

**Is the modern risk based approach to public sector internal audit really appropriate for countries with less developed systems and less well trained public officials?**

Introduction:

Much of the advice about internal financial control in the public sector being given by consultants and aid agencies to countries with less developed systems and less well trained public officials is, perfectly properly, that internal audit should be introduced or significantly developed. However, this advice is frequently based upon internal financial control and internal audit as practiced in developed countries where there exists a highly sophisticated public service. The purpose of this article is to argue that we make a mistake in assuming that this model of internal audit with its focus on risk is necessarily an appropriate model for public sectors in countries with vastly different circumstances. Indeed such an approach can be inappropriate and positively damaging.

Internal audit used to operate within narrow terms of reference. It would focus on inspecting financial records, financial systems and controls. It would examine whether established procedures and policies were being complied with, were assets being properly safeguarded, perhaps were employees functioning efficiently, whether the financial records were being accurately maintained. An important emphasis was on fraud detection. In summary the internal audit principal concern was with financial probity and regularity. Internal audit was a 'financial checker' and in a sense the internal auditor's work was closely related to that of the external auditor. To be successful the internal auditor needed to have the support of an interested 'owner', usually in the public sector, the chief finance officer or, rarely, another senior manager. The interested 'owner' in the private sector wished to ensure the 'integrity' and 'profitability' or in the public sector rigorous financial control and compliance with laws and regulations'.

The pressure for change in this role came partly from the internal audit profession and partly from management, both were looking for ways to add value to the internal audit function, and at the same time reduce the cost. The internal audit philosophy that has emerged from this has heavily influenced the general approach to internal audit which is being adopted on a worldwide basis.

The basic assumptions underlying current approaches to internal audit:

In North America and Western Europe the current definition of internal audit is that it "is an assurance function that primarily provides an independent and objective opinion to the organisation on the degree to which the internal control environment supports and promotes the achievement of the organisation's objectives. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources." (CIPFA Code of Practice for Internal Auditors in Local Government)

(This definition is not that dissimilar from that developed by the United States based IIA.)

Traditional internal audit focussed on the audit of transaction, their accuracy and compliance with the relevant rules and regulations, in contrast to the current internal audit approach which focuses on systems (the internal control environment and internal control) and is not so explicit about the accuracy of records or compliance with rules and regulations except to the extent necessary to ensure that the internal control systems works effectively.

Thus current conventional wisdom is that internal audit resources should be directed to those systems and activities that present the greatest risk to the operational integrity of the organisation. The internal auditor, along with the management should together identify the areas of potential greatest risk with the internal auditor then drawing up an audit plan which would be agreed with the management. Through this managers of organisations would gain the assurance that their risk management processes support their capacity to achieve their objectives. 'Internal audit occupies a unique position .....with a remit to review the whole of risk control and governance, with the added value of independence.' (H.M. Treasury)

There is an implicit understanding that the system of internal control can provide only reasonable and not absolute assurance that assets are safeguarded, that transactions are authorised and properly recorded, and that material errors or irregularities are either prevented or would be detected within a timely period. Even though in the public sector (in the UK, for example) great care is taken to establish sound control arrangements in the widest possible sense, the public sector is still dependent on people actually exercising control and following the defined arrangements. If people don't follow the rules or carry out the proper checks before certifying or authorizing an activity, risks will arise. Deliberate breach, though, is the exception, rather than the rule, partly because of the culture and partly also because the systems of management and the internal financial and other controls that exists are entirely relevant to current needs and circumstances.

Lying behind the definition of internal audit set out above, the risk approach and a willingness to recognise that only reasonable and not absolute assurance can be provided, are a number of assumptions, because the definition has been developed and applied in countries with a sophisticated public sector and usually well trained public servants. These assumptions include:

- That underlying internal control systems (financial and non financial) do exist and are generally sound and are relevant to current needs and circumstances;
- The extent of fraud and corruption is relatively limited;
- Standards of ethical behaviour and governance are generally high;
- An adequate reporting system exists;
- Action generally, will be taken on internal audit reports;
- Management is of reasonable quality and reasonably well trained;
- A clear distinction exists between official and political levels of management.

Systems of internal financial control are based on a well established framework of regular management information, financial regulations, administrative procedures (including segregation of duties), management supervision, and a system of delegation and accountability. (See box)

What is more, there is an accepted recognition that the prime responsibility for determining risk and for defining the internal control system lies with management which is both willing and able to take on this responsibility.

All this seems to be an eminently sensible rationale. However, is the modern definition of internal audit and the rationale for this definition appropriate in all circumstances and particularly in those of developing countries?

Systems of internal control include:

- Comprehensive budgeting arrangements;
- setting targets to measure financial and other performance;
- the preparation of regular financial and performance reports which indicate actual expenditure and performance against the forecasts;
- clearly-defined capital expenditure guidelines; and,
- as appropriate, formal project management disciplines.

(Extract from the Local Government Accounting Corp)

#### A risk based approach to internal audit:

Risk is now the determining factor in the decision about where to allocate internal audit resources, with integrity of the internal control system regularly reaching beyond the financial control element. Internal audit also has had to deal with new challenges, such as value for money audit (performance audit), computer audit and systems review, but it always has to balance the demands on its resources from these requirements with those of the overall integrity of the internal control system. Risk assessment helps it to do that.

A risk based approach to internal audit works well when the assumptions that determine the modern approach to internal audit apply and as part of this:

- Management fully understands and participates in the risk assessment process;
- There is a significant variability in the level of risk between systems and activities that allows judgements to be made about where the greatest risks exist;
- Management and internal audit both have the technical capacity to identify and assess comparative risk;
- Internal audit has the technical capacity and the resources available to it to enable it to undertake risk based audits;
- A relevant and well designed internal control system exists which is cost effective and well understood and for which senior management takes full responsibility;
- The internal control system is regularly and adequately examined by internal audit;

- Internal audit reports are systematically reviewed and followed up by management (and politicians, as necessary) and where appropriate by the Supreme Audit Institution;
- There is a clear distinction between the roles of management and politician..

Where these assumptions do not exist, or exist only with significant weaknesses, as is the situation in many developing countries, then the question that has to be addressed is, is a risk based internal audit approach, with risk being determined within the organisation, the most appropriate one? And the answer to this question has to be, 'no'.

Yet the conventional internal audit professional attitude and internal audit consultancy recommendations as a general rule (often made by foreigners trained in modern internal audit approaches) seem to recognise the appropriateness of only one approach, the risk based approach.

The reality in many developing and some transitional economy countries:

The fact is that the reality often is exactly the opposite to what we expect to see, viz,

- Underlying internal control systems do not exist or that where they do exist they are generally unsound with outdated rules and regulations which are not relevant, and cover few if any of the features outlined above, and are not therefore providing any real form of assurance;
- Supervising managers understand little about the importance of confirming compliance with laid down procedures by their staff and the general control environment does not therefore provide any real form of assurance;
- Sometimes, the authorisation and certification controls can be used as barriers from which to extort small but regular 'commissions';
- The extent of fraud and corruption is considerable;
- Standards of ethical behaviour and governance are generally low;
- The reporting system is inadequate;
- Little or no action will generally be taken on internal audit reports;
- Official and political levels of management are not clearly separated.

The situations that are often found are that:

- Politicians in effect act as the 'day to day' managers (often having responsibility for signing routine documents such as orders for goods and services) and therefore can feel politically exposed by effective internal audit;
- There is little or no management understanding of risk and the need to identify risk and to introduce the appropriate safeguards;
- Management and internal audit are untrained in identifying and assessing comparative risk;
- Management and internal audit do not cooperate in the development of the internal audit plan;
- There is systemic weakness in the majority of systems and in key systems such as payroll and procurement, limited political or management willingness to

- remedy failings and where failings provide the opportunity to recoup inadequate remuneration for public servants;
- Internal audit capacity is technically limited, and/or perceives internal audit as a form of financial control;
  - The internal control system is weak, or is operated in a routine and bureaucratic manner following extremely detailed rules and procedures which are irrelevant to current circumstances (often having been taken on and remaining unchanged, from the colonial period) and achieving any success depends upon finding ways round the rules;
  - Internal audit as a consequence focuses on adherence to the process of internal control rather than the adequacy and the operational effectiveness of the internal control system;
  - The much needed independence of the internal auditor with an ability to report directly to top management does not really exist (or exists in only a very limited way);
  - External audit is also weak and the accountability processes, such as reporting to an effective Public Accounts Committee, are deficient.

Given these circumstances, does the developed economy model of internal audit remain relevant? Is it appropriate for the internal auditor to focus attention on a sophisticated risk-based audit approach? Does not pursuit of the prevailing developed country approach (ideology?) to internal audit leaves a vacuum? What is more, the inevitability (at least in general) is that the management and technical capacity of the internal audit function will be limited for exactly the same reasons as the limit to the capacity of public sector management in general. These problems are compounded where internal audit does not have the degree of independence that good governance requires as necessary and (in some cases) even (a cynical point!) management may not want it to have. Therefore, there is unlikely to be available a high quality and expert internal audit capacity able to react to the deficiencies in the internal control system and the operational public sector environment.

Therefore, how can it be argued that the modern approach to internal audit in these circumstances, is the appropriate internal audit approach? The high risk areas are very often what many would see as the traditional audit areas including procurement, payroll and control over assets and revenue assessment and collection. The question becomes of more significance as aid agencies, concerned that aid does not leak into inappropriate spending or that there is actual diversion of funds for private purposes seek to switch from programme support to direct budgetary support. With the latter there is a much greater risk of funds being siphoned off compared with programme support.

#### Corporate governance:

A further factor affecting current developments in internal audit, is the intensive interest in effective corporate governance arrangements. This has highlighted even more, the significance of internal control and the role of internal audit. But corporate governance arrangements are no longer left solely to the organisation to determine. External influences, sometimes external to the country, can have a powerful influence. So in many organisations (both public and private) the arrangements for corporate governance and effectively for internal control are no longer wholly left to the

management. What this has done is to effectively modify the conventional internally set risk based approach to internal control, by forcing onto the risk agenda, external requirements some of which are enforced by the regulatory authorities such as the separation of the roles of chairman and chief executive and the requirement to publish a statement of internal control.

However, external influences over the public sector to improve the quality of management are much more difficult to establish. Individual countries are sovereign and generally are at liberty to accept or reject external pressure as they see fit. There is one important exception to this which is where international treaty obligations may require adherence to certain standards and the best example of this is the accession requirements for joining the European Union and in particular those covered in Chapter 28.

#### Modifications to a modern internal audit approach:

Therefore, is the right advice about internal audit being provided to developing countries and other countries with weak management of their public sectors? There is no point in training people to apply a sophisticated audit approach and to undertake risk based, performance and other complex audits if they do not have an understanding of the basic audit techniques and when and how to use them. There is also no point in trying to develop sophisticated audits if the information and the reporting systems either do not exist or are very weak and the organisational management capabilities are of very limited capacity. What is more we add to the disservice to developing countries if we do not recognise that internal audit has evolved over a long period in developed countries and that the more recent developments in internal audit have taken perhaps 10 –15 years to become established, and indeed they are still evolving.

So what should we be advising developing country internal audit departments to do? The circumstances outlined above represent a comprehensive statement of systemic risk. The internal audit approach must be adjusted to reflect this situation for it to provide any real benefit. Aid agencies should be wholly realistic about this. This isn't to say that developing internal audit units should not be trying to adopt international best standards. Rather, the emphasis should be on working with internal audit to develop a realistic plan to bring the internal audit function up to internationally accepted standards within an acceptable timeframe. Effective reform to internal audit though, can only be achieved at the pace of effective management reform. The two should not get out of step. The internal audit reform plan should take account of the management circumstances and operational environment as well as the country environment, and it has to start from there. In addition we should resist the idea of too rapid change. Training of internal auditors, on its own, is not enough.

That also means we should look back at the original purposes of internal audit in countries with weak public sector management, that is to the roles of financial probity and financial regularity. The key question is what management reform is needed and what should be the programme of internal audit to help improve financial probity and financial regularity both in the circumstances of a weak management and as that management capability improves? (There is almost nothing worse than having an internal, or external, audit that hasn't the capacity to match management reform.)

However, for many developing countries at the present time, there is potentially an important difference to stimulate reform. This difference is that there can be a role for systematic external pressure from aid agencies as part of the process of switching from programme aid to direct budgetary support.

The European Union provides a good example in another context, of what can be done to improve public sector management arrangements including public financial control in those countries seeking to join the European Union. (The Chapter 28 requirements involve regular reviews of progress with failure in meeting requirements resulting in delay in the accession timetable.)

Of course, the relationships between aid agencies and recipient countries are different from those that exist between the European Commission and aspirant members. But they are not that different in contemplating the switch from programme to direct budgetary support. There is a clear incentive for recipient countries to improve their management and systems in order to gain the benefits of direct budgetary support and whilst the donor role is much more about influencing rather than regulating, there does remain the opportunity for penalty if improvement conditions are not met. Any improvements sought by the aid agencies though should be benign and clearly would not work unless supported by the recipient national government (the 'interested owner'). To that extent a commonality of interests should be achievable. This would involve the aid agencies (and they would need to cooperate in this) identifying those areas of activity over which they have a particular concern. What is more they should set a programme of reform activity and systematically require its application, reviewing progress on a regular basis. Improving internal audit should be seen as complementary to improving management. Management needs to understand that internal audit is a tool of management and respond to that.

Effective internal audit can only exist if the right circumstances exist and if they do not exist then little reliance can be placed on internal audit. In particular there has to be local ownership of reform and a real desire at the highest political level to achieve progress (the role referred to above of the 'interested owner') in ensuring that resources are directed to those areas where policy decisions indicate that they should go. There has to be a management capability.

An essential financial environmental condition is, that a robust budgetary system with clear policy objective exists, which for developing countries receiving international aid, would be policy objectives in line with an agreed poverty reduction strategy.

A second financial environmental condition concerns the accounting system. This is equivalent to the traditional role of ensuring that adequate financial records exist are properly kept. An effective accounting system should exist which records, on a timely basis, spending in a similar format to the budget.

These two financial environmental conditions then provide the internal auditor with the basic raw material on which to work.

The internal auditor should ensure as far as possible that fraud and corruption and other misuse of funds is minimised. This involves the internal auditor in seeking to ensure, with the support of management (which is essential), that:

- the budget is comprehensive on both the expenditure and income sides and meets all legal and regulatory requirements;
- the accounting system works effectively and provides in a timely manner the information that management requires to manage the budget;
- variations between the budget and actual spending (whether up or down are adequately reported and authorised);
- timely bank reconciliations are completed, with major discrepancies being investigated and reported on to management;
- suspense accounts and other 'irregular' accounts are reconciled and cleared;
- the payroll is robust, 'ghost' employees are eliminated and that appropriate payments are made to employees;
- procurement is carried out in a manner that serves to minimise corruption
- revenues due are properly assessed, billed and collected with appropriate recovery arrangements put in place and operative.

This does not mean that the auditor has to check (or pre check) every document. That remains the responsibility of management. What it does mean is that the internal auditor should engage with these systems sufficiently to ensure that the requirements for those systems are met. Management should expect this as a minimum, should agree the audit plan and react to the internal audit report findings.

The internal audit work programme is then effectively decided through this process. (Of course different country circumstances will require modification to some of these requirements, but the principles outlined above should apply.). If this means transaction testing and indeed extensive transaction testing because of the scale of error, then this does need to be accepted. (Sampling may be employed but above small percentages of error, complete audits may be required.)

Even to achieve these more limited objectives, extensive training of both management and internal auditors will be required. This training will be for:

- management on the practicalities of internal control and their responsibilities as managers;
- management on the role of internal audit and their relationships with it;
- internal auditors in basic practical audit techniques;
- internal auditors to allow them gradually work towards more sophisticated systems based approaches.

This process will take time. What is more internal audit is not a mechanical activity given to easy regulation in the form of rules and procedures. Successful internal audit requires imagination and an ability to think 'outside the box'. It also requires long term support and short term consultancy assignments aimed at producing audit manuals and equivalent products (important though they are) do not of themselves produce good internal auditors. In fact they can do the opposite by making the process appear more mechanical.

In the near term the key role of the internal auditor in those countries with weak public sectors should then be to focus on the roles of financial probity and financial regularity. Neither the aid agencies nor consultants advising the aid agencies should expect more than this.

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