Chapter 10

Internal audit management

Internal audit is the monitoring component of internal control. It is aimed at minimising the probability of the occurrence of error, inefficient and uneconomic practices or fraud. Internal audit contributes to value for money in government if this aim is achieved at a reasonable cost. This chapter presents three reforms that lead to better results of internal audit at lower costs.

Independence of the internal auditor is an essential condition for effective audit reports. A first reform shows how the independence of the internal auditor can be assured.

The second and third reforms address the task package of the internal auditors and the criteria for the need and size of internal audit units. Limiting the task package by eliminating regularity audit and certification, and strict criteria for need and size of internal audit units can in many countries lead to substantial savings.

Introduction

What is internal audit?

Internal audit has developed over the previous decade as a managerial support service aimed at reducing risk. Internal audit is seen as a component of the broader concept of "internal control" which refers to all managerial activities aimed at "minimising the probability of the occurrence of error, inefficient and uneconomic[1] practices or fraud" (INTOSAI, 2004). In this view internal audit is seen as the monitoring component of internal control and part of an organisation's internal control structure.

The function of internal audit (IA) in the public sector will lead to value for money if the audit activities have impact at a reasonable cost. Impact means that IA adds value by helping the management of ministries and agencies in mitigating the risk of occurrences of errors, inefficient and uneconomic practices, or fraud. Basic requirements for effective internal audit are 1) that internal auditors can act sufficiently independently, 2) report to decision makers and 3) that quality of their work is ensured.

Sufficient independence

Internal auditors are not fully independent unlike external auditors in the public sector who belong to the Supreme Audit Institution (SAI). Internal audit is a support service for management. However, in order to be effective, internal auditors should have sufficient independence to warn management for risk, even in circumstances where their warnings are not welcome. In most OECD countries internal auditors are civil servants and have to agree their work programme with the top-management of the organisation. However, their functional and operational independence should be guaranteed, preferably by law. This implies that they should have no operational responsibilities, be positioned at the top of the organisation, and be able to carry out their work in freedom and objectively.

Reporting to decision-makers

Internal auditors should report to decision makers to have impact. But who is the decision maker? Internal auditors report normally to the top of the organisation: to the minister or top civil servant of a ministry or the managing director of an agency. Of course, the right to report to top management does not, in practice, guarantee that recommendations of internal auditors are followed up, but then internal audit is a support service, and the ultimate responsibility for the minimisation of risk rests with management.

Assurance of quality

The evolution of the internal audit function in the public sector has led to a more professional audit approach. Internal auditors are trained in auditing, however mostly in auditing of private sector organisations. To assist management of public sector organisations effectively (and have impact) audit reports should focus more on the key risks of public sector organisations, which are different from those of private sector organisations. Compliance with laws and regulations is of course a key factor, but internal auditors will be more and more involved in (financial) management problems more broadly. Classical public finance expertise is needed but also for example knowledge of policy and decision making processes in a political environment, of new budget practices, and of the security of large ICT systems. Some OECD countries have experienced the lack of this type of knowledge and skills and have started with specific education programmes for internal auditors in the public sector.

Two types of audit

Internal audits are of two types:

- Compliance audit: this type of audit verifies that financial management complies with the appropriations of the budget laws and other regulations, private contracts concluded and customary practice;
- Performance audit: this type of audit assesses the economy of input, the efficiency of output, and the effectiveness of government's policies in relation to outcomes.

In some OECD countries the tasks of internal auditors also comprises the audit of the government's annual accounts (financial or regularity audit), resulting in a statement that these accounts provide a "true and fair view" (certification), although that task is internationally not regarded as a core task of internal audit.

In principle the objectives and tasks of internal audit and of external audit are the same. Both aim to support the Government (and in the case of external audit: the Parliament) in mitigating the risk of occurrences of errors, inefficient and uneconomic practices, or fraud. However, their legal status and reporting line is different. The independence of a SAI is mostly guaranteed by constitution or by law and the main customer of the SAI products is the national Parliament. The independence of internal audit is guaranteed by law or by Government decree and internal auditors report to senior management of an organisation. However, SAIs also provide an annual opinion on the ministry's or agency's financial accounts (financial audit and certification), besides carrying out compliance and performance audits. Internal auditors usually do not.

Internal auditors and SAIs often co-ordinate their activities. This coordination may include exchange of plans and reports, and co-operation on methodology and training, and does not compromise the independence of external audit, nor does it shut down the reporting line of IA to management (EC, 2012 and INTOSAI, 2010b).

Internal audit standard setting

In OECD countries internal audit standards are developed by Ministries of Finance (MoF). In OECD countries, that are also European Union members, standard setting is a task of a so called Central Harmonisation Unit within the MoF. In countries where internal audit has been recently introduced national governments have developed standards for which international standards were often the basis.

Most well-known international internal audit standards are developed by the Institute of Internal Auditors (IIA), which publishes the "International Standards for the Professional Practice of Internal Auditing" (IIA, 2010). Although they primarily focus on private organisations, some guidance documents for public governments have been developed as well (OECD, 2011b).

A noticeable development in recent years is that national laws or regulations on internal audit refer to recognised international standards and good practice (EC, 2012).

Reforms of this chapter

This chapter focuses on three reforms:

1. The first is ensuring the independence of the internal auditor. The internal auditor's position should be strong and clear. Regulation of the internal audit function in the public sector in a law or secondary legislation is important. A good example of a country with a well-balanced law is Canada.
2. The second reform concerns defining criteria for need and size of internal audit units. The value for money study indicates that there are differences in size of internal audit units. Internal audit is a support service, which is an important help for management in mitigating (financial) risks. It must in itself operate in an efficient way. Finding the balance between large bureaucratic internal units and ineffective small units is the real challenge. Sweden is an inspiring example.
3. The third reform is related to the core task of internal audit: to assist management in achieving its objectives with the least possible risks. There are countries that have assigned other tasks to internal audit units too, such as the task of certification of financial statements. This can lead to overlap with the tasks of SAIs (Netherlands/Denmark). Canada is a good example where the tasks of IA are clearly defined.

Reform 10.1. Ensuring independence of Internal Audit

Characteristics of the reform

The reform consists of clearly regulating the independence of internal audit in the public sector. By ensuring independence and access to top management internal audit will be in a strong position when it comes to objectively advising management on risk of occurrences of errors, inefficient and uneconomic practices, or fraud.

Where did it occur?

The ten countries participating in the Value for Money Study provided information about the legal basis of the IA function. The IA function is regulated by law in nearly all countries and mostly through the Budget Code or similar laws on government accounting or financial management (Australia, Austria, Canada, Finland, Netherlands, New Zealand, and Spain). The Northern European countries Denmark, Norway and Sweden have made other legal arrangements. Table 10.1 provides an overview of the legal basis and reporting line of Internal Audit.

Table 10.1. Internal Audit Legislation

	Legal basis	Criteria establishment IA unit	IA report addressed to	IA report to SAI
Australia	FMA Act and CAC Act**	At the discretion of Head of ministry or agency	Head of ministry or agency	Not all reports
Austria	Federal Law on the Competencies of the Ministries (*Bundesministeriengesetz*)	IIA standards	Minister or Head of agency	50 % of reports
Canada	Financial Administration Act Law and Policy on internal audit	Government Policy on internal audit	Deputy Head via the Departmental Audit Committee with a copy to the Office of Comptroller General	All reports
Denmark	Auditor General Act	Auditor General Act	Head of ministry or agency and SAI	All reports
Finland	Central Government Budget Act and Central Government Budget Decree	Head of ministry or agency	Head of ministry or agency	All reports
Netherlands	Government's Accounting Act	n.a.*	Minister and head of agency	90% of reports
New Zealand	Public Finance Act	Head of ministry or agency	Head of ministry or agency and Audit Committee	n.a.*
Norway	Financial Management Regulation of Ministry of Finance	Head of ministry or agency	Head of ministry or agency and other officials	75 % of reports
Spain	General Budget Law	n.a.*	Minister and head of agency	25% of reports
Sweden	Government Ordinance on internal audit	At the discretion of the Government	Head or Board of Agency and head of ministry	All reports

Notes: *Data not available; ** Financial Management and Accountability Act 1997 and Commonwealth Authorities and Companies Act 1997.

Source: Responses to the Value for Money questionnaire.

Analysis

It is internationally agreed that internal audit must be independent, and internal auditors must be objective in performing their work (IIA, 2010). This means that the internal audit activity must be free from interference in the determination of the scope of work, the performance of work, and the communication of results to senior management. Independence is also the freedom from conditions that threaten the ability of the internal auditors to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to carry out the responsibilities of the internal auditor effectively, the head of the IA unit should have direct and unrestricted access to senior management. Objectivity is an unbiased mental attitude that allows internal auditors to perform their tasks in such a manner that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.

In the public sector the IA staff are subordinate to the minister/head of ministry (permanent secretary or secretary-general) or chief executives of agencies. It is in the interest of the management of ministries and agencies that the internal auditor can operate in full freedom. Ensuring their independence should ideally be anchored in a separate law, although this is not directly necessary to guarantee independence. None of the ten countries in the Value for Money study have regulated IA in a separate law but eight countries have specific framework articles about the internal audit function in their Organic Budget Laws or Financial Management laws. Norway and Sweden have regulated IA only in secondary legislation.

Ensuring independence means that the role and responsibilities of the head of the IA unit and IA staff are clearly defined. The procedure for the appointment and dismissal of at least the head of an IA unit should contain special guarantees. In the event that a minister or a chief executive of an agency is entitled to appoint and dismiss the head of an IA unit the Ministry of Finance, the Audit Committee, if one exists (see below), and possibly the Supreme Audit Institution should be involved. The legal framework of Canada may function as an example of how IA and its independence could be regulated. The legal framework is provided by the Policy of Internal Audit which is set out by the government's Treasury Board.

The Policy directly supports and recognises the role and responsibilities of deputy heads of ministries and agencies as accounting officers, as laid out in Part I.1 of the Financial Administration Act. While deputy heads are responsible for the management of their departments, the Policy provides a clear and integrated assignment of responsibilities for internal auditing between deputy heads and the Comptroller General who supports strong internal auditing across government.

Boxes 10.1 and 10.2 provide more information about the main responsibilities concerning internal audit in Canada.

Box 10.1. Policy requirements for Deputy Heads of Departments related to Internal Audit

Deputy heads of all departments are responsible for:

Ensuring that internal audit resources are sufficient to achieve the risk-based internal audit plan

Deputy heads of large departments are responsible for:

Establishing and maintaining an independent departmental audit committee that includes a majority of external members recruited from outside of the federal public administration. An independent and objective perspective is essential to the audit committee members' capacity to challenge and effectively assess their key areas of responsibility.

Appointing a qualified chief audit executive, reporting directly to the deputy head, to lead and direct the internal audit function.

The deputy head should ensure that:

The chief audit executive (CAE):

- Is not assigned any departmental management or operational responsibilities which may compromise the independence and objectivity of the CAE in respect of the CAE's internal audit responsibilities;
- Has unfettered access to the departmental audit committee and to the committee chair and/or vice-chair;

Box 10.1. Policy requirements for Deputy Heads of Departments related to Internal Audit *(continued)*

- Has access to all departmental records, databases, workplaces and employees, and has the authority within the context of carrying out its departmental risk-based audit plan or other engagements to obtain information and explanations from departmental employees and contractors; and
- Has unimpaired ability to carry out his or her responsibilities, including reporting findings to the deputy head, to the departmental audit committee and, as appropriate, to the Comptroller General.

The Comptroller General or his or her representative:

- Is a member of the selection committee during the CAE's appointment process;
- Is advised of the appointment, transfer or departure of the CAE; and
- Is consulted on the proposed position description of the CAE.

The Comptroller General:

- Is consulted on the establishment of clear responsibilities and performance expectations for the CAE;
- Is consulted on the periodic performance evaluation of the CAE; and
- Is consulted on the intention to remove a CAE for reasons relating to the CAE's professional performance.

Source: Provided by the Treasury Board of Canada Secretariat.

Box 10.2. Responsibilities Comptroller General related to internal audit

The Comptroller General is responsible for:

Providing government-wide functional leadership of internal auditing

Providing leadership and having measures in place to support the capacity, proficiency and sustainability of the internal audit community government-wide.

Determining the professional standards for internal auditing in the federal government.

Providing advice, guidance and support on the application of the Policy on Internal Audit and related instruments.

Supporting the establishment and operation of appropriately qualified audit committees, as well as providing guidance on expected audit committee practices government-wide.

Establishing competency profiles to guide the recruitment of external audit committee members and establishing or proposing other requirements related to the terms and conditions of appointment for audit committee members.

Box 10.2. Responsibilities Comptroller General related to internal audit *(continued)*

Identifying and communicating to deputy heads through a risk-based horizontal audit plan internal audits to be considered for inclusion in departmental risk-based internal audit plans.

Establishing an independent Small Departments Audit Committee to provide the Comptroller General with guidance and advice on internal auditing in small departments.

Leading internal audit engagements in small departments and those that address government-wide, sectoral or thematic risks or issues identified in the government-wide risk-based internal audit plan.

Source: Provided by the Treasury Board of Canada Secretariat.

The independence of internal audit could be strengthened if an Audit Committee is established. The tasks of audit committees can differ. Their task can be limited to reviewing external and/or internal audit reports but can also be much broader. In Canada for example the Departmental Audit Committees provide objective advice and recommendations to the deputy head regarding the sufficiency, quality, and results of assurance of the department's risk management in general.

To be of value for ensuring the independence of internal audit, members of audit committees should preferably be independent of the public administration. In Canada Audit Committees must include a majority of external members recruited from outside of the federal public administration (see Box 10.3). Diversity of experience is encouraged. Members of an audit committee are selected so that their collective skills, knowledge, and experience will allow the committee to competently and efficiently undertake its duties. Committee membership from within the federal public administration is limited to individuals at the level of deputy head. Audit Committee members are jointly selected by the deputy head and the Comptroller General and their appointment is approved by the Treasury Board.

Box 10.3. Tasks of large departmental audit committees in Canada

Task Internal Audit Function (Directive on Internal Auditing in the Government of Canada, 1 April 2012):

- recommend, and periodically review, a departmental internal audit policy or charter for the approval of the deputy head;
- provide advice to the deputy head on the sufficiency of resources of the internal audit function;
- review and recommend for approval a multi-year risk-based internal audit plan;
- monitor and assess the performance of the internal audit function;
- provide advice to the deputy head on the recruitment and appointment, as well as the performance of the chief audit executive;
- review and recommend for approval internal audit reports and corresponding management action plans to address recommendations;
- review regular reports on progress against the risk-based internal audit plan; and
- be made aware of internal audit engagements or tasks that do not result in a report to the committee, and be informed of all matters of significance arising from such work.

Source: Provided by the Treasury Board of Canada Secretariat.

The independence of internal auditors can further be enhanced by the status of employment (INTOSAI, 2010a). In general it is recommendable that they have the status of civil servant (with all protection implied by that status).

Supreme Audit Institutions could be a “line of defence”. In the Netherlands the appointment and dismissal of a Head of an internal audit unit has to be approved by the Dutch Court of Audit. In Denmark Heads of IA units are appointed by the Danish National Audit Office (“*Rigsrevionen*”).

Feasibility of the reform

The independence of at least the heads of internal audit units should be guaranteed. A strong position in an organisation, access to top-management and protection by several legal safeguards will strengthen the internal audit function in its task to support management with objective recommendations on risks of occurrences of errors, inefficient and uneconomic practices, or fraud.

The Canadian example shows that a combination of several measures can ensure the necessary independence of the IA function. Countries where internal audit has not been organised as it has been in Canada, strengthening of the position of internal audit may be considered. Countries where internal audit is not regulated by law may consider to do so.

Reform 10.2. Criteria for need and size of internal audit

Characteristics of the reform

The role of internal audit in OECD Member countries has evolved over the last two decades. From a transaction oriented ex-post control activity with focus on compliance and regularity, it now concentrates more on evaluating and mitigating risks.

This development has occurred in the private sector as well as in the public sector and has been stimulated by external developments such as the introduction of new Control Framework of Committee of Sponsoring Organisations of the Treadway Commission (COSO) in 1992, and the accession of former socialist countries to the European Union. However, the extent to which the development of new views on internal audit have impacted on the size of the internal audit capacity turns out to be very different between countries. The Value for Money perspective, that is the point of departure for the present study, should also be applied to internal audit capacity. Internal audit units should only be established where there is a real value for money justification and, if established, it should have critical mass. The implications of IA ‘new style’ have not always been well considered and taken into account. This reform focuses on the necessity of defining criteria for the need and size of internal audit units in public sector organisations.

Where did it occur?

Australia, Canada and Sweden are the only countries participating in the study where criteria have been defined for the government as a whole. Only in Sweden was the criteria are defined in a way that requires justification of costs and benefits in separate cases. This has led to a relatively small size of the total internal audit capacity in that country.

Analysis

Size of the internal audit capacity

The ten countries participating in the Value for Money Study all provided information about the organisation and size of the internal audit function. In nearly all countries participating in the study internal audit is decentralised except in Spain, where it is centralised in the Ministry of Economy and Finance. The size of the internal audit function varies from 769 in total in the Netherlands to 33 in Finland, and from 25-40 per unit in the Netherlands to 1-4 per unit in Finland or Norway. Clear criteria for the need and size of internal audit units in separate, concrete cases are not well defined, except in Sweden. In most countries it is up to the management of the ministry or agency to decide about the establishment and size of the IA units. Table10.2 provides an overview of the organisation and numbers of IA staff in the participating countries in the Value for Money study.

Table 10.2. Internal Audit Organisation and Staff

	Organisational structure of internal audit	Setting criteria for establishment of internal audit unit	Number of internal audit units in ministries	Size of total internal audit staff central government	Of which Support staff
Australia	Decentralised	Head of ministry or agency	From 8 to 1 **	227	42
Austria	Decentralised	IIA standards	From 2 to 1	100	10
Canada	Decentralised	Policy of IA of Treasury Board	1	525	75
Denmark	Decentralised	Supreme Audit Institution	More than 1	80	*
Finland	Decentralised	Head of ministry or agency	1	33	0
Netherlands	Centralised (4 ministries) and decentralised (rest of ministries)	*	From 3 to 1	769	124
New Zealand	Decentralised	Head of ministry or agency	*	*	*
Norway	Decentralised	Head of ministry or agency	In 13 agencies	26-52	*
Spain	Centralised (Ministry of Economy and Finance)	*	*	180	*
Sweden	Decentralised (in agencies)	Government decision	In 61 agencies	124	3

Notes: * Data not available; ** There are 194 internal audit committees: 104 under the FMA Act and 90 under the CAC Act

Source: Responses to Value for Money questionnaire.

Under the influence of New Public Management the establishment of internal audit units in most of the countries participating in the Value for Money study is left to the management of the ministry or agency. In some other countries the establishment of internal audit units has to comply with certain general criteria laid down in law or by-law (Australia, Canada, Sweden).

In Australia and Canada this has led to a relatively large capacity of internal audit, without need for the ministries and agencies concerned to justify added value in separate cases. In Sweden, establishment of an internal audit unit requires government approval in separate cases. In practice Norway comes next to Sweden in this respect. The countries are cautious in establishing IA units. Where they have been established the units are mostly of a small size (2-4 staff or even 1 person). This risk approach to the establishment of internal audit is sensible and efficient. However, this cautious approach should still be based on explicit and transparent criteria. Such criteria should not be too general, for instance only looking at the total expenditures of the ministry or agency, but should reflect the concrete risks the ministry or agency is facing in view of its tasks, policies, expenditures and revenues. In practice the establishment of internal audit units can best be taken in consultation with the central standard setter in the Ministry of Finance (often called harmonisation unit). This unit is best equipped to weigh the costs of IA capacity against the benefits (see Reform 6.2).

Centralisation or decentralisation

In most countries internal audit support services are decentralised over ministries and agencies. This reflects the need for internal auditors to have direct access to heads of ministries and agencies and to gain the confidence of the senior management. However, in Spain and in the Netherlands internal audit support services are concentrated in one unit for the whole of central government.

In the Netherlands the central internal audit unit has the character of a shared service centre. As a consequence of a governmental efficiency programme the Netherlands started in 2010 to concentrate internal audit units of four ministries in one governmental Audit Service. This was part of a wider effort to concentrate support services, including ICT, human resources and accommodation in shared service centres in order to benefit from economies of scale and specialised expertise. This process of internal audit centralisation will continue until all internal audit units are centralised under the umbrella of the Ministry of Finance. Compared with other countries participating in the study the number of internal audit staff in the Netherland is relatively high. However, a core task of internal audit in the Netherlands is certification of the annual ministerial financial statements and not supporting management in mitigating the risks of occurrences of errors, inefficient and uneconomic practices, or fraud. If the task of internal audit would be reduced to supporting management in mitigating their risks, the size of internal audit staff could be substantially reduced (see Reform 10.3). Moreover, concentrating the internal audit task in a single shared service centre might be understandable from the point of view of financial certification, but is more problematic from the point of view of risk management, which requires a confidence relation with the management of ministries and agencies.

Similar observations can be made about Spain, where internal audit is also concentrated for the whole of government. In that country too, internal audit is tasked with certification of financial statements next to compliance and performance audits, and the IA capacity is relatively large.

Feasibility of the reform

A thorough analysis of the need for establishing an internal audit unit in ministries and agencies and about the minimum size of the unit to be effective could help all countries participating in the Value for Money study in defining the optimal size of internal audit. Such an analysis could, for example be organised as a spending review (see Reform 7.6). Countries such as Australia, Canada, the Netherlands and Spain, with relatively large internal audit capacity may use this analysis to reconsider their approach towards internal audit and realise substantial savings.

Reform 10.3. Limit the remit of Internal Audit to its core task: to support risk management

Characteristics of the reform

The core task of internal audit is supporting management by giving an opinion about risks of occurrences of errors, inefficient and uneconomic practices, or fraud. Some countries have assigned other tasks to IA units too, such as the task of certification of the annual Government's accounts, which SAIs are carrying out as well (Netherlands/Denmark). Other OECD countries such as France or Turkey, which traditionally have another control regime than other European and Anglo Saxon countries, have introduced internal audit in the public administration during the last decade but they are still carrying out financial inspection[2] tasks too, which influences the development of internal audit in these countries.

The reform consists of focusing internal audit on its core task: to support management in mitigating the risk of occurrences of errors, inefficient and uneconomic practices, or fraud.

Where did it occur?

Nearly all countries participating in the Value for Money study carry out compliance audit and performance audit in line with IIA or comparable standards. The internal audit units in the Netherlands, Denmark and Spain and to a certain degree in Austria and New Zealand provide certification of financial statements.

Analysis

Table 10.3 provides an overview of the scope of internal audit in the participating countries in the Value for Money study

Table 10.3. Scope of Internal audit

	Tasks of Internal Audit
Australia	Primarily compliance audit (support management to comply with obligations). Performance audits are accomplished at Chief Executive's discretion.
Austria	Compliance and performance audit in line with IIA standards. Joint certification of financial statements in area of international financial resources
Canada	Governance, risk management and control processes audit in line with IIA standards

Table 10.3. Scope of Internal audit *(continued)*

	Tasks of Internal Audit
Denmark	Audit of financial statements (certification) on behalf of SAI and additionally compliance and performance l audit.
Finland	Compliance and performance audit in line with IIA standards.
Netherlands	Audit of financial statements (certification) and performance (focus on risk management, control and governance processes).
New Zealand	Compliance and performance audit in line with IIA standards. Audit of financial statements at the discretion of the head of Organisation
Norway	Performance Audit.
Spain	Audit of financial statement (certification) and compliance audits.
Sweden	Compliance and performance audit.

Source: Responses to Value for Money questionnaire.

Canada is a good example of a country where the tasks are clearly defined in regulation, the so-called "Policy Internal Audit" (from Treasury Board). Box 10.4 presents the tasks of internal audit according to the Policy.

Box 10.4. Policy Internal Audit, April 2012

Policy Statement

Objective

The objective of this Policy is to contribute to the improvement of public sector management by ensuring a strong, credible, effective and sustainable internal audit function within departments as well as government-wide.

Expected Results

Deputy heads are effectively supported in their role of accounting officer by a strong, credible internal auditing regime that contributes directly to sound risk management, control and governance, and is independent from line management.

Deputy heads are provided with independent assurance from internal auditing, and advice from the audit committee, regarding the effectiveness of risk management, control and governance processes, at the departmental level and the Comptroller General is provided with the same at the government-wide level.

Source: Provided by the Treasury Board of Canada Secretariat.

This reform mostly concerns those countries participating in the study where the core task of IA is not supporting management in mitigating risk, but where the main focus of

IA is on certification of financial statements. These countries are Denmark, Netherlands and Spain.

Denmark and the Netherlands have an Anglo Saxon tradition of financial management and control and audit, but Spain represents the countries such as France and Turkey with a large emphasis on preliminary control of legality of transactions (*ex ante* control) and the financial inspection type of *ex post* control. Internal audit has been introduced in these countries during the last decade and is developing.

The specifics of these countries are dealt with in more detail below.

Denmark

Box 10.5. Internal audit in Denmark

In Denmark the Auditor General Act of 1991 (amended in 2006) regulates IA. Section 9.1 of the Auditor General Act (AGA) states that: "the Auditor General may arrange with the minister concerned that auditing the state accounts and accounts of institutions, associations, foundations, etc., whose expenses or accounting deficits are covered by grants financed by the state or by contributions, duties, or other revenues according to statute shall be performed in a specified defined co-operation between the Auditor General and an internal audit body".

Thus the cornerstone of internal audit is the agreement entered into with the "Rigsrevisionen" (RR, the Danish SAI) under Section 9 of the Auditor General Act. In 2009 there were 28 agreements with several ministries including the ministries of Finance, Defence, Food, Taxation, Justice, and Transport. The organisation of the IA function is a reflection of the governance structure in the specific areas. The duties which internal auditors carry out and the part of the ministry covered by the audit differ from ministry to ministry. In some ministries internal audits are more focused, both in terms of the areas audited such as the Police department, Railway Infrastructure department and Danish Broadcasting Corporation.

After the agreement between the RR and the minister has been signed, the internal audit unit will carry out most of the financial audit work within a ministry (or of the agreed part of the ministry), with the RR overseeing the work, using findings of the internal auditor and carrying out an additional audit if needed. (This is a provision to ensure an effective co-ordination of the total audit work and to avoid double auditing activities). The internal auditors report to the head of ministry and top management of the ministerial department or agency and the RR. The RR retains overall responsibility for the performance of the audit and issues the audit opinion on the ministry as a whole.

Source: OECD (2011a).

In practice the internal audit units act as affiliates of the RR in Denmark. The RR determines when an internal audit unit is established, as well as the conditions under which the unit should work. In practice the RR is very cautious in establishing new internal audit units and not pro-active. Only when the RR is convinced that deficiencies in financial management (a weak accounting procedure for example) of a department or agency have been sufficiently been addressed, it will cooperate in setting up an IA function.

Currently the development of the internal audit function in Denmark goes in the opposite direction as in other OECD countries. In Denmark the internal audit units support the SAI by carrying out the certification of financial statements task. The establishment of internal audit units in ministries and agencies in other OECD countries is generally a decision of the executive branch and is based on its own legal regulation.

External audit institutions might have an advisory role but not a decisive role as in Denmark.

Netherlands

The internal audit function in the Netherlands was established in 1987. The Government Accounts Act defines three tasks for the internal audit departments of the state level:

1. Audits which certify the annual financial statements of ministries and agencies in terms of a "true and fair view".
2. Performance audits (including compliance and information technology types of audits).
3. Audits of Third Parties, which receive and spend public funds.

The statutory task of certification of the annual financial statement of ministries and agencies is rather exceptional for internal audit. In most countries and also in the countries of the Value for Money Study internal audit concerns merely Performance Audits.

Since 1987 the tasks of internal audit have evolved as the financial management and control situation improved in the 1990s. The tasks were even extended. However, the large expansion of the internal audit units (50 in 1987 and 769 in 2010) in the 20th century has led also to discussions on how the quality ('added value') and the cost effectiveness of the internal audit services can be improved. The situation in the Netherlands has a historical background. Box10.6 describes the subsequent development.

Box 10.6. Development of internal audit in the Netherlands

Until 1987, the function of internal audit on the state level was underdeveloped and never got real attention from the management of ministries. Then the Minister of Finance presented to the Parliament the "Plan Operation State Accounting system 1987- 1992" for improving the state accounting system. Improving the internal audit function was a part of this plan. Besides many other measures to improve the quality of internal audit, it was decided that internal audit units should add a 'fair and true' opinion to the annual accounts of each ministry. The new function of internal audit was laid down in a Government decree of 1987, which was amended in 1995. The task of the internal audit departments was then extended with auditing non-financial management and the internal audit departments should also give an opinion on the annual accounts of the newly established agencies.

A spending review in 2001 ("Kordes Commission") recommended to broaden the scope of the internal audit departments and to expand the task of the internal audit departments with periodical audits of policies and management. The expansion of the tasks of the internal audit departments implied that the internal audit function was transformed into a multidisciplinary audit function. The working group also recommended to centralise specialism's ('create pools'), and to initiate inter-ministerial personnel policy. An evaluation of the implementation of the recommendations of the Kordes Commission in 2003 was clear: the internal audit departments were restructured, but the transition of the work was incomplete. The statutory task required a minimum capacity of the audit service. Another spending review led in 2004 to the conclusion that the balance between efficiency and regularity in internal audit had swung too much to regularity. There were too many complex rules and too little differentiation in types of audits. Overlaps in the control system were abolished, ministers became responsible for regularity and the role of the audit units became more transparent. But the nature and the scale of the audit work did not change.

Box 10.6. Development of internal audit in the Netherlands
(continued)

In 2008 the "Memorandum Central Government Reform' concluded that concentration of support services could lead to a reduction of audit cost. It was also decided that the audit activities of four ministries, which volunteered, as an experiment should be concentrated in one service in order to improve the audit quality. The evaluation of this experiment was clear: concentration will be further continued but abolishing the statutory task was not on the agenda.

Source: OECD (2011b).

The description in Box 10.6 of the development of the internal audit in the Netherlands since 1987 shows that the tasks of internal audit have evolved. However, it is striking that the question whether this balance could better achieved by excluding the certification of financial statements from the statutory tasks of the internal audit units and to let them focus on supporting management in mitigating the risks of occurrences of errors, inefficient and uneconomic practices, or fraud has never deeply been discussed. The question whether internal audit units should annually certify the accounts of a ministry or agency has been discussed in spending reviews of 2001 and 2004 (see Box 10.6), but has not led to a fundamental change.

In international practice certifying the annual financial statement of the state and in many cases of local governments is recognised as the core task of the external audit function, the SAI, and is regulated by INTOSAI.[3]

The efforts since 2001 to improve the quality of internal audit have been hindered by the capacity need for the statutory certification task. It can also be argued that the advisory task of the internal auditor concerning risk mitigation (the result of the various types of audit activity) and the annual certification task are leading to a conflict of interest. Centralising the IA activities in the Ministry of Finance does not solve this problem, but even creates a new problem: in the long run the internal auditors could be regarded as representatives of the Ministry of Finance and serving the interests of this ministry ('watchdog of Finance') and not the interests of the line ministry they are auditing. Indeed, according to the international principles, internal audit is a tool of management and the internal auditor is a part of the organisation he/she audits with sufficiently guarantees independence.

Transferring the statutory certification task to the Court of Audit might seem a radical policy change, but in international perspective the Netherlands (with Denmark and Spain) stands alone and its vision on internal audit is an exception rather than the rule. Transferring the statutory task will not only lead to a clear division of task between internal and external audit but will also lead to savings. Indeed, the Court of Audit reviews yearly the statutory audit work of the internal auditor. One third of the Court's audit capacity is reserved for this activity. On an annual basis a substantial saving could be realised by abolishing the certification task of IA.

Spain

The General Comptroller of the State Administration (IGAE) is the internal control organ of the economic and financial management of the Government. It is in charge of verifying, by means of preliminary control of legality and ongoing financial control, that the economic and financial activity of the Government observes the principles of legality, economy, efficiency and efficacy as the managing and executive centre of the government accounts it is responsible for providing reliable, comprehensive, professional and independent information on public management and for issuing the necessary procedures for its proper development.

Besides this control task the IGAE carries out audit tasks: audit of annual financial statements (certification), compliance audits, and all types of performance audits (such as audit of budgetary programmes, audit of programme contracts, audit of state tax accounts, audits of privatisations) (EC, 2012). The IGAE is the only institution that performs IA (at the federal level) and has 180 staff at its disposal for the audit tasks.

As the certification of the annual Government's financial statements may take substantial resources the IGAE may consider to leave this task to the Spanish SAI, the *Tribunal de Cuentas*, for the same reasons described for the Netherlands. The development of internal audit in Spain could highly benefit from such a decision and substantial savings could be realised.

Feasibility of the reform

This reform has a long-term perspective. It will require amendments to the legal framework of the three countries concerned. But before amending laws or regulations a thorough analysis and debate between Governments and SAIs of the three countries about the results of this analysis will be needed.

Notes

1. Uneconomic means wasteful or extravagant. It means not getting the right amount of resources, of the right quality, delivered at the right time and place, at the lowest cost. (INTOSAI, 2004)
2. Financial Inspection is an *expost* control activity, which aims to detect irregularities, punish perpetrators and recover damages to the public sector organisation;
3. The reason that internal auditors in the Netherlands still annually certify the ministerial financial statements is related to how the Dutch Court of Audit perceives the ministerial accountability concept. The Dutch Court of Audit is of the opinion that the minister is accountable for the reliability of the accounts and a sound financial management and control and that the annual internal audit report "serves the minister in deciding whether the financial accounts under his supervision can be released" (Baayens,van der Wielen, 2009). In this view the Court of Audit is not a part of the executive branch and can therefore not function as the certifying body for government institutions.

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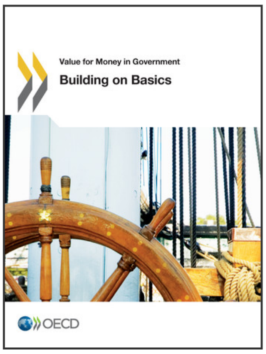

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