be qualified as low, medium or high, is based on the professional judgement of the internal auditor. The decision whether the manifestation of a certain risk is probable or not, is a result also of the professional judgement of the auditor.

Risk Assessment exercise should be carried out in full consultation with the BOs' senior Management. The Head of Internal Audit should present the findings of the exercise to the Head of the Budget Organisation for agreement if possible.

The summary of the Risk assessment is a «Working» document that should be maintained and updated in the light of changing circumstances and risk perceptions – in particular as a result of Internal Audit activity, other audit or Management reviews, new initiatives and other change.

Classification of risk

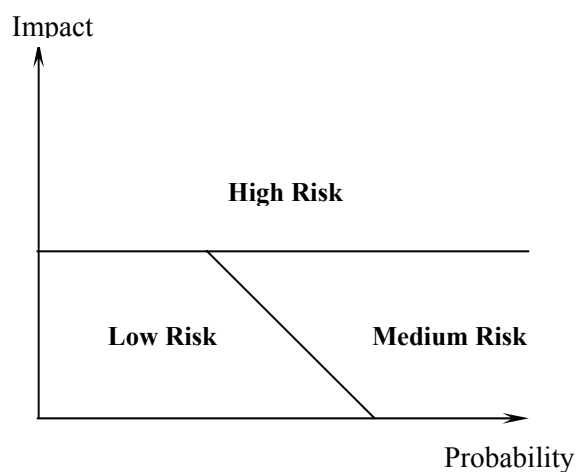


Figure No. 1

APPENDICE N
RISK ASSESSMENT TECHNIQUES

Source David McNamee and Sten Bjelke

Three steps:

1. Identify risk.
2. Measure risk.
3. Prioritize/rank risk.

Commonly used techniques:

1. Identify risk

- i. Exposure analysis.
- ii. Event Trees and Fault Trees.
- iii. Environmental Analysis.
- iv. Threat Scenarios.
- v. Delphi techniques and other collaborative sessions.

1.1. Classification of Risk:

- ◆ Inherent Risks,
- ◆ Control Risks, and
- ◆ Detection Risks.

Modern risk assessment methods do *not classify risks!*.

2. Measure risk

2. Controls Evaluation Tables.
3. Matrix/Analytical Hierarchy Process.
4. Sensitivity Assessments.

3. Prioritize/rank risk

1. Most priority risk rankings are variations on the same process:
 - b. Threat and risks are characterized as risk factors.
 - c. The relationship of risk factors among themselves are shown by weighting.
 - d. Auditable units are examined for the strength of the presence of these factors and are given a score to reflect that.
 - e. The weight factors and their unit scores are used in a formula to derive a value for “total risk”.
 - f. The score are ranked by some ranking algorithm, either absolutely by score or by first dividing the scores into categories and ranking by category.
2. Worst case / priority ranked by assessed effect on important objectives.

Modern Approach to Risk Assessment.

Risk Self Assessment Methods and other modern methods often are based on the following techniques:

- 1.3 and 1.4 in combination,
- 2.3 and
- 3.2.

APPENDICE O

STRATEGY FOR CHU REVIEW

SIGMA, FEBRUARY 2005

1. Review CHU and its role.

Objective – to ascertain the:-

- Delivery of its responsibilities for overseeing and promoting internal audit interests and development.
- Production and updating of methodology.
- Identification and promulgation of good practice (Standards and PRAG) and latest developments.
- Capacity and resources of CHU.
- Capability of CHU – professional expertise and practical experience
- Quality assurance role – internal and external.
- Networking facilitator.
- Public/external relations/promotion of role of internal audit.
- Developmental role
- Leadership role
- Liaison with professional bodies.
- Training development.
- Problem issues and identified challenges.
- Liaison with external auditors, EU and national.
- Liaison with CHUs in other countries.
- Liaison with European Commission and SIGMA
- Annual Report on IA (and PIFC)

Essential Approach.

Interviews within the CHU and external parties as appropriate.

File and report examination

2. Internal audit and the central/ general provisions for:-

- An effective control environment, and risk management roles
- Corporate Governance issues – Audit Committees
- Professionalism.
- Training: Plans and strategies national and ministerial.
- Relations with external auditors.
- Networking – national groups and international.
- Long term strategy for status, professionalism, recruitment, retention, pay and conditions.
- IA for Local Government etc

Essential approach

Interviews outside the CHU with eg the IIA , the training provider(s), the external auditors, the Civil Service dept., the Minister or vice-Minister of Finance, the EU representation, etc.

This will have an overlap with the first part of the strategy and there will need to be close communication if both the parts are to be carried out effectively