

## **KEEPING AN EYE ON SUBNATIONAL GOVERNMENTS: INTERNAL CONTROL AND AUDIT AT LOCAL LEVELS**

*Mustafa Baltaci and Serdar Yilmaz*

### ***Abstract***

Fiscal decentralization in developing countries has been at the center stage of public sector reforms in the last two decades. Yet, a closer look at the recent reforms in the developing world indicates that decentralization does not necessarily translate into better outcomes because of waste, corruption, and inefficiencies. The success of decentralization depends on the existence of a framework that keeps local or “subnational” governments on track and holds local government officials accountable for results—two missing components in most recent decentralization efforts. This paper attempts to close this implementation gap by developing a conceptual framework of internal control and audit at the local level. We analyze the role of internal control in public financial management practice and specify the necessary steps in establishing contemporary internal control and audit systems in a subnational government.

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# 1. Introduction

An internal control and audit framework aims at improving financial and administrative management capacity by limiting fiscal behaviors that result in waste, misallocation, and corruption. While common both in the public and the private sector, these financial management tools have been widely overlooked in the context of decentralization in developing countries. In this paper, we argue that in order to achieve efficiency and effectiveness at the local or “subnational” governmental level—that which is below the central level—internal control and audit should be among the key components of a fiscal decentralization program.

In recent years, fiscal decentralization programs implemented in many developing countries have given local governments additional service responsibilities and access to more public funding, either in the form of intergovernmental transfers or through the authority to raise taxes from a wider variety of local sources. But expanding their expenditure responsibilities and spending authority without improving public financial management systems have had little impact on service delivery outcomes. The absence of effective public financial management systems at both central and local levels have sometimes resulted in fiscal imbalance, weak accountability, political capture, and deterioration in public services. In some cases the consequent weaknesses in local government’s financial management have posed threats to their national economies. Fiscally distressed local governments of Argentina, for example, significantly increased the country’s vulnerability to external shocks by maintaining far too much borrowing with poor fiduciary management. Similarly, India, Brazil, and Columbia have experienced excessive fiscal deficits with their subnational governments because of such factors as weak local political capacity, lack of internal control and external oversight, and expectation of bailouts when localities borrow beyond their means. Therefore, a grave need exists to keep local governments fiscally on track and to hold local government officials accountable for results. A contemporary internal control and audit framework could help to achieve both these objectives.<sup>1</sup>

A number of good examples of contemporary internal control and audit systems exist. Both the United States and Britain have championed internal control and audit at all levels of government. Similarly, the European Union (EU) has heavily invested in developing internal control and audit systems, particularly in candidate countries. Support for Improvement in Governance and Management (SIGMA), a joint entity of the EU and the Organization for Economic Co-operation and Development (OECD), has been singled out as the catalyst to encourage the transition countries to build effective internal control and audit systems.

However, examples of internal control and audit at the subnational level are rare particularly in developing countries. In many cases, reformers have placed more emphasis on improving capacity and building control mechanisms at the central government level. Regrettably, establishing internal control and audit practices at the local government level has received little or no attention, even in countries where decentralization programs devolve more responsibilities to local governments.<sup>2</sup>

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<sup>1</sup> It is important to note that internal control and audit are not necessarily stand-alone management tools; they can be effective only to the extent that accounting and governance systems operate. Internal control and audit functions should be established and aligned with broader governance reforms such as strategic planning, accounting, budgeting, medium-term expenditure framework, procurement, reporting, external audit, public debt, and asset management.

<sup>2</sup> The literature on internal control and audit is scarce and it concentrates on internal control and audit practices at the central government level. For example, the International Monetary Fund (IMF) and World Bank staff studies

This paper is an attempt to close this implementation gap by developing a conceptual framework of internal control and audit for use at the local level. Section two, therefore, introduces a series of factors that create weak local government accountability structures. Section three introduces the concept of internal control, particularly focusing on contemporary internal control systems. Section four discusses internal audit as part of a broader control framework, highlighting the differences between internal control and internal audit. Section five concludes with a summary of main points and their relation to public financial management (PFM). There are five annexes appended to this paper to illustrate the general points of the discussion with country examples.



## 2. The Need for Improving Accountability in Decentralization

Fiscal decentralization is a broad concept relating to intergovernmental institutions, budgetary processes, and financial arrangements underlying the central-local relationship in a country. With the implementation of a decentralization program, the legal and political authority to plan projects, make decisions and manage public functions is transferred from the central government and its agencies to local governments. Although the motivation behind decentralization is different in each country, the underlying concern for decentralization has always been to improve the quality of public services and the effectiveness of the public administration system.

A close review of previous decentralization efforts indicates that they frequently have failed to deliver the expected outcomes in local service provision and improving public administration. Many developing countries have reported that decentralization cultivated weak fiscal discipline and poor expenditure management, attributable to a combination of weak managerial capacity in local governments, pervasive capture by local elites, widespread mismanagement or misallocation of public resources or both, and rampant corruption. To counter the impact of these influences, the decentralized structure must ensure conformity with the rules and regulations, expenditure controls, and monitoring performance. A contemporary internal control framework accompanied by an effective internal audit process could both aid the external audit process and assist central governments in their monitoring efforts over local governments with regard to effectiveness, corruption, waste, and misuse.

In many countries, however, local governments lack control and audit procedures. Using selected countries as examples of current decentralization reforms, Table 1 provides a brief summary of internal control systems and issues arising from inadequacy or lack of internal control systems.

**Table 1: Local Governments and Internal Controls in Selected Countries**

Country	Internal Control System at the Local Level	Issues Arising Due to Lack of Internal Controls
Argentina	Lack of legal instruments and no political willingness to improve internal control and audit systems.	High level of indebtedness in local governments and failures in providing urban services.
Bosnia	Lack of contemporary internal control and audit systems.	Impaired safeguarding measures against abuse, misuse, fraud, and irregularities; widespread corruption; misconduct and misuse of public funds; and public disaffection against government institutions.
China	<i>Ex ante</i> expenditure control and compliance audits.	Common problems in compliance with laws and regulations; unlawful tax practices.
Columbia	Unclear legal framework defining the functions and responsibilities of the fiscal control agencies; and ineffective internal control mechanisms	Negligence, corruption, and misuse of public funds.
India-Karnataka State	Inefficient control and audit practices, old fashioned rule books, lack of timely and reliable information; focus on compliance audits, and inadequate follow-up with audit findings.	Frequent case of abuse, misuse and fraud; irregularities and malpractices in procurement; lack of adherence to the stated rules and procedures.
Indonesia	Weak internal control and audit systems.	Unethical and uneconomic operations due to pervasive corruption, inefficient cash management, and collusive practices in procurement.
Philippines	Weak internal control environment, non-existent internal audit, and lack of timely financial information.	Lack of compliance with laws, rules and regulations; fraud and irregularities; and overpaid public purchase and procurement.

For example, Bosnia and Herzegovina is a federalist state with highly decentralized government structure where, in the absence of modern internal control and audit systems, governments at all levels have failed to develop sound budget practices (World Bank, 2003a). The lack of control systems makes safeguarding against abuse, misuse, fraud, and irregularities impossible. In Bosnia, widespread corruption is coupled with low public morale and distrust towards public institutions (World Bank, 2003a). At least one report on the country concludes that without establishing an effective control system at the subnational level, detection and control of misconduct in public procurement is next to impossible (World Bank, 2002b).<sup>3</sup>

In the Philippines, despite of the enactment of the 1991 Local Government Code to devolve more responsibilities to subnational governments, the internal control environment and institutional arrangements for financial accountability remain extremely weak at the local level (World Bank, 2004d;

<sup>3</sup> Only three out of ten cantons in the Federation of Bosnia—Sarajevo, Tuzla and Bihac—have recently introduced internal control and audit functions to strengthen the line of defence against waste and corruption (World Bank, 2003a).

Commission on Audit, 2003). The absence of key control mechanisms is one of the factors for weak governance in local government units (World Bank, 2003c and 2004d). Frauds, irregularities, lack of compliance with regulations, and the inability of local governments to produce timely accurate financial information are the major impediments on the way to fulfilling accountability obligations.

Similarly, Indonesia has recently devolved decision-making power on major service delivery items from the central to the subnational level. Yet, diagnostic studies report that the lack of fraud and corruption detection and prevention systems is a major snag in improving local accountability (World Bank, 2003b). Inefficient cash management, collusive practices in procurement, and weaknesses in internal control and audit, among other demanding issues, have remained constant concerns to the country's decentralization program. It is reported that only 5 percent of budgetary transactions of local governments are audited by the regional and provincial internal audit bodies and only 50 percent of the local authorities are checked periodically by the external audit institution (Khan and Sondhi, 2005).

In India, the constitutional amendments of 1993 aim for "revolutionizing democratic participation and local development planning." However, the subnational fiscal crisis of the late 1990s has revealed a number of accountability flaws in the public finance framework (World Bank, 2005c). Many Indian states have now adopted financial management reform programs and have passed fiscal responsibility acts. In Karnataka State, for example, there have been irregularities and malpractices in the public procurement system, resulting in public distrust to the system. In order to reform the public procurement system, the State Government enacted the Karnataka Transparency in Public Procurement Act to enhance transparency in the tendering process and minimize opportunities for manipulations and corrupt practices (World Bank, 2004b).

In Argentina, the past decade was marked by recurring deficits and indebtedness at all levels of governments. There have been recent efforts to enhance local government finance (World Bank, 2002a). Only with the enactment of the Fiscal Responsibility Laws in 1999 and 2004, have subnational governments begun to implement fiscal reforms that ensure citizen control over their operations and predictability of their fiscal policy performance. However, recent diagnostic studies show that there is a lack of legal instruments and political willingness to improve the internal control system at the subnational level (Arlia, 2005).

In China, subnational governments accounted for about 70 percent of government spending in 2002 (World Bank, 2005b). However, internal control and auditing remains a weak link in the subnational expenditure management (Mountfield and Wong, 2005). Subnational governments have their own audit bureaus, but they are "under the direct authority of the executive branch, compromising their independence" (Mountfield and Wong, 2005) and the focus is mostly on compliance audits. According to a recent report by the China's National Audit Office, the external audit institution, local governments engage in unlawful tax practices by granting tax cut and/or exemptions or implementing tax rebate policies (National Audit Office of China, 2004).

Colombia has been engaged in a major experiment of decentralization for the past fifteen years. However the legal framework is still unclear in defining the functions and responsibilities of the entities involved in their subnational fiscal control. In the present situation, fiscal control is highly centralized, and provincial comptroller offices have little autonomy. Additionally, a multi-layer bureaucracy often makes the control process sluggish (World Bank, 2005a). Such factors lead to a vulnerable internal control environment where fraud, negligence, and corruption remain as significant risks to local governance (World Bank, 2005a).

These examples and others like them lead us to the conclusion that local governments have to improve their administrative and financial management capacities for decentralization to produce better outcomes. The success of a fiscal decentralization program depends on strengthening the ability of subnational governments to manage revenues and expenditures more efficiently and to provide services more effectively. Furthermore, in countries where public services corruption, waste, and inefficiencies are widespread, these problems are usually compounded at the local level. Contemporary internal controls and well-functioning internal audit systems are meant to deliver key assurances to all stakeholders against these problems. In the absence of a contemporary internal control system, with internal audit as a safeguard for checking efficiency and effectiveness of that system, local governments are vulnerable to waste, corruption, and inefficiencies.

### 3. Contemporary Internal Controls <sup>4</sup>

An internal control framework is a set of organizational policies and procedures to ensure reliable record keeping, to safeguard assets, to promote operational efficiency, and to monitor adherence to policies and directives. The functional and broader definition of internal control includes such actions as: supervising management to ensure that they have an adequate level of funding to deliver services; transaction compliance with legal frameworks; and consistent practices with stated policies, organizational objectives, and performance criteria. Internal control is about establishing a system where all actions are monitored proactively, irregularities are corrected, and deficiencies are reported to the top management. According to the International Organization of Supreme Audit Institutions (INTOSAI), it is not about “one event or circumstance, but a series of actions that permeate an entity’s activities. These actions occur throughout an entity’s operations on an ongoing basis.” (2004: 6)<sup>5</sup> The lack of these organizational policies and procedures—namely internal controls—may result in such problems as: (1) unethical, uneconomic, inefficient, and ineffective operations; (2) weak accountability links; (3) unlawful actions; and (4) lack of safeguarding measures against waste, abuse, mismanagement, errors, fraud and irregularities.<sup>6</sup>

Until recently, “control” has been viewed as a system of *ex ante* financial and compliance controls that generally are operated by a central government agency, usually the Ministry of Finance (MoF). Lately, the control paradigm in the public sector has witnessed a conspicuous shift from classic *ex ante* expenditure checks to contemporary financial and non-financial internal controls. The contemporary definition of internal control includes a broader context, which not only refers to the traditional role of financial expenditure controls, but also provides management with the capability to supervise service delivery effectiveness. Therefore, contemporary internal control is a management tool to ensure that an institution’s leadership is (1) functioning in accordance with stated policies and procedures; (2) delivering services efficiently and effectively; (3) protecting assets and properties from improper use; (4) keeping timely and precise accounts; and (5) producing fiscal and non-fiscal information accurately.

The goal of a contemporary internal control framework is to ensure that resources are managed properly and accountability is maintained. In this framework, the tools that management can employ range from *ex ante* expenditure controls to compliancy checks, inventory controls, recordkeeping, reporting, and monitoring (see Figure 1). However, a contemporary internal control framework is more than a set of traditional *ex ante* financial and compliance controls. It is based upon a system of management in-

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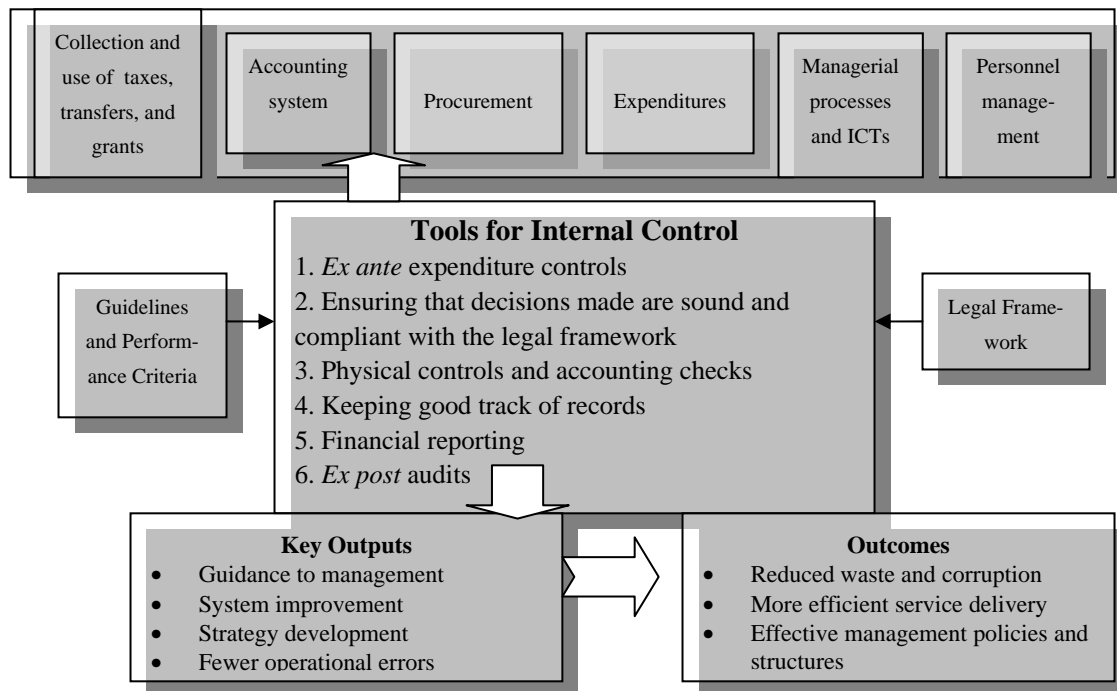
<sup>4</sup> The public sector has borrowed contemporary internal control practices from the private sector. The Committee on Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization to improve the quality of financial reporting through business ethics, effective internal controls, and corporate governance. In 1992, COSO published its “Internal Control-Integrated Framework,” a flagship of internal control guidelines. This framework consists of five components: (a) control environment, (b) risk assessment, (c) control activities, (d) information and communication, and (e) monitoring. For more information, see <[www.coso.org](http://www.coso.org)>.

<sup>5</sup> The INTOSAI is the professional organization of supreme audit institutions in countries that belong to the United Nations or its specialist agencies. INTOSAI’s published guidelines incorporate a detailed analysis of internal control, definition, objectives, control environment, risk assessment, control activities, monitoring, roles, and responsibilities. Although adopting these guidelines is not mandatory for member countries, the INTOSAI standards should be a guiding principle in creating internal control systems at all levels of government, including the local level. For more information, see <[www.intosai.org](http://www.intosai.org)>.

<sup>6</sup> According to INTOSAI, the objectives of an internal control system are: (1) executing orderly, ethical, economical, efficient, and effective operations; (2) fulfilling accountability obligations; (3) complying with applicable laws; and (4) safeguarding resources against loss, misuse, and damage (2004).

formation, financial regulations; and administrative procedures for assessing such activities as: revenue collection, accounting, and procurement practices; policy and decision making processes; expenditure effectiveness; and human resource management. It suggests a variety of tools for ensuring that policies and procedures are compliant with the legal framework, as well as for ensuring effective and efficient service delivery.<sup>7</sup>

**Figure 1: Internal Control Processes**



Contemporary control activities include a wide range of activities like approvals, verifications, and reviews of operating performance. These control activities can be organized as:

*a) Accounting controls* that are aimed at covering the procedures and documentation concerned with safeguarding assets and the reliability of financial records. A strong internal control system with coherent *accounting checks* enables the accountants and managers to check for errors and misuse of public resources.

*b) Administrative controls* that are applied in covering the procedures and records concerning the decision-making processes that lead employees to carry out authorized activities in achieving the organization's objectives. For example, physical check is an important administrative tool by which staff that are in charge of control processes undertake regular checks on the goods and removable items owned by the entity. Physical checks help to ensure that the organization's property is used appropriately.

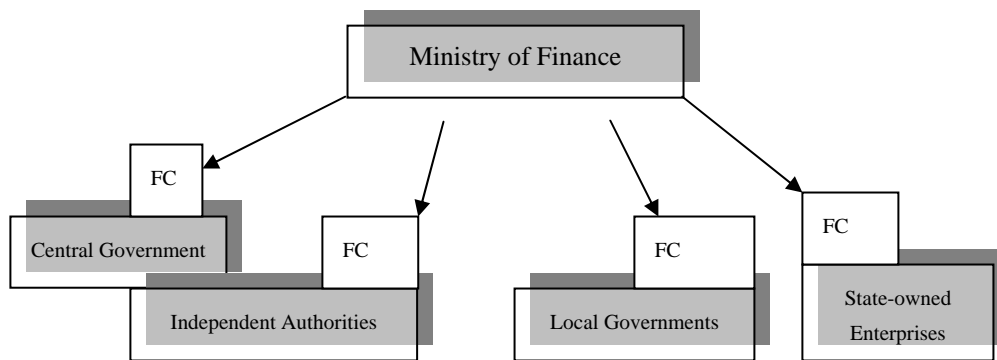
*c) Management controls* that are used to cover all the plans, policies, procedures, and practices needed for employees to achieve the entity's objectives. In this context, for example, hierarchical checks provide a powerful tool to make sure that responsibilities are handled in accordance with policies and

<sup>7</sup> It is important to recognize that internal control has inherent limitations, and it does not necessarily provide an *absolute assurance*. Indeed, only a *reasonable level of assurance* is attainable, equating to a satisfactory level of confidence under given considerations of costs, benefits, and risks (INTOSAI, 2004).

procedures. These controls help to build a bottom-to-top trust with functioning communication among managerial levels while it diminishes the opportunity for corruption and misuse.<sup>8</sup>

In a traditional financial control framework, such tools are usually underemployed and the institutional arrangements have relevant shortcomings. The responsibility for controls, for example, is rested with the Ministry of Finance (MoF) instead of the public institution in question. As the sole practitioner of the budgeting and fund allocation, the MoF exercises control functions on subnational governments as well as line agencies. Financial and compliance checks are usually carried out by financial controllers who are posted to public sector institutions by the MoF. Controllers report perceived irregularities to the MoF rather than to the public institution in question. The MoF may conduct *ex ante* controls from the headquarters in the event that no individual controller is assigned. In this centralized control model, the MoF authorizes a broad range of departmental activities such as providing clearance for purchases, procurement, and personnel recruitments. As shown in Figure 2, in a centralized internal control model, the MoF independently detaches its financial controllers to the spending institutions—including local governments—to oversee the public financial management practices.

**Figure 2: Centralized Internal Control Model**



The paradigm of contemporary internal control, on the other hand, holds every single public institution accountable. It requires each public institution to administer the internal control programs itself rather than an outsider. It is based on the premise that each institution would be in charge of managing its finances in delivering outputs. Thus, public institutions are required to assemble a financial control department. The controllers’ job is not only financial controls but also participation in the decision-making processes of public financial management transactions. This participation includes, for example, a permanent seat in the procurement committees. Respectively, contemporary internal controls are embedded in an entity’s managerial processes as checks and balances performed at all layers. Norms and values are internalized rather than being imposed externally. More emphasis is given to horizontal and hierarchical interactions within the institution. Contemporary internal control, therefore, assigns responsibilities to all staff and not only to the budget and accounting officials.

In a decentralized control model, the MoF is only given limited power since internal controls are task-aligned with individual organizations. Such limited power does not mean that there is no role for the central government. Indeed, the central government should set the standards and monitor the effectiveness of the internal control systems at the local level. In the United Kingdom, for example, local authorities apply their own systems but through a framework of generally accepted rules and procedures endorsed by professional bodies such as the Chartered Institute of Public Finance and Account-

<sup>8</sup> INTOSAI Guidelines for Internal Control Standards (2004).

tancy (CIPFA) and the Treasury. In Albania, each budget institution has a finance office that is responsible for first level controls in the budget execution. The finance officer ensures completeness of documentation, availability of budget allocation, and compliance with departmental rules. The Council of Ministers ensures that an effective internal control framework is in place and maintained. This process enhances the ministers' understanding of the state's management and provides positive incentives for ministries to correct any deficiencies reported by the internal control system (OECD, 2004). In the United States, the Single Audit Act designs a control framework for centrally-funded earmarked transfers to local authorities. Accordingly, the White House Office of Management and Budget is legally assigned to issue circulars to delineate the framework and to coordinate the control works. See Annex I for examples of other countries.

A decentralized contemporary control approach is desirable when a decentralization program devolves more fiscal responsibilities to local governments. In a fiscally decentralized structure, since local governments are invested with the power in budget preparation and execution, they also should be in charge of managing the internal control systems in order to strengthen downward accountability links. A decentralized contemporary control approach will mandate local governments to keep reliable records of resources and properties; to develop results-oriented policies; to be effective, efficient, and economic in service delivery; and to be proactive in taking necessary measure for perceived risks. Furthermore, the decentralized model helps to achieve "subsidiarity" in the local governments by building internalized values and principles. See Annex 2 for a discussion of issues in establishing contemporary internal control frameworks at the local level.

Contemporary internal control systems offer a golden opportunity for stakeholders to be more informed on the day-to-day activities of a public sector entity. However, the success of an internal control system is profoundly affected not only by the attitudes of the management and employees but also by the establishment of safeguards. The following features of a management system for internal controls are important to efficacy: (1) decisive leadership that is responsible for designing, implementing, supervising, maintaining, and documenting the internal control system; (2) well-considered internal control design aligned with the organizational objectives; (3) committed personnel who perform their jobs in accordance with the pre-stated policies, procedures, regulations, and ethical rules; (4) effective risk identification and system monitoring mechanisms; and (5) internal audit and independent internal auditors, as part of the internal control system that provides a set of sound safeguarding processes.

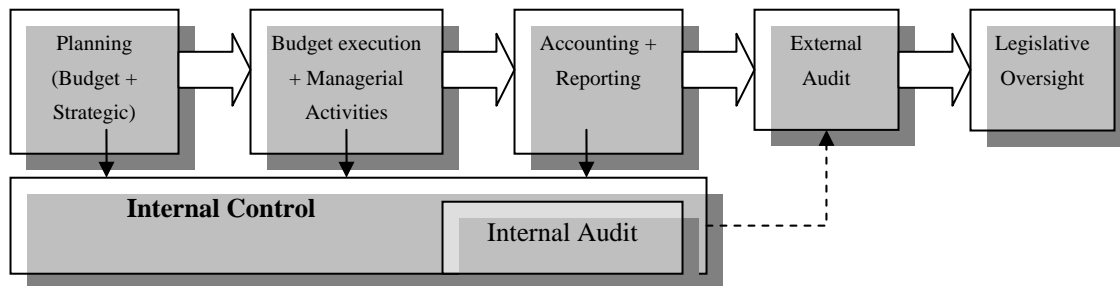


## 4. Key Module in the Control Systems: Internal Audit

“Internal control” and “internal audit” are profoundly close and commonly intertwined terms, which often are used interchangeably. However, there are functional and operational distinctions between internal control and internal audit. Internal controls are the systems put in place to ensure sound financial management and service delivery whereas internal audit is the check of those systems. Internal control processes are intended to provide generic assurances to mitigate the probable risks via *ex ante* expenditure checks whereas internal auditors are engaged in *ex post* compliance, performance, and financial audits. The feature that most distinguishes internal audit from internal control is that internal audit operates independently from the administration and internal control structure.<sup>9</sup>

An effective control system should be composed of both financial and non-financial controls applicable to each phase of the decision-making processes, as Figure 3 illustrates. Such a system has three main components: (1) risk identification, (2) development of internal control systems and procedures to counter the perceived risks, and (3) establishment of an internal audit procedure for checking internal control efficiency and effectiveness (Allen and Tommasi, 1997). It includes independent internal auditors as a safeguard to oversee managerial decisions, activities, and program results. In an organization, it is the leadership team’s responsibility to develop a *modus operandi* for control system. The management team should oversee the functioning of the control system and ensure that the information is floated smoothly across the main actors, especially the management team, internal auditors, and external auditors.

**Figure 3: Public Financial Management Cycle**



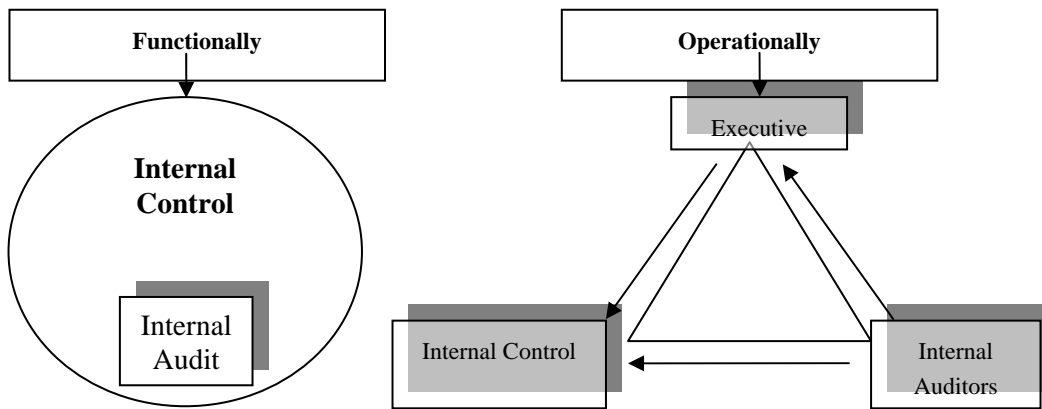
The goal of internal audit should be to add value and improve an organization’s operations and control structure. Internal audit provides both governments and related parties with a powerful tool for understanding the extent to which the public institution in question has delivered on-budget and effective services. Therefore, internal audit is “a well-defined activity and a recognized profession” (Madsen, 2003) that is performed by professionals who determine whether the decision making is sound and effective. Ideally, internal auditors are excluded from day-to-day management activities, and they are not allowed to intervene in decision-making circles. This limited scope suggests shifting the internal

<sup>9</sup> Internal audit is neither a new nor a recent issue for corporate governance. The Institute of Internal Auditors (IIA) was formed in 1941 to promote auditing in privately-held companies in order to help developing corporate structures foresee future risks and protect companies from failure. Since then, the IIA has been the prime catalyst of internal audit practices by publishing auditing standards, issuing professional certificates, and delivering training programs. Currently, the IIA is involved in various activities from publishing reports and studies on governmental audit, to upgrading standards through increased attention on public sector dynamics, and to actively organizing seminars and workshops for representatives from various government departments. For more information, see <[www.theiia.org](http://www.theiia.org)>.

audit from *ex ante* to *ex post* reviews, which means that auditors should engage in testing the conformity and effectiveness of the complete transactions and expenditures.

From a *functional* point of view, internal audit assists the effectiveness of internal control as a supporting element in overseeing the proper use of revenues and authority. Internal audit, in this sense, is viewed as an integral part of the entire control system. It is the last step before the external audit checks whether the decision making was proper, effective, and compliant with the policies and procedures. However, internal audit needs to be *operationally* independent and separately situated from the administration. Figure 4 illustrates these linkages.

**Figure 4: Functional and Operational Linkages in Internal Control and Audit**



While there is a degree of continuing communication between audit and administration, internal auditors should not be commanded by the top management, and there should be no intervention by the administration to affect the audit results. The mandate, scope, methodology, and results should be determined solely by the internal auditors (i.e., by the chief auditor or the audit committee) without seeking consent from the senior management. Internal auditors usually communicate with the administration at two points: first, when handing over the audit reviews, and second, when discussing the audit results. If an audit committee is assembled to facilitate the communication between the top management and auditors, auditors can submit their reports to this committee. There should be also a link between internal auditors and external auditors (supreme audit institutions). By definition, external auditors independently, and usually on behalf of a legislative body, inspect public institutions for their financial and non-financial activities. In assessing the effectiveness of an institution's control framework, the external auditor may use the work of internal auditors, who are a part of the internal control system and are more apt to provide guidance on the system in place. Annex III presents a brief discussion on the process of building an audit committee.

In many countries, the scope of an internal audit function is limited to *ex ante* expenditure controls and compliance both at the central and subnational level. Box 1 defines and discusses three different types of audits.

**Box I: Three Types of Audit**

*Compliance audit* points to the checks carried out to evaluate how well the organization complies with and adhere to relevant policies, laws, directions, plans, and procedures. The compliance emerges as the basic element of conducting an audit.

*Financial audit* is relevant to assessing the internal control systems that ensure the quality of accounting information and financial reporting. Financial audits include financial statement, accounts, accounting, receipts, and other financially-related issues. Financial statement audits provide reasonable assurance about whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows in conformity with the accounting standards. Financial audits also include determining whether (1) financial information is presented in accordance with established or stated criteria, (2) the entity has adhered to specific financial compliance requirements, or (3) the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives.

Finally, *performance audit* aims to review whether a particular activity is completed in a way that has produced effective, efficient, and economic results. It is viewed as an objective examination of evidence for providing a reasonable assessment of an organization's performance.

Source: Adapted from Government Accountability Office (GAO), Government Auditing Standards, July 1999.

However, in certain countries, auditing has evolved to cover all aspects of governance. Table 2 illustrates the changing character of internal audit. In these countries, the internal audit embarks on a mandate of evaluating programs in the light of pre-set performance criteria and organizational objectives. In other words, the internal audit system in these countries adds value to the effectiveness of public sector operations by enabling objective scrutiny. Internal auditing in the Ontario province of Canada, for example, has experienced a cultural and functional transformation in late 1990s. In 1998, as a first step toward improving its internal audit service, the provincial government combined small units that provided auditing service to the province's 23 ministries and created an integrated internal audit division under the direction of a chief internal auditor. Over the course of a year, the division undertook a strategic planning exercise to develop its vision, mission, values, and strategic goals. The strategic plan that emerged from this exercise established a client-focused vision for the division and provided a framework for serving the needs of the province. The transformation process has gained support from senior management and the cabinet approved an internal audit directive to serve as the division's most important tool for ensuring sound corporate governance. After the transformation was complete, the client satisfaction rating rose steadily, from 75 percent in 1999 to 88 percent in 2003. The staff and clients now see the auditors as business partners and valuable contributors to effective, efficient program delivery rather than as adversaries (Lapointe, 2004).

**Table 2: Evolution of Internal Audit**

<b>Traditionally perceived role</b>	<b>Defined modern role</b>
Police	Partners in the organization
Financial focus	Governance focus
Focus on tangible assets	Focus also on intangible assets
Compliance based	Performance and risk based
Reactive	Proactive
<i>Ex ante</i>	Ranges from <i>ex ante</i> to <i>ex post</i>

Source: Adapted from OECD/PIFC Expert Group, Internal Control Systems in Candidate Countries, 2004.

Internal auditing, however, is a demanding task to accomplish in local governments. Annex 4 discusses the basic elements of internal auditing. Establishing an audit body requires answers to a set of critical questions, such as where to start, how to organize audit work and its scope, as how to achieve integrity and independence at the same time (see Annex 3). As discussed above, clear-cut examples of local governments that have both sound internal control and audit systems often exist in affluent countries where decentralization is successfully accomplished at virtually all lower levels. In developing countries, however, capacity problems prevail to such an extent that local governments either are negligent in committing to accountable financial management or are weak in their capacity to develop such management.

Yet examples of good practices are apparent in a number of countries that have acted to promote fiscal accountability and internal audit mechanisms at local governments. As such, Singapore, Hong Kong, and Argentina have created ethics offices for their cities. Supreme Audit Institutions of many developing countries have started to include local governments effectively in their audit work. Others recently have initiated internal audit systems at the local level. In Pakistan, for example, the North West Frontier Province (NWFP) has made positive strides in the establishment and operation of Internal Audit Units. Internal audit units are established in four main departments including the Health, Education, Police, and Public Works Departments. The NWFP Government has now taken on the initiative for the establishment of Internal Auditors in all other provincial departments (World Bank, 2004c). In India's Orissa State, the audit of urban local bodies is conducted annually by the Local Fund Auditors of the State Finance Department. Audit successfully covers all local transactions. When embezzlements are detected, the auditor has the power to allow the errant employee to replace the stolen amount. Serious irregularities are reported to the appropriate authorities for necessary action (Subramanian, 2005).

## 5. Conclusion

In this paper, we argue that the success of a fiscal decentralization program depends on strengthening the ability of subnational governments to manage revenues and expenditures more efficiently and to provide services more effectively. Local governments in many developing countries have been affected adversely by decentralization policies because they have not been provided the necessary instruments to enhance the monitoring of local government performance and accountability checks. Under circumstances where no accountability programs exist, the misuse and waste of public funds is inevitable. As a result, countries need to highlight the necessity of transparent financial systems with effective internal control and audit structures in local governments.

We identify internal control and audit as key components of public financial management (PFM) systems for increasing efficiency and effectiveness in local government operations. An effective, efficient, transparent, and rules-based PFM system is an essential tool for a government in the implementation of a fiscal decentralization program. Within the PFM framework, internal control and audit functions support fiscal decentralization process by promoting transparency and accountability in the use of public resources, ensuring allocation of public resources in accordance with citizens' priorities, and supporting aggregate fiscal discipline. A well-functioning internal control and audit system provides all stakeholders with broader outputs and outcomes as it seeks to deliver better guidance to the management by mitigating and eliminating risks, developing effective strategic development plans, removing inherent errors and inconsistencies within the system, and strengthening integrity through multiple-checks. Thus, effective decentralization strategies require that the subnational government strengthen its internal control and audit instruments while devolving more power to local governments.

In addressing control and audit reforms, local government practitioners need to account for the different dynamics of internal control and audit. Both entail careful consideration and demand a series of subsequent actions. It is important to note that internal control and audit systems are not a complete or magical solution on their own. They do not necessarily resolve all challenges in a public financial management apparatus. Instead, to improve governance structures and accountability frameworks necessitates a broader strategy encompassing the whole spectrum of PFM issues, which include planning, budgeting, accounting, procurement, public debt, asset management, reporting, external audit and legislative oversight. Regardless of the coverage of a decentralization program, we believe an effort to reform intergovernmental fiscal system should include internal control and audit due to the crucial role they play in enhancing accountability and effectiveness of local government operations.

## Annexes

### ***ANNEX I: Internal Control and Audit in Local Governments across the World***

*The United States* is one of the countries that champions internal control in local government. With the help of its greatly decentralized public sector structure, the United States has adopted an understanding of modern internal control practices particularly in local agencies. According to the present legal construction of the United States, the local governments are responsible for designing internal control systems while being invested with the power to audit if the risks are encountered according to the Government Accountability Office (GAO) standards on governmental auditing. The GAO, along with state auditors, ensures that a local government has not failed to revisit its risks through designing effective internal controls and audits. The Governmental Accounting Standards Board (GASB) promulgates the accounting guidelines and financial reporting standards for state and local governments whereas the White House's Office of Management and Budget (OMB) sets the internal control standards for the use of federal funds. According to these standards, every local government official has responsibility regarding the condition of management controls. For example, a city management is responsible for setting up and maintaining an adequate system of internal controls. It is critical that management set the right tone at the top by clearly stating management's expectations for integrity, honesty, and impartiality; prescribing ethics code and conflict of interest guidelines; and periodically assessing whether appropriate controls are in place. Management, however, is accountable for the City Council which provides policies, guidance, and oversight. The Council asks departments questions about their controls. The City Auditor plays an important role in evaluating the effectiveness of control systems and contributes to the ongoing effectiveness of management controls by making relevant recommendations. Also, all other staff members are made aware of their responsibility to contribute to the City's management controls.

The subnational audit system in the United States is also unique. State auditors are assigned to oversee both state departments and some programs of lower-tier governments. For example, in Pennsylvania, the Auditor General of State, who is an elected official, leads a team carrying out performance and financial audits in the state departments. In addition, he or she initiates audit programs to ensure that pension plans established by municipalities for their police officers, paid firefighters, and non-uniformed employees are properly funded and that they are administered in compliance with applicable laws, regulations, contracts, procedures, and policies.<sup>10</sup> The State Auditor plays a dual role as the internal auditor of the State's operations and the external auditor of selected municipal programs. At the municipal level, the city usually has its own auditor.

In Philadelphia, a major Pennsylvania city, there is an elected city controller who has broad authority and responsibility for protecting the public's interest in the handling of the City's money. The Controller's Office performs annual financial and performance audits of every City officer, department, board, and commission and any agency receiving appropriations from the City. An annual financial audit and other reviews of the School District of Philadelphia are also performed, as are special audits whenever the Controller deems them necessary, or as requested by the Mayor. The Controller acts as internal auditor to the City's activities while becoming an external auditor to the school districts.<sup>11</sup>

As an elected official, the New York City Comptroller serves as the Chief Financial Officer and Controller of the city. The mission of the comptroller office is to ensure the financial health of New York City by providing periodic information to the Mayor, the City Council, and the general public. The

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<sup>10</sup> For more information, see <[www.auditorgen.state.pa.us](http://www.auditorgen.state.pa.us)>

<sup>11</sup> For more information, see <[www.philadelphiacontroller.org](http://www.philadelphiacontroller.org)>

Comptroller advises on City programs and operations, fiscal policies, and financial transactions. In addition, the Comptroller manages pension funds; performs budgetary analysis; audits city agencies; oversees budget and contract authorization and prepares warrants for payment. The Comptroller's office involve a great number of staff including accountants, attorneys, IT analysts, economists, engineers, budget, and financial and investment analysts.<sup>12</sup>

In *Sweden*, the mandate of auditors is regulated in national legislation and in local regulations like the Local Government Act and the Companies Act. In local governments (municipalities and county councils), the ultimate decision-making powers are exercised by the assembly while responsibility for preparing matters and for administration and execution rests with elected representatives in committees and assembly drafting committees. Auditing is the assembly's instrument for inspecting the activities of committees and assembly drafting committees. The Local Government Auditing Inquiry (1998) emphasizes that auditing is the instrument of the entire assembly and that the citizen's priorities should be its primary focus. The assembly elects the auditors for a period of four years. All auditors fulfil their individual mandates independently. The auditors' inspection and determination should follow "generally accepted auditing standards in local governments," which are published by the Swedish Association of Local Authorities and the Swedish Federation of County Councils (Swedish Government Official Reports, 2004).

In *France*, the Decentralization Law of 1982 assigned a new court, the regional audit chamber, to be responsible for *ex post* auditing of local authority accounts. This court's duty is to verify accounts of public accountants of these territorial communities and their public institutions; review management of these communities as well as the management of their public institutions, which directly or indirectly depend on or receive financial assistance from them; and help in verifying budgets of communities and their public institutions through advice, formal notice, or proposals under certain circumstances and according to procedure set by the law. In terms of management controls, the court has the power to control management of communities or local public bodies. It verifies whether there are any irregularities in the management by expenditure sanctioning authority or the managing authority, and it also verifies the efficiency of management. However, the French model does not necessarily entirely fit into the modern definition of internal auditing in local governments. Rather, the audit chamber acts like a miniaturized court of accounts for that region.<sup>13</sup>

In New South Wales (NSW) of *Australia*, the Independent Commission against Corruption (ICAC) found that 80 percent of general managers considered that internal audit was important. However, the same research found that only about 20 percent of councils had an audit charter, internal auditor, or audit committee as of 2001. The Local Government Act, Local Government (Financial Management) Regulation (1999), and the Local Government Code of Accounting Practice and Financial Reporting establish requirements for financial audit. State Government agencies are bound by Section 11 of the Public Finance and Audit Act 1983 requiring the establishment of a system of internal audit where practicable. The NSW Treasury has also issued a supporting Best Practice Guide-Internal Control and Internal Audit in June 1995. In the Victoria jurisdiction, the Local Government Act 1989 included the requirement for councils to have Audit Committees. Audit Committees should comprise at least three members, including two who are not members of the council. The guidelines require council to have and review the Internal Auditor's Charter, qualifications, and resources; have an approved audit plan; and monitor management's response to audit reports (NSW Department of Local Government, 2005).

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<sup>12</sup> For more information on the NYC's Comptroller Office, see <[www.comptroller.nyc.gov](http://www.comptroller.nyc.gov)>

<sup>13</sup> For more information on the mandate of the regional audit chambers, see <[http://www.intosaitaudit.org/mandates/mandates/Mandates/France.html#France\\_H6](http://www.intosaitaudit.org/mandates/mandates/Mandates/France.html#France_H6)>.

In the *United Kingdom*, the “Code of Practice for Internal Audit in Local Government” was issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) in 2000. CIPFA updated the code and released a consultative report in 2003. Major accounts and audit legislations require that all principal local government organizations in England, Wales, Scotland, and Northern Ireland should make provision for internal audit in accordance with the Code of Practice. Internal auditors of local governments are appointed by the Audit Commission, an independent public body responsible for ensuring that public money is spent economically, efficiently, and effectively in the areas of local government, housing, health, criminal justice, and fire and rescue services.<sup>14</sup>

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<sup>14</sup> For more information on the role of the Audit Commission, see <<http://www.audit-commission.gov.uk/>>



## ***ANNEX II: Establishing Effective Internal Control in Local Governments***

Not all local agencies have the capacity and professional staff to undertake the primary responsibilities associated with internal controls. Many local governments are struggling to cope with ineffective budgetary processes along with out-dated accounting and planning techniques. Variations in the size of local organizations present different obstacles toward building effective local government internal control systems. For example, local governments in major cities seem to be more prepared to engage in modern internal control practices and procedures since they have greater access to revenues with stronger capacity. Smaller local governments (measured in total financial capacity and population) continually grapple with basic problems such as unsustainable revenues and budget deficits, unpaid public employees, and indebtedness. Major metropolitan governments can shift more readily to full-framed internal control systems, while relatively smaller ones may be capable only of a certain system upgrade level. Regarding small, local governments that are unable to build effective internal control systems, an alternative can be considered. For example, a local agency with no or few budgeting personnel may consider unifying its control procedures with a neighboring local authority facing similar shortcomings. Employing a group of accounting officials and internal auditors jointly may help to reduce burdensome personnel costs.

Below, we present a straightforward, five-step strategy for creating internal control systems in a local government.

### ***Step 1: Understand the current structure***

A local government must first review the control system currently in place. A detailed analysis of what does and does not work within the existing administrative and financial (budgetary and accounting) processes would provide useful hints for the next steps. In brief, some of the typical problems that contemporary local government organizations face are: (1) lack of clear objectives and organizational goals; (2) lack of, or ambiguous, legal framework governing the control structure; (3) lack of ethical integrity rules and professionalism; (4) pervasive individual misconducts; (5) high risk of fraud, misuse, and waste; (6) inefficient accounting and cash management; (7) lack of existing accountability systems, which lead to clutter and delay in major projects; and (8) inertia and lack of motivation. Perceived risks and monitoring procedures also need to be included in the assessment. Such extensive work usually is done by a professional consultant who is hired by the local government in question.

### ***Step 2: Design a control framework***

According to the weaknesses and strengths indicated within the preliminary analysis, an appropriate control framework needs to be designed. Improvising a proper structure is certainly challenging and requires advanced knowledge of financial management. However, a local government can adopt a ready-made control assessment design by making minor adjustments to the generally-accepted internal control guidelines. The COSO's "Internal Control-Integrated Framework"<sup>15</sup> and the INTOSAI's guideline for internal control standards have been recognized as the most common in both defining and evaluating internal controls. The two guidelines commonly provide a clear-cut framework consisting of five interrelated components: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

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<sup>15</sup> The United States Sarbanes-Oxley Act in 2002 requires organizations to adhere to internal control adequacy, with serious consequences for noncompliance. The United States Securities and Exchange Commission, accountable for enforcement of Sarbanes-Oxley, recognizes only the COSO framework as an acceptable model for control.

*Control environment*, the foundation for all other components of internal control, provides discipline and structure. It incorporates ethical values, management's tone (willingness) and operating style, and the hierarchy of authority (the level of interaction among the managerial layers). *Risk assessment* refers to the ability of an organization to address relevant risks in order to achieve stated objectives. *Control activities* are the policies and procedures that help to ensure that management directives are performed properly. They include a wide range of activities like approvals, verifications, and reviews of operating performance. It is important that pertinent *information* must be identified, captured, and communicated in a certain form that enables staff to perform their responsibilities on a timely basis. An effective communication stream with internal and external parties also is a key factor. *Monitoring* is a way of assessing the quality of the system's performance over time. It requires that the flaws in internal control should be reported upward to the top management. This responsibility is partly addressed by the internal auditors. However, after decisions are made, the management must perform ongoing monitoring.

The central government can play a role in setting the standards of internal control and monitoring the implementation by local governments as is in the United Kingdom. This achieves a certain level of standardization for local governments; and makes easier for external oversight to evaluate the effectiveness and efficiency of internal control systems.

### ***Step 3: Prepare/Revise the legal framework***

Existence of a strong legal basis in local governments also is pertinent per the need to clearly define duties, responsibilities, policies, processes, and objectives. A clear definition of the main mission, responsible parties, and authorities and responsibilities would help to streamline internal control. A cohesive legal framework also enables the management to compare results to the intended objectives.

The proposed legislation should particularly include the designation of related financial actors and their responsibilities. Three significant actors for control activities are the authorizing official (senior manager or his/her deputies), program manager (department heads or project managers), and accounting officer. The *program manager* proposes an activity (e.g., purchase, procurement, and consultancy payments), the *senior manager* clears the demand (or signs the proposal), and finally the *accounting officer* makes the payment from the related budget allocation. This is called *segregation of duties* in financial management and denotes the fact that each actor cannot assume any responsibility of the other two.<sup>16</sup> Some instances, however, include other individuals such as procurement officer or procurement committee members; and they occur between the program manager and the senior manager in terms of the decision-making hierarchy. The senior manager, in any case, is empowered to veto of the requested purchase. In local governments, the top official (mayor, governor, or secretary) typically is designated as the senior manager. Yet the authority is often delegated to an individual in the next lower tier.

### ***Step 4: Explore the instruments to practice internal control***

Although modern internal control is more of a permeated duty in all layers of government, tangible tools are still required. The common practices of control suggest several modalities that might provide some practical instruments such as physical checks, accounting checks, and horizontal checks. As such, staff who are in charge of control processes undertake regular checks on the goods and removable items owned by the entity: this process is called *physical checks*. Physical checks help to ensure

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<sup>16</sup> The European Commission has elaborated the "principle of segregation of duties" within a framework for Financial Regulation (No 2343/2002; 23 December, 2002).

that the organization's property is used appropriately. In many instances, each individual unit is required to maintain an inventory of public properties to account for all items. A discovery of a missing item may cause both a disciplinary measure and/or reimbursement by the responsible person for the loss endured.

Governments are expected to improve double-checks on accounting activities. Engaging in fast-flowing financial activities might make some public accountants and cashiers vulnerable to quantitative errors in the accounts. Indeed, checks are not always cashed in the right amount, cash receipts may be unrecorded, and payments may not be posted to the right person. A strong internal control system with coherent *accounting checks* enables the accountants and managers to rely more on the existing data and records in managing the programs.

*Hierarchical controls* similarly provide a powerful tool to make sure the responsibilities are handled in accordance with policies and procedures. These controls help to build a bottom-to-top trust with functioning communication among managerial levels while it diminishes the opportunity for corruption and misuse. Likewise, some activities require cooperation among different operational departments. The counter-controls, in this case, are called *horizontal checks*, which enable managers to correct intentional or unintentional errors. In a construction project cycle, for instance, as a capital management unit oversees the progress of the construction, the contractor's entitlements are sent to the accounts payable with a clearance. If the accounts payable assessment considers the payment request improper, it might need either to deny the request or to return it to the constructions unit for a careful re-examination.

Finally *internal audit* emerges as a sound safeguard to ensure the internal controls are effective and to give accurate guidance to the management.

#### ***Step 5: Implement the proposed framework***

Implementation is unquestionably the most significant part of an internal control action. It takes unrelenting sustainability, leadership, patience, and devotion. It requires the internal control to be owned by those who have a decisive influence upon it. Namely, executive bodies, legislative, and taxpayers play a role in this ongoing process; legislative bodies cannot be considered in isolation from the executive bodies. Legislative bodies are meant to give guidance to the management while being in charge of establishing the legal framework.

### ***Annex III: Starting from Scratch: Building an Audit Unit in Local Government***

Establishing an audit body does not need to open a “Pandora’s box” of unknown issues. Yet it is important to answer some critical questions in the process of audit formation. For example, one needs to know where to start and what to do, how to organize audit work and its scope in a local government, and how to build the necessary integrity and independence criteria. The following analysis demonstrates the requirements of instituting internal audit in a local government.

*A straightforward agenda:* Having a clear agenda mandated by a decisive political driver is a significant feature when assembling an audit body. As such, a local government is often given an agenda in connection either with the external pressures (e.g., a mandatory regulation of central government, budgetary requirements, and donors’ recommendations) or with interior demands (e.g., locally-adopted legislations, updates in accounting and budgetary policies, and political executives who are eager to reform public services). Proposed policy changes that work best encapsulate not only internal auditing elements but also the related compartments of accountability like sound control environment, risk management, monitoring, and transparency. Success would be more likely if the mandate is owned by a powerful executive.

*Legal Framework:* An audit charter needs to be put into effect by the authorized body like the city council or executive board. The charter should (1) provide simple definitions for internal audit, objectives, mission, operations to be audited, the meaning of chief executive officer and auditors, status, duties, and responsibilities; (2) clarify who will have the authority upon the budget of internal audit unit; (3) explicate the methods to be pursued in appointing a chief auditor and individual auditors; (4) make clear the qualities and professionalism required for the internal auditors; (5) outline auditing standards and certification processes; and (6) name and explain the types of audit and audit reports, scope of audit, audit schedule, records, and the authorized bodies who will be receiving and following up on the audit reports. As it is for internal control, the MoF (or Treasury or External Auditor) might play a role in setting the framework and monitoring its effectiveness in order to achieve uniformity of audit standards across the country.

*Chief Auditor:* An experienced person who has qualities that fit the charter should be appointed as the independent chief auditor by either the executive board or the legislative body. The chief auditor ensures that ordinances are in place to administer the internal audit standards, ethic rules, and audit work. He or she ensures that internal auditors are hired, that they operate in accordance with these regulations, and that audits are conducted as they are explicated in the charter. Audit results are communicated via the chief auditor to the senior management for addressing the advised reinforcements. The appointment and removal of the chief auditor by an executive should be subject to legislative confirmation to negate any partisan influence on his or her independence.

*Independence:* The senior management and local politicians should not interfere with any decision on hiring and firing of internal auditors and the scope, design, and areas of audit work while all of these are subject to the legislative body review. Internal auditors should be invested with a full, free, and unrestricted access to all records of finance, personnel, contracts, documents, and reports. The management should develop a rapport with the audit unit to negotiate, if necessary, the audit results. An open support proclaimed by the management (perhaps an internal circular) that delineates employee behavior regarding the audit work and audit results might be a great help. While the independence of audit is assured with a legal statute, it really is a matter of time for the audit culture to be completely settled into and absorbed within an organization.

*Audit Committee:* In some instances, an audit committee would exist to consult with the chief auditor regarding the audit results and follow-up with reinforcements. The committee assists in facilitating communication and audit results between the executive and the chief auditor. Further, the executive may have special requests from the internal audit to identify pitfalls and shortcomings in a particular program; and the committee assists in voicing such requests. The audit committee preferably includes representatives from the senior management, budgetary and accounting officials, legislative, and the head of internal audit. Members of the committee, therefore, should be assigned by the legislative body, and at least one member should be appointed from members of the legislative body.

*Audit scope and work:* The auditors should be mandated to perform compliance, financial, and performance audits in all departments, offices, activities, and programs of a local entity. Limitations on this scope would undermine the effectiveness of internal audit and cripple the expected outcomes from it. Thus, the audit should cover all programs regardless of internal boundaries or geographical restrictions; and the internal auditors should be able to conduct audits not only in the headquarters, but also in chapters, subsidies, government-run enterprises, and related agencies.

#### ***Annex IV: Basic Elements of Internal Audit***

In its “International Standards for the Professional Practice of Internal Auditing,” the IIA states: “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 objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes” (IIA, 2005). Jack Diamond argues that this broad view of the IIA’s role certainly places it more centrally as an important element of public financial management. Moving beyond a narrow compliance standpoint, this renewed approach embraces a wider definition of internal control, with more emphasis on management controls and information and communications processes (Diamond, 2001).

This broad definition strikes initially at four critical points that demand further explication: (1) independence, (2) objective assurance, (3) adding value, and (4) a systemic, disciplined approach.

*Independence:* According to Cecilia Norton, “Internal audit must contribute positively to the management, while at the same time not becoming its servant but faithfully report on the status to the board or other equivalent governing body” (Van Gangesberghe, 2005:1). Audit should be isolated from any intervention posed against its objectivity. Such threats may stem from a variety of resources such as political or administrative pressures to reduce the ability of auditors or to change the course of a particular audit. And the threats might come under different forms such as budget reductions, limited supplies and facilities, and dismissal from the office. A concrete audit charter to bind all parties strictly is considered the most effective way to reduce the outer influence on audit. Similarly, personal misbehavior (e.g., misuse, graft, and bribery) undoubtedly can impact the audit’s independence and objectivity. A code of ethics, therefore, is indispensable to the internal audit in providing a safeguard against such illicit actions.

The IIA points to an organizationally-independent internal audit for privately-held entities governed by an executive board and run by a chief executive officer (CEO). In this sense, internal auditors are obliged to report to the CEO, who will reinforce the recommendations; however, the board—and not the CEO—holds the power to hire, fire, and administer the internal auditors and the audit work.

In public sector institutions, the organizational structure of internal auditors represents variations that highlight two outstanding issues regarding objectivity: statutory independence and budgetary independence. Driven by ideology and efforts to avoid corrupt behaviors, senior management often becomes eager to intervene in the audit reviews, the scope of work, and the results. To avoid such attempts, the status of internal audit should be adjusted to carry out its function effectively. The chief auditor should hold an adequately powerful position to be isolated from such influences. The chief auditor is given responsibility to facilitate the effective discussion and negotiation of the results of internal audit with the senior management. He or she ensures that the audit results are reflected in the managerial action. Also, the chief auditor is obliged to take measures to keep individual auditors from getting involved in any managerial operations, biased reviews, and the potential for conflict of interest. The chief auditor prepares the annual work schedule to make sure that no internal auditors are embedded in a particular department for an extended timeframe that might compromise the arm’s length relationship.

A second concern is related to the budget of internal audit unit. So long as it is subject to legislative oversight, the amount of funds allocated to the audit unit should be determined by the unit itself rather

than any other service level. Otherwise, any management that feels threatened may exploit budget-making power as a way to limit the scope and effectiveness of audit work.

*Objective assurance:* While evaluating the organization's programs, systems, and processes, the internal auditor is required to deliver an audit report that has a precise conclusion based on robust evidence. An internal auditor is bound to the organization's legal framework, objectives, and performance criteria in order to assess available evidence with an appropriate methodology and to provide a written assessment. An auditor can rely on common sense to reach a concrete conclusion where inadequate evidence exists. However, the auditor should remember that he or she is neither a prosecutor to arraign someone nor a judge to reprimand an illicit act. Instead, the auditor needs to consider whether the public money has been or is being used in accordance with the performance framework and legal statutes. The audit engagements normally involve three parties: (1) auditee, or person/s who have a degree of responsibility regarding the activity in question; (2) auditor, or person/s assessing the activity in question; and (3) senior management, or person/s who require to appeal to the written audit assessments (IIA, 2005).

*Add value:* Internal audit is intended to provide value to the organization by improving opportunities to meet the organizational objectives, by identifying operational improvements, and by mitigating the risks through objective assurance. Evolving features of internal auditing have brought some modifications to the definition of added value. For example, in a traditional approach, savings from the loss endured in public programs—or plugging the hole—has been a fundamental goal *vis-à-vis* the present where delivering services effectively, efficiently, economically, and ethically have emerged as primary goals.

*A systematic, disciplined approach:* Internal audit is carried out in a way that, with some exceptions, produces similar conclusions for similar engagements and actions. Audit services need to be protected from personal bias and guided by the audit standards. Because there are similar types of irregularities and misconducts worldwide, IIA became the first to publish audit standards in 1978 in an effort to streamline the process of evaluating entities. Some countries have followed up by issuing government auditing standards, such as the GAO in the United States. This effort is commendable since a unified method used in governmental auditing enormously helps to facilitate public program assessment by explaining the means to be applied and the ends to be achieved. As per the local authorities, having internal audit guidelines is essential to helping assigned auditors who are struggling to understand from what point to start in an engagement and how to handle the financial and performance audits.

### ***Annex V: Importance of Risk Management***

An effective internal control cycle is a dynamic process within which the administration should be continuously alert in order to address the arising risks and issues. Risk assessment is therefore central to internal control as it enables the management to identify and mitigate potential risks. Without recognizing perceived risks, the financial management system of a local government would remain vulnerable to both external circumstances (e.g., economic shocks, devaluation, high-inflation, and policy changes by central government in taxation or in the transfers' formula) and internal conditions (e.g., budgetary deficits, irregularities in earmarked funds, poor pension funds management, over-borrowing, and overspending in capital projects). Characteristics of risk vary from one set of circumstances to another. However, there are commonly acknowledged risks that may arise in any type of public organization such as corruption, misuse, fraud, systemic and individual errors, waste, mismanagement, inefficiencies in budget and accounting, unreliable financial records, inadequate ethical values, insufficient managerial oversight and monitoring, and various failures in exercising budgetary power and in generating reliable information.

In addressing potential risks, the INTOSAI's guideline (2004) for internal control standards proposes a four-phase risk assessment model: (1) identify the risks, (2) evaluate the risks, (3) assess the risk appetite,<sup>17</sup> and (4) develop responses. The model reflects actions for identifying and countering risks; it also reflects actions for detecting and fixing deficiencies within the internal control system. Risk management, therefore, plays a secondary but still important role for developing the right internal control mechanisms.

A precise response for negating harmful impacts is appropriate in a sound risk assessment system. The response varies from eliminating the risk and its causes, to treating the risk, and to tolerating it to a certain degree. After all, it is the management's responsibility to determine (1) the severity of a risk, (2) the organization's desire to mitigate the perceived risk, (3) the magnitude of the response, and (4) the scope of pre-emptive actions for future risks.

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<sup>17</sup> Risk appetite is "the amount of risk to which the local government entity is prepared to be exposed before it judges action to be necessary." (INTOSAI, 2004)



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