

# THE ROLE OF INTERNAL AUDIT IN THE BUDGET SYSTEM REFORM

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## **Abstract:**

*The paper presents one of the weak areas of the public management in the emerging countries: the internal audit, and reviewing international standards for government auditing and accounting, emphasizes that internal audit is a central component of internal financial controls aimed at protecting the government's financial interests in the initial stages of the transition to performance-oriented budgeting.*

**Key words:** *internal audit, financial management*

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In moving a budget system toward developed countries standards (like OECD), it must be based on a solid platform of financial management within such government institutions. Three areas related to internal management control system must be restructured: internal audit, management information system and costing systems. First the role of internal audit (IA) must need to be better defined. Recently, there has been progress in reaching a consensus on the audit standards that governments should meet. Specifically both the International Organization on Supreme Audit Institutions (INTOSAI) and the Institute of Internal Auditors (IIA) have issued standards (4) to guide the auditing and accounting professions. While these are not compulsory, they are generally regarded as „best practices”, and so it is expected that as countries develop their own public sector auditing standards, they will try to keep them consistent with these international standards.

The standards adopt a broad view of the role of IA, placing it as a more central element of public expenditure management, rather than as a narrow function of compliance or financial regularity. The emphasis is on IA as a management tool and as an integral part of both management and information and communications processes. From this perspective, the purpose of IA is to review, appraise, and report to budget managers on the soundness and adequacy of internal controls (e.g., safeguarding assets, ensuring reliable records promoting operational efficiency, monitoring adherence to policies and directives). The IA is thus seen as performing a „watchdog” role to ensure the effectiveness of internal management controls.

The standards stress four aspects of IA, which unfortunately appear hard for many countries to attain, including many emerging economies (Diamond, (4)):

- Independence to make objective judgments, this implies that the auditor will have no direct management responsibility for what is being audited, will be free to choose any transaction/topic for audit, and will be allowed access to all necessary information to come to an informed judgment. Unfortunately, in many countries, systemic governance problems often imply real difficulty in ensuring the auditor's independence.
- Professional proficiency, assumes an appropriate audit methodology, technical competence, and sufficient levels of resourcing for the IA function. In many countries, skilled auditors are in short supply, professional proficiency is very low, and/or the government's pay scale is insufficient to attract or retain suitable

staff. These factors often represent an important constraint on attempts to strengthen the IA function.

- Wide scope for IA. The scope of the IA described in these international standards is based on the broader view that IA is a tool of management, helping to close the loop in the agency's public expenditure management cycle by ensuring the efficient and effective use of resources. This, in turn, assumes a mechanism for follow-up action on audit reports. In many parts of the world, including in many emerging economies, IA continues to be defined rather narrowly – focusing on financial compliance and regularity, rather than on broader management issues. Moreover, governance problems and a lack of professional competence also constrain the internal auditor to this narrower role and hinder his or her ability to generate timely and relevant reports.
- Effective management of the IA function: in many countries, management of IA is poor – poor work practices, lack of planning and personnel management, and little support from the external audit agency. Additionally, management is constrained by the institutional arrangements for IA, which often compromise the role of the auditor and an aid to internal management.

Even among developed countries, organization of the IA function varies greatly, for example, from centralized to decentralized approaches. Despite the variety of IA approaches among these countries, there are some common general principles. First, IA is viewed as a central component of internal financial controls aimed at protecting the government's financial interest. The important concept is the *internality* of this executive function, distinguishing it from external audit. Second, although IA activities include traditional compliance and regularity operations, they can be defined quite widely to include substantive tests and systems, performance, and IT audits. Third, to function effectively, the internal auditor must be functionally separated from the day-to-day management of an organization (otherwise the accountability of designated managers will be diluted), but at the same time, the auditor must have input to top management to ensure that his or her findings and recommendations result in corrective action. Fourth, internationally recognized auditing standards should be upheld.

### **Developing the internal audit function in emerging economies**

In developing the IA function, the most important step for emerging economies is to determine the role of the IA in the country's budget management system. Establishing such an overall framework involves two basic design issues:

- Whether to adopt a control or a management orientation – a question of the objectives to be pursued by the IA function;
- The degree to which IA is centralized - a question of the organization of the IA function.

Once these overarching issues are resolved, there are further issues related to how this will be implemented at the agency level:

- The relationship with external audit – a question of responsibilities and coordination;
- How to restructure work practices in agencies – a question of operational effectiveness.

### **Deciding the objectives of internal audit**

There are a variety of interpretations of the role of IA. In his study Diamond (1) conclude “At the one extreme, there is the centralized view of IA as a support function, assisting the Finance Ministry monitoring ministry and department compliance with the

Finance Ministry financial regulations, instructions and accounting procedures. The emphasis is on compliance and control. Alternatively, under a decentralized approach, IA is viewed as assisting budget managers in the effective discharge of their responsibilities by providing feedback on their use of public resources through the submission of reports and, when justified, the provision of recommendations for corrective action”.

The overall design of the IA function should be geared to the specific priorities of the country. For countries with governance problems, the foremost objective should be to ensure compliance with financial laws and regulations (Diamond). For those emerging economies facing a high degree of fiscal stress, the need to attain macroeconomic objectives should be paramount. For those countries that can ensure compliance with the law and have reached a fair degree of macroeconomic stability, public sector orientation plays an important role in public sector performance. If the public service is oriented towards serving its citizens, bureaucratic red tape and corruption would be minimal and judiciary will further enforce accountability through timely and fair decisions in the administration of justice. One finds such an orientation typically lacking in some developing countries (2).

### **The degree of centralization**

A fundamental design issue is the degree of centralization in the organization of Public sector orientation and the IA function. The centralized approach has often been viewed as better from a capacity-building viewpoint, because it is argued that this approach allows easier maintenance and better development of the proficiency of internal auditors. A composite ranking of countries of three indicators of government orientation, judicial efficiency, bureaucratic efficiency, and the lack of corruption, provides a good indicator of public sector orientation and performance. (Huther, and Shah) relate the degree of expenditure decentralization to the ranking of countries on individual indicators as well as to the composite rank on government orientation and find that all of these correlations show a positive, and statistically significant, association. This suggests that typically decentralized country is more responsive to citizen preferences in service delivery and strive harder to serve their people than centralized countries (2).

But with a scarcity of skilled manpower, a decentralized approach often implies the diversion of IA staff to other duties that will reduce the proficiency of the staff. However, if the Finance Ministry develops a special cadre, it will be able to concentrate scarce auditing resources and so maintain proficiency, ensure the auditors' specialization, and develop centralized standards and training programs for them; also it will foster greater independence. The audit should be conducted with adequate independence. The centralized option is better in this regard, it is argued, since the IA is managed by the Finance Ministry outside the direct control of line ministry managers. However, the necessity of independence is in direct conflict with the necessity for the Finance Ministry's close cooperation with other departments for budget management.

In Romania General Directorate of Public Internal Audit is a functional structure formed on the device's own National Agency for Fiscal Administration (ANAF- ro), directly subordinate to the President of, in accordance with the Internal Public Audit Law nr.672/2002.

The main objectives of the Romanian General Directorate of Public Internal Audit are:

- To help public entities, both overall and its structures, through opinions and recommendations;
- To ensure better risk management;
- To improve the quality of management, control and internal audit;
- To improve efficiency and effectiveness of operations.

Structure direction of GDPA consists of:

1. Service public internal audit own unit of the National Tax Administration Agency;
2. Subordinate units public internal audit department ;
3. Public internal audit section for large taxpayers;
4. Audit department information technology systems;
5. Methodology and summary section.

In weighing these two options – a centralized or a decentralized design for the IA – after Diamond “there are considerations that suggest the answer will be country specific. First, for many countries the danger is very real that in an entirely centralized approach, the Finance Ministry will assume responsibility for the rectitude of financial management in budget institutions, undermining the basic accountability of budget managers. Second, in some countries, the risk of political interference with routine budget management is high, so that the budget manager's accountability is undermined from above, and therefore a centralized system is justified. Third, where the administrative capacity to perform IA function is low, with regard to the recruitment and retention of competent staff, a centralized system controlled by the Finance Ministry is also recommended. Given the time it takes to establish a professional corps of internal auditors, including in many emerging economies, this is a most relevant consideration.”

The Romanian General Directorate of Public Internal Audit shall:

- made public internal audit to assess whether the financial management and control systems of the public entity are transparent and conform to the standards of legality, regularity, economy, efficiency and effectiveness;
- undertakes advice to bring added value and improve the management of public entity, risk management and internal control;
- carried out external evaluation missions by verifying compliance with rules, instructions and the Code of ethical conduct within the internal audit structures formed in the Financial Guard and National Customs Authority and their subordinated territorial units and initiate corrective measures, in cooperation with the audited head structure ;
- ensure the processing, approval and transmission of its annual report on audit work and audit work of territorial structures to the Public Internal Audit Division of the Ministry of Finance ;
- provides development assurance program and quality improvement in all aspects of public internal audit;
- prepare briefings, summaries, analysis, management and documentation at the request of the National Agency for Fiscal Administration or on its own initiative when requirements so dictate;
- monitor the dynamic progress in implementing recommendations made by the public internal audit reports;
- pursues professional development needs of staff in the general direction of the IAC and subordinate;

- proposing to General Directorate of Public Internal Audit of Ministry of Finance, in accordance with regulatory powers, for modifying / expanding the legal framework for public internal audit;
- aims at maintaining a high degree of integrity, ethics and morality in public internal audit activity;
- propose development strategies of internal audit in line with medium-term Strategic Objectives of the National Agency for Tax Administration;
- ensure confidentiality of data and information on conducted public internal audits

*Ensure the independence of IA.* An important objective in restructuring the IA function is to give some assurance of its independence from day-to-day management and hence of greater objectivity in its evaluations. Obviously, the degree of IA independence is not the same as for external audit, which reports to parliament. Rather, the IIA defines internal audit independence as follows: "internal auditors are independent when they can carryout their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organizational status and objectivity."

Ideally, the internal auditor should be responsible to the minister or the chief executive of the ministry or agency. In a decentralized model, the internal auditor will report directly to this top official. In the centralized approach, having the centralized audit office reporting directly to the minister of finance helps ensure the independence of the IA. The internal auditor is responsible to the head of the ministry/agency and is part of that agency's staff and part of the chief executive's management team. However, care must be taken not to infringe the cardinal rule of audit: an auditor should not audit him- or herself.

The approach adopted in performance audit, therefore, involves the examination and evaluation of arrangements for securing good value for money within entities that are in receipt of public funds. The audit will also aim to expose serious waste, extravagance or other examples of poor performance. The auditor's role is to evaluate how far and how well the management of resources is being discharged by the organization concerned.

*Restructure work practices.* A strategic decision to be taken in many emerging economies is where bet to deploy scarce audit skills. After Diamond there are ways to economize on the use of these scarce IA resources:

- Prioritize to extend the scope of IA: improved work practices can often offer significant savings - say by moving away from extensive pre-audit of vouchers to a sampling approach – as can improved management of the audit function through focusing on priority areas and key weaknesses. One area that can typically benefit from IA review is the evaluation of internal controls. An important function of the IA should be to examine and evaluate the adequacy and effectiveness of internal controls in existing systems, as well as in any new systems before these are introduced. This clearly implies that the entire system of internal control has to be reviewed for each ministry, department, or agency as well as by function. This needs to be emphasized because, with strong internal controls, the system will automatically have its own checks and balances to minimize the possibility of errors, irregularities, and fraudulent manipulations.
- Create special teams: in examining the IA of transitional economies, it is not unusual to discover many functions that are either not being performed or for witch coverage is superficial because of inadequate staff, lack of specialized skills etc. Often the most productive use of limited IA staff is in central

teams earmarked for conducting special audits in government agencies with the assistance of IA staff already stationed there.

- Better formulated work plans: existing operational standards for IA require that the internal auditor adequately plan, control and record his work. Such planning should be done not only for individual audit assignments, but also for varying time periods such a quarter, a year, or even longer periods.

While the above approaches can make IA more effective, undoubtedly this requires proper resourcing, which may be difficult. However, the returns could be substantial so far as a sound IA function is considered a precondition for introducing a more devolved performance budgeting model.

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