# RFIX WG: Concept note on the roles and relationships of Internal Audit, Supreme Audit Institutions and Financial Inspection

## Background

1. The concepts underlying the roles of state institutions involved in audit and financial inspection reflect:

(a) The historical development of public financial management and administration in the country concerned;

(b) Developments in international standards and best practices in audit and internal control;

1. For this reason the type of audit and control institutions that exist in each country and the rules and regulations that govern their operations vary from one country to another.
2. Internal Audit has existed in many countries for a long time and is a key feature of the Anglo-Saxon model of Financial Management. However internal audit was not part of the Francophone model of Financial Management, which is the basis for financial management in countries that were previously part of the Soviet Union.
3. Over the past 15-20 years many countries that operated under the francophone model have introduced Internal Audit as new audit institutions in their countries. Most countries have also sought to change their SAI from an external control institution operating under the Court Model to an external audit institution operating under the audit office model[[1]](#footnote-1).
4. The introduction of these new audit functions alongside the traditional and powerful institutions with the role of financial inspection/external control has led to the need to clarify the roles and functions of these institutions. It has also led to the need to promote ways of effective cooperation and coordination between the three institutions that may now exist in a single country.
5. International standards exist concerning the work of internal and external audit (known as Supreme Audit Institutions for the Government sector). And these standards include guidance concerning the relationship between internal and external audit.
6. Similar international standards do not exist concerning the work of Financial Inspection bodies and their relationship with internal and external audit. This is because these bodies exist mainly in countries that were previously part of the Soviet Union.
7. However the independent status and control activities of Financial Inspection bodies have many common features with audit bodies. FI institutions: are usually independent of those bodies they inspect; focus on the review of financial transactions; examine the extent to which inspected bodies comply with financial rules and regulations; and issue reports on their findings focusing on areas of non-compliance.
8. The major differences are (a) that FI bodies usually have powers to levy penalties on individuals that fail to comply with financial rules and regulations; (b) that the reporting lines of FI and audit bodies are different – (FI usually report to the Minister of Finance, IA reports to the head of the institution they audit and SAIs report to Parliament); and (c) that audit bodies usually have a wider mandate to the examine economy efficiency and effectiveness of public expenditure.
9. There are no international fora where representatives from each type of institution can meet to discuss these issues. The RIFIX working group was therefore established under PEMPAL[[2]](#footnote-2) Internal Audit Community of Practice to provide an opportunity for professional contact and debate amongst these institutions and to promote best practices for cooperation across countries with all three institutions.
10. Specifically the RIFIX working group has the following objectives:
* To study international standards and practices on the role and functions of IA, FI and SAI;
* To examine and promote good practice from countries that have established effective relationship between IA, FI and SAI;
* To identify the main differences between IA, FI and SAI and define modes for cooperation;
* To reveal main obstacles and challenges in the interaction of IA, FI and SAI and propose practical solutions.
1. The RIFIX working group is not a standard setting body. Its goal is to promote guidance and share experiences that will result in better financial management through more effective cooperation and coordination.

## Aim of the concept paper

1. The aim of this concept paper is to elaborate the main differences and similarities between three sets of rules regulating internal audit (IA), external audit (SAI) and financial inspection (FI). The paper also considers future work plans for RIFIX.
2. Sections 3-9 consider the roles of IA, SAI and FI; identifies similarities and differences and elaborates ways to avoid overlapping in functions and improve relationships.
3. Section 10 considers the aims of the working group in the future and what documents should be drafted under its supervision.

## The Definitions of Internal Audit, Supreme Audit Institutions and Financial Inspection

1. The Working Group uses the following definitions in relation to these functions.

**Public Sector audit and inspection environment**

1. The public-sector audit and inspection environment can be defined[[3]](#footnote-3) as that in which governments and other public-sector entities exercise responsibility for the use of resources derived from taxation and other sources in the delivery of services to citizens and other recipients. These entities are accountable for their management and performance, and for the use of resources, both to those that provide the resources and to those, including citizens, who depend on the services delivered using those resources. Public-sector auditing and/or inspection helps to create suitable conditions and reinforce the expectation that public-sector entities and public servants will perform their functions effectively, efficiently, ethically and in accordance with the applicable laws and regulations.

**Public Sector Auditing**

1. Public-sector audit can be defined[[4]](#footnote-4) as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria. Public-sector auditing is essential in that it provides legislative and oversight bodies, those charged with governance and the general public with information and independent and objective assessments concerning the stewardship and performance of government policies, programmes or operations*.*
2. There are three main types of public-sector audit[[5]](#footnote-5):
* Financial audit, which focuses on determining whether an entity’s financial information is presented in accordance with the applicable financial reporting and regulatory framework. This is accomplished by obtaining sufficient and appropriate audit evidence to enable the auditor to express an opinion as to whether the financial information is free from material misstatement due to fraud or error.
* Performance audit, which focuses on whether interventions, programmes and institutions are performing in accordance with the principles of economy, efficiency and effectiveness and whether there is room for improvement.
* Compliance audit, which focuses on whether a particular subject matter is in compliance with authorities identified as criteria. Compliance auditing is performed by assessing whether activities, financial transactions and information are, in all material respects, in compliance with the authorities which govern the audited entity.

**Internal Audit**

1. **IA** is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. [[6]](#footnote-6)
2. **IIA** define 2 main types of audits[[7]](#footnote-7):
* **Assurance Services.** *An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements*.
* **Consulting Services.** *Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organization’s governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.*

**Supreme Audit Institutions**

1. An **SAI** is an independent national agency responsible for the public sector auditing of government revenue and spending according to INTOSAI standards.

**Financial Inspection**

1. **FI** is an activity for the protection of public financial interests through the conduct of ex-post financial inspections for establishing violations of the statutory acts, regulating the budget, economic or accounting activities, as well as any indicators of frauds committed; detecting fraud and irregularities, etc. [[8]](#footnote-8)

[To obtain endorsement of this definition by RIFIX WG at meeting is Astana.]

## Roles

**Internal Audit**

1. Internal audit as a function developed as an integral part of the system of internal control during the last Century. As organizations in both the public and private sector increased in size, senior managers could no longer maintain personal oversight of the system of internal control. They therefore created small units independent of line managers and reporting to them alone to advise whether controls were operating as planned. Traditionally the focus of internal audit was on compliance with procedures (the controls that should be in place) and financial matters.
2. As internal audit has evolved, the role of internal audit has been codified in standards issued initially in the United States by the Institute of Internal Auditors but increasingly used globally. The functions of internal audit have also expanded beyond compliance with regulations and reviews of financial systems to encompass advisory work focusing on wider management issues, including the audit of the economy, efficiency and effectiveness of income and expenditure.
3. A further and fairly recent development has been the creation of audit committees to assure the effectiveness of internal audit and reinforce its independence from line management by providing the Chief Executive with expert advice of the effectiveness of the audit function. In the public sector audit committees also usually have a role in promoting effective coordination between the internal and external auditor.
4. It is now generally accepted that Internal Audit work should be carried out in accordance with laid down standards related to the planning execution and reporting of internal audit work.
5. For countries that have decided to introduce internal audit in recent years there is a body of best practice that can be used to help define how internal audit should best operate. And this includes guidance on the relationship with external auditors.

**Supreme Audit Institutions**

1. The phrase Supreme Audit Institution is used to describe the institution in a country that represents the highest level of independent oversight of central government finances.
2. There are essentially two models under which SAIs operate: a Court model, introduced under the francophone system of financial management, which gets its powers from the judicial functions of state, and an audit office model, introduced under the Anglo-Saxon system of financial management, which gets its powers from the legislative functions of state.
3. The traditional functions of the two main types of SAIs are also different. This reflects the way that budgets are approved by Parliament. In the francophone model, the budget is a very detailed document where separate budget authority is provided to large numbers of budget holders in each Government Department and Agency. In the Anglo Saxon model budget authority is provided to the head of each Government Ministry or Agency and then delegated by the Ministry or Agency head to subordinates.
4. Courts of Accounts (or Chambers of Control) essentially pass judgement on the legality of expenditure made by individual budget holders within Government Departments. By contrast Audit Offices audit the implementation of the total budget provided to the Department by carrying out a financial audit. Audit Offices usually provide an audit opinion on the financial statements for each Government Ministry.
5. The global trend, promoted by institutions such as the World Bank, the International Monetary Fund and the European Union, has been to encourage a shift of SAI functions from the Court model towards the Audit Office model. Courts of Accounts are increasingly encouraged to provide overall opinions on the accounts of government. Courts of Accounts still exist but in many countries they no longer have judicial powers, they provide opinions on national accounts to Parliament and they issue reports to Parliament on the audits undertaken. In this situation the Court model reflects the way that decisions are taken rather than the way the institution acts.
6. For SAIs that have made, or are making, the transition from the Court to the Audit Office model there can be significant challenges in retraining staff to work as auditors and moving from an external control/compliance function to an audit function.

**Financial Inspection**

1. The function of Financial Inspection has its roots in highly centralized government systems with detailed budgets where the Ministry of Finance retains a central inspection role as part of the system of overall financial control. The main role of FI is compliance focused: to control the budget expenditures of budget holders of state government bodies as well as other organizations that receive funds from the budget to verify that budgeted funds have been spent in accordance with the law. The focus is to ensure that budgeted funds have been spent without violations of the legal and regulatory framework or in a fraudulent and irregular manner.
2. Where countries are transitioning from a francophone to an Anglophone model of financial control, the longer-term role of financial inspection will often require review. This is needed to ensure that there is a balance between the roles of internal audit and financial inspection that promotes rather than detracts from the accountability of each individual Minister to Parliament.

## 4.1The impact of SAIs roles on relationships with IA and FI.

1. As noted above there are two main models of SAIs. For the purpose of this concept note it is helpful to sub-classify Supreme Audit Institutions as either SAI (External Control) or SAI (External Audit), defined as follows.
* An SAI (External Control) is an SAI that continues to operate under the francophone model. Its focus is on compliance with regulations, it has judicial powers to levy penalties and does not report to Parliament.
* An SAI (External Audit) is an SAI that operates under (or is moving towards) the Anglo Saxon model. Its focus is on providing audit opinions on the financial statements of the Government, it does not have powers to levy penalties and it reports the results of its activities to Parliament.
1. Using these classifications it is clear that IA and an SAI (External Audit) will have more in common than IA and an SAI (External Control). IA and SAI (External Audit) are both audit institutions that operate to audit standards based on the same (audit) concepts. Similarly FI and an SAI (External Control) will have more in common than FI and an SAI (External Audit). As they are both control institutions rather than audit bodies.
2. Where an SAI is transitioning from an SAI (External Control) to an SAI (External Audit) the relationships with both IA and FI will change over time.
* Initially the SAI will have a lot in common with FI. They will probably share forward plans in terms of the organizations both institutions control. And the way both institutions carry out controls work will be very similar.
* As the SAI transitions towards audit work it will have less in common with FI. There will not be the same need to share forward plans because each institution will be doing different types of examination. The SAI will however need to engage more with IA because audit standards require external auditors to review internal controls (of which IA is a part) and also because the external auditor may want to place reliance on the work of internal audit in forming their own opinion on the financial statements.

## Key features of the role and work of IA SAIs and FI

1. Table 1 outlines the key features of the role, methods and approach of IA, FI and SAI, distinguishing between SAIs that carry out external audit and SAIs that carry out external control.

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| **Table 1; Key features of IA, SAIs and FI** |
|  | **IA** | **SAI (EA)** | **SAI (EC)** | **FI** |
| **Powers derive from:** | Minister | Parliament | Judicial law | Ministry of Finance |
| **Reports to:** | Minister | Parliament | Public, through publication of decisions. | Ministry of Finance |
| **Must be independent of**  | Line management in Ministries | Government | Government | The Ministries controlled |
| **Can rely on the work of others**? | Yes | Yes | No | No |
| **Can issue penalties/fines** | No | No | Yes | Yes |
| **International standards exist** | Yes(IIA) | Yes INTOSAI  | Yes INTOSAI | No |
| **Standards govern work** | Yes if IA is mandated to follow standards.  | Yes if SAI law requires SAI to follow standards | Yes if SAI law requires SAI to follow standards | No |
| **Provides Opinion on Financial Statements** | No | Yes | No | No |
| **Examines Financial transactions** | Yes | Yes | Yes | Yes |
| **Provides annual report to Parliament** | No | Yes | May provide a report on outcome of controls work | No |
| **Conducts ex-ante reviews of systems and processes** | Yes | No | No | No |
| **Risk based planning** | Yes | Yes | Possibly | Possibly |
| **Scope of examination** | All areas of the Ministry’s work | Financial Statements Policy implementation | All Financial transactions and finance related processes. | All Financial transactions and finance related processes |
| **Coverage** | Cyclical in accordance with IA strategy | Annual audit opinion on Financial StatementsCyclical Performance Audit | Cyclical – aim to control all budget holders over a number of years | Cyclical – aim to control all budget holders over a number of years |
| **Approach** | Systems reviews Compliance with regulationsPerformance audit | Financial Audit|Regularity AuditPerformance Audit | Review of compliance with regulations | Review of compliance with Regulations |
| **Purpose of any review of internal controls** | To provide assurance to management on the effectiveness of controls. | To determine whether controls are operating effectively to reduce direct testing by SAI | To identify areas of non-compliance and violations of regulations | To identify areas of non-compliance and violations of regulations |
| **Role in relation to fraud and corruption** | May identify areas of possible fraud and corruption from audit work. May also carry out audits in areas of high risk of Fraud and corruption | May identify areas of possible fraud and corruption from other audit work | May identify areas of possible fraud and corruption from other controls work | Inspection may be planned to examine areas of high risk of fraud and corruption.May identify areas of possible fraud and corruption from other controls work |

1. Table 1 shows that the scope for cooperation between IA/FI and SAIs will be different for SAIs that operate as External Audit and External Control institutions.

[To consider Table 1 and analysis further following meeting in Astana]

## Main areas of potential overlap

1. Table 1 shows that there is potential for the overlap of work across the three different institutions. The key areas of possible overlap are:
* The audit or control of one institution by three separate entities because of the cyclical coverage of controls and audit work. A single budget holder may be controlled by FI and SAI(EC) and audited by IA and SAI(EA).
* The review of the same financial transactions by different entities. Financial transactions may be subject to both control and audit. It is also possible that different control institutions come to different findings on whether violations exist or not.
* All institutions may identify cases of potential fraud and corruption. The main difference is that both IA and FI may focus their examinations on areas of high risk of fraud and corruption. IA may focus on the effectiveness of systems of internal control fighting fraud and corruption, whereas FI may focus on identifying actual cases of fraud and corruption. SAIs and IA may also identify cases of fraud and corruption when carrying other work (i.e. audit or controls not directed at fraud and corruption. None of the institutions is responsible for the actual prosecution of cases of fraud and corruption and these are usually passed to another institution.
* The examination of systems of internal control. All the institutions may examine aspects of internal control. But the objectives of each are different.
1. Some level of overlap is inevitable. But it may not cause problems. For example, because IA is responsible for providing assurance on the effectiveness of internal control, they will need to cover all high risk areas as part of their planned work. But the SAI (EA) may also have identified the same high-risk areas for examination. However, the audit standards recognise this and provide for the External auditor to place reliance on the work others (including an internal auditor) provided that the external auditor is satisfied that this work has been done to an appropriate standard.[[9]](#footnote-9)

## The benefits and risks of cooperation

1. Benefits. A range of benefits may be obtained from co-operation. These may include:
* An exchange of ideas and knowledge;
* Strengthening their mutual ability to promote good governance and accountability practices, and enhancing management understanding of the importance of internal control;
* More effective audit and inspections based on a clearer understanding of respective audit roles and requirements
* Minimizing disruption to the audited entity;
* A more informed dialogue on the risks facing the organisation leading to more effective focusing of audit and inspection effort and to more useful advice to management
* Better coordinated audit and inspection activity based on joint planning and communication of needs that maximizes audit coverage based on risk assessments and identified significant risks;
* A better understanding by all parties of the results arising from each other’s work which may inform respective future work plans and programmes
* Increased scope for use of each others work.
1. Risks Cooperation is not risk free. Inherent in the coordination and cooperation process are certain risks, which should be managed. For example:
* Possible compromise of confidentiality, independence, and objectivity;
* Possible conflicts of interest across the three parties;
* Dilution of responsibilities;
* Use of different professional standards or lack of standards relating to the work undertaken;
* Misinterpretation of conclusions when using each other’s work;
* Possible difference of conclusions or opinions on the subject matter;
* The possibility that potential findings of the another organisation may be prematurely communicated to an external party; and
1. In general the risks may be lower for institutions that carry out similar types of work. For example cooperation between IA and SAI (External Audit) and between FI and SAI (External Control).

## A Cooperation Framework

1. The UK NAO and INTOSAI have promoted the 4Cs as a basis for cooperation between internal and external audit and these could be used as a framework for promoting cooperation between IA, SAI and FI. The 4Cs are: **C**ommitment, **C**onsultation, **C**ommunication and **C**onfidence.
* **Commitment.** Effective cooperation between IA, FI and SAIs can only be achieved if all parties are willing and committed to developing coordinated and effective audit and inspection services. IA/FI and SAIs have their respective roles, responsibilities and accountabilities. However, these roles often overlap and effective co-operation demands a willingness from all parties to work flexibly to ensure that work is properly coordinated in these areas. Co-operation is likely to be most successful where all parties take an active role in promoting co-operation and are willing to undertake changes to help bring it about. In short, commitment is an attitude of mind.
* **Consultation** – regular consultations between the three institutions would provide the basis for identifying opportunities for beneficial cooperation and the mechanisms for helping to bring it about. Consultation will provide clarification of ambiguous issues and will ease their work.
* **Communication.** Communication is a two way process. Regular and open communication between the three institutions is essential to the success of co-operation. Communication that is open and transparent that will build trust between IA, SAI and FI when conducting audits and inspections. Formal communications can take form of meetings, for example to share plans and/or risk assessments. Informal meetings can also be used to promote better understanding of the roles of all three parties. The procedures to facilitate effective co-operation should ideally be agreed by all parties and summarized in a commonly approved document.
* **Confidence** – All parties should have confidence when dealing with each other. Whenever SAI and/ or FI is using the findings and reports of the IA it needs to be confident that the standard of work undertaken is appropriate and acceptable.
1. There are several options for cooperation between IA, SAI and FI. The depth of cooperation may vary and below is an indicative list of ways of cooperation:
* Communication of audit planning/audit strategy (e.g. joint planning sessions);
* Regular meetings between auditors of IA, SAI and FI;
* Arrangements for the sharing of information (including consultation procedures);
* Communication of the results of audits/inspections to each other;
* Organizing common training programs and courses;
* Developing methodologies;
* Sharing training materials, methodologies and audit work programs;
* Granting access to audit documentation;
* Secondment or lending of staff (e.g. training on the job);
* Use of certain aspects of each other’s work to determine the nature, timing and extent of audit procedures to be performed;
* Collaborating on certain audit procedures, such as collecting audit evidence or testing data;
* Widely involving CHU in the processes of coordination between IA, SAI and FI.

## RIFIX Working Group: Future work

[This content of this section of the paper is to be updated following the working group meeting in Astana]

1. Under the leadership of the RIFIX WG the following documents have to be drafted including:
* The roles and functions of the IA, FI and SAI with purpose to avoid overlapping;
* A model for interactions and relationship;
* Sample Agreements on cooperation between IA and EA; IA and FI.

## References

1. INTOSAI GOV 9150, Coordination and Cooperation between SAIs and Internal Auditors in the Public Sector.
*http://www.issai.org/media/13353/intosai\_gov\_9150\_e\_.pdf*
2. Cooperation between internal and external auditors: A good practice guide, UK NAO & HM Treasury

*https://www.gov.uk/government/uploads/system/uploads/attachment\_data/file/207223/Good\_practice\_guidance\_-\_co-operation\_between\_internal\_and\_external\_auditors.pdf*

1. Paper on Internal Control Audit and Inspection in Serbia. <http://www.ige.hu/letolt/budgetguide/17--%206%20%20Internal%20Control%20and%20Audit.pdf>
2. INTOSAI, Conference on strengthening external public auditing in INTOSAI regions, Vienna, Austria, 26-27 May, 2010
*http://www.intosai.org/uploads/intosaipublikation02112010small.pdf*
1. The SAI may still function as a court in terms of its decision-making processes but key changes often include new roles: to provide an opinion on the financial statements; to carry out performance audits (economy, efficiency and effectiveness). Powers to levy penalties are often also removed. [↑](#footnote-ref-1)
2. The RIFIX Working Group was established following consultations between PEMPAL member countries on the importance of differentiating the roles of IA, SAI and FI. First reference to this topic was made at the 7th Plenary Meeting in Yalta, Ukraine in 2010. A further discussion of the role of FI and its links to the IA took place during the 13th Plenary Meeting in Ohrid, Macedonia in 2011. A broader agenda was presented during the 17th Plenary Meeting in Hungary in 2012. This time principles of and differences between the functions of SAI, IA and FI services was the main topic. The RIFIX Working group was officially created at the 23rd Plenary Meeting in Tbilisi 2013. [↑](#footnote-ref-2)
3. ISSAI 100 Fundamental principles of public sector auditing INTOSAI [↑](#footnote-ref-3)
4. Ibid [↑](#footnote-ref-4)
5. Ibid [↑](#footnote-ref-5)
6. IIA (The Institute of Internal Auditors) standards [↑](#footnote-ref-6)
7. Ibid [↑](#footnote-ref-7)
8. *RIFIX working Group definition* [↑](#footnote-ref-8)
9. As the external auditor, the Supreme Audit Institution has the task of examining the effectiveness of internal audit. If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and internal audit. *INTOSAI Lima declaration Section 3.3* [↑](#footnote-ref-9)