



## INTERNAL AUDITING IN LOCAL GOVERNMENTS

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### **Abstract**

Internal audit provides support to the leader of the local government in the establishment of an effective and comprehensive internal control system by assessing and providing recommendations for improvement of internal control system.

The aim of this research is to assess the development perspective of internal audit in local governments in Latvia.

Three tasks have been set in order to reach the aim of this research: 1) analyze the nature of the internal audit, 2) analyze the basic needs of internal audit in local governments in Latvia, 3) research internal audit development situation in Latvian local governments.

The research is based on three methods: 1) logically constructive method – logical interpretation of the already published by the other authors data about internal audit in local governments, 2) monographic method – interpretation of the data based on proven knowledge about internal audit in local governments, 3) document analysis method – study and evaluation of the normative acts and scientific researches, parameters of local governments budgets at the context of the aim of this research.

From the results of the research the author has come to the following conclusions. The internal audit has been organized and is working only in 19 out of 119 local governments in Latvia. Internal audit in local governments should be developed by making changes in Latvian legislation – it is necessary to introduce mandatory requirement in the legislative acts about foundation of internal audit in local governments accordingly to the criteria of local government budget indicators, number of the staff in the local government and number of enterprises with local government share capital.

### **Preamble**

Internal auditing is part of the monitoring function of internal control that examines and evaluates the adequacy and effectiveness of other controls [1].

The Institute of Internal Auditors (IIA) defines internal auditing as:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its



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objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes [2].

The objective of this research is to assess the development perspective of internal audit in local governments in Latvia.

Three tasks have been set in order to reach the aim of this research: 1) analyze the nature of the internal audit, 2) analyze the basic needs of internal audit in local governments in Latvia, 3) research internal audit development situation in Latvian local governments.

The study contains a description of internal audit guidelines, research results about internal audit units in Latvia local governments and conclusions and proposals.

## Internal Audit Guidelines

The essential parts of internal audit definition are as follows:

- Internal indicates that auditing activities are carried on within organizations. Today employees of the organization may conduct internal audit activities, or they may be outsourced to other professionals outside the organization who serve the entity;
- Independent and objective makes it clear that the auditor's judgement has value when it is free of bias;
- Systematic, disciplined approach implies that the internal auditor follows professional standards that guide internal audit work;
- Helps an organization accomplish its objectives indicates that internal auditing exists to aid or benefit the entire organization and is guided by the organization's goals and objectives. Some specific ways in which internal auditors add value include a focus on the improvement of *the organization's operations and the effectiveness of risk management, control, and governance processes* [1].

International standards for the professional practice of internal auditing part 1100 – Independence and Objectivity determine that the internal audit activity must be independent, and internal auditors must be objective in performing their work.

**Independence** is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Part 1110 – **Organizational Independence** determines that the chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity. Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board:

- approving the internal audit charter;
- approving the risk based internal audit plan;



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- receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters;
- approving decisions regarding the appointment and removal of the chief audit executive; and
- making appropriate inquiries of management and the chief audit [3].

## Internal Audit in Latvia Local Governments

In this research author find out that just in 19 local governments out of 119 is internal department formed or one internal auditor is working in unit of Finance or Accountancy department of local government.

Below in Figure 1 obviously we can see that incomes and expenses per one inhabitant in local government are not uppermost indicators for internal audit unit size. Most of all internal audit units have just one internal auditor, what is not the best internal audit practice consider to International Audit Standards.

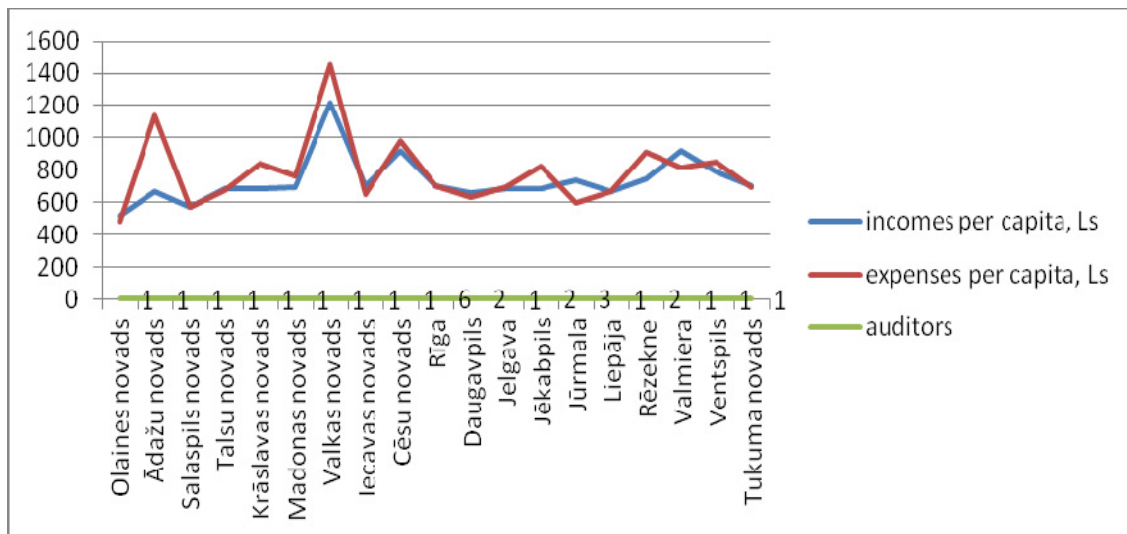


Figure 1. Incomes and Expenses per capita and number of auditors in Latvia local governments in 2011

Source: Author's construction based on data from LR Central Statistical Bureau (inhabitant's data on 30.09.2011) and Ministry of Finance, data (data on 31.12.2011) and authors research data.

From data in Table 1 below we can see that incomes per one inhabitant in local governments with internal audit are within 518 and 1219 lats, whereas expenses are within 485 and 1453 lats per one inhabitant in local government, overall average incomes and expenses are 750 lats per one inhabitant.



Table 1

## Incomes per one inhabitant in local governments with internal audit

	N	Minimum	Maximum	Mean
Incomes_per_capita	19	518.00	1219.00	732.6842
Expenses_per_capita	19	485.00	1453.00	786.6842
Area	19	18.00	2160.00	468.0000
Valid N (listwise)	19			

Source: Author's construction based on research data

Below in Figure 2 we can see local governments with internal audit divided groups of Latvia planning regions, most of all local governments with internal audit are located in Riga planning region, 21% local governments with internal audit are located in Vidzeme, but equally 16% out of local governments with internal audit are located in Latgale, Zemgale and Kurzeme regions.

It is necessary to introduce mandatory requirement in the legislative acts about foundation of internal audit and size of internal audit unit in local governments accordingly to the criterions of local government income, expenses criteria per capita and local government area etc. There is possibility to form internal audit functions just in larger local governments.

Internal audit must exist beside State Audit Office of Latvia (Valsts kontrole) and external auditors (sworn auditors). All audit plans must be concerted actions between all of audits accordingly with International Standards on Auditing 610 standard using the work of Internal Auditors and both audits must improve organisations performance not increase administrative burden.

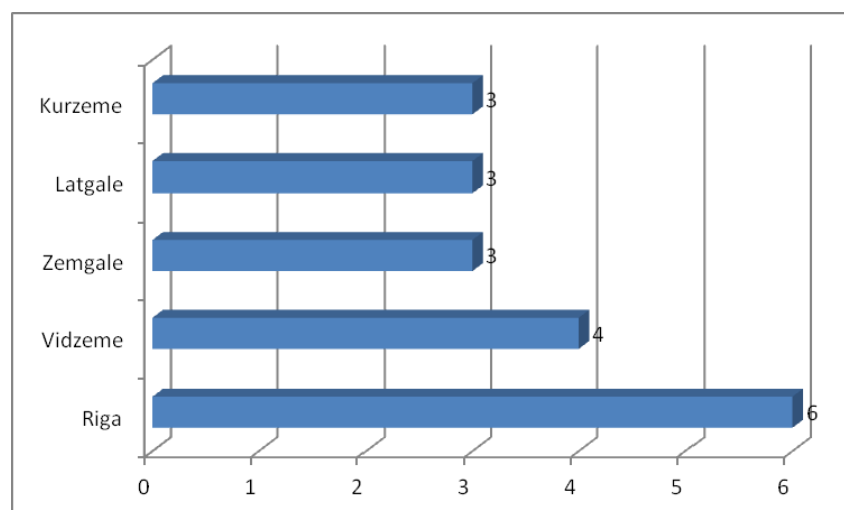


Figure 2. Number of Local governments with Internal Audit on January, 2012

Source: Author's construction based on research data



After analyzing local governments with internal audit organizational schemes author comes to conclusion that in eleven local governments with internal audit organizational structural schemes internal audit position is found according to International Internal Audit Standards which stated, *that Organizational independence is effectively achieved when the chief audit executive reports functionally to the board* [3].

Below in Table 2 we can see that there were no organization scheme included in four local governments home pages and in four local governments organization schemes were found nonconformity with International Internal Audit Standards, because internal auditor is employee in Finance or administrative unit of local government administration and is not directly fed to the chief operation officer or council chairmen.

From Table 2 data we can see that in 10 local governments with internal audit organizational structural schemes internal audit position was founded according to International Internal Audit Standards.

Table 2

### Internal audit in organizational structure in local governments

No.	Local government	Dependency	Is it according to International Internal Audit Standards
1	Cesu novads	Council chairman	Yes
2	Daugavpils	Council chairman	Yes
3	Valkas novads	Council chairman	Yes
4	Iecavas novads	Council	Yes
5	Jelgava	No accurate information	
6	Jekabpils	Administrative department	No
7	Krāslavas novads	No accurate information	
8	Madonas novads	Unit of Finance	No
9	Rezekne	Council chairman	Yes
10	Rīga	Council chairman	Yes
11	Salaspils novads	No accurate information	
12	Talsu novads	Deputy of Council chairman	Yes
13	Valmiera	Council chairman	Yes
14	Adazu novads	Council chairman	Yes
15	Liepāja	No accurate information	
16	Ventspils	Finance unit	No
17	Jurmala	Council chairman	Yes
18	Tukuma novads	Finance unit	No

\* on January 2012 in Ventspils is one internal audit staff unit vacancy

Source: Author's construction based on research data



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After summarizing data from this research authors comes to conclusions that there are some questions for future author's researches – it is quite important to analyze number of the staff in the local government, internal audit function size and number of enterprises with local government share capital which are significant indicators from author's point of view, it is quite important to understand what kind of methodology use internal auditors in local governments.

It is necessary to define criterions in further researches for internal audit implementation in local governments.

## Conclusions and Proposals

1. At the beginning of the year 2012 internal audit has been organized and is working just in 19 out of 119 local governments in Latvia.
2. It is necessary to introduce mandatory requirement in the legislative acts about foundation of internal audit and size of internal audit unit in local governments accordingly to the criterions of local government income, expenses criteria per capita.
3. Just in 10 local Latvia governments out of 18 internal audit positions was founded according to International Internal Audit Standards.
4. It is quite important to analyze number of the internal audit function size in the local governments and number of enterprises with local government share capital and it is quite important to understand what kind of methodology use internal auditors in local governments in further researches.

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