



# INTERNAL AUDIT OF ENTERPRISES IN THE PUBLIC SECTOR

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- ▣ *The process of the public internal financial control reformation in Ukraine, introduction of the European model of risk-oriented internal control, its elements and internal audit in enterprises of the public sector are studied.*
- ▣ *Internal control, internal audit, public sector, internal control system, competency management.*

## ВНУТРІШНІЙ АУДИТ УСТАНОВ СЕКТОРА ДЕРЖАВНОГО УПРАВЛІННЯ

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- ▣ *Досліджено процес реформування державного внутрішнього фінансового контролю в Україні, впровадження європейської моделі ризик-орієнтованого внутрішнього контролю, його елементів та внутрішнього аудиту в установах сектора державного управління.*
- ▣ *Внутрішній контроль, внутрішній аудит, сектор державного управління, система внутрішнього контролю, ефективність управління.*

## ВНУТРЕННИЙ АУДИТ УЧРЕЖДЕНИЙ СЕКТОРА ГОСУДАРСТВЕННОГО УПРАВЛЕНИЯ

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- ▣ *Исследован процесс реформирования государственного внутреннего финансового контроля в Украине, внедрение европейской модели риск-ориентированного внутреннего контроля, его элементов и внутреннего аудита организаций сектора государственного управления.*
- ▣ *Внутренний контроль, внутренний аудит, сектор государственного управления, система внутреннего контроля, эффективность управления.*

### Abstract

In July 2012, the experts of the World Bank and the European Union have presented the Report on Effectiveness of the Government Financial Management in Ukraine. According to the appraisal, «the Ukrainian system of government financial management demonstrates the weakest indicators for internal audit in spite of very strong and powerful system of inspection and verification, and traditions of control. The internal audit is focused on the analysis of the system and effectiveness of controls in this regulatory system. Exactly this direction is developed insufficiently in Ukraine. I. Bizli, expert of the EU, has recommended «to think how exactly the internal audit system has to be reformed to make it effective».

No matter how we think about external evaluation of economic development of the country, records of the recognized international experts as to real condition of the government financial management have considerable influence on perception of our state in the

world. Therefore, an issue as to development of audit and control in the government finance system becomes urgent for the specialists and researches in this field.

### **Analysis of recent researches, earlier unresolved problems, formulation of goals and summary of basic material**

A monograph of Volodymyr Shevchuk «Control of Economic System in the Society with Transition Economy» published in 1998 became the first substantial research in the sphere of modernization of the state control function amid the building of market-based economy. In our opinion, up to this day it remains the most powerful scientific work as to the role and the ways of control development in Ukraine. Separate directions of realization of control function both in the area of the public financial control and independent audit were developing next. Such concepts as internal control, in-house control and internal audit became a subject of researches on numerous doctoral and candidate's dissertations.

The specialists, who adapted many global provisions on the state audit during generalization of the practice of control, obtained considerable results in the researches (I. Stefaniuk, N. Ruban, and O. Chechulina). In the part of researches related to the state internal audit, publications of experts such as T. Baidashnikova, A. Krivchenkova, A. Liubys-Rodchenko, and R. Rudnitska are mainly dedicated to the comments of regulatory documents in force or analyse debatable provisions of these documents.

In our opinion, reformation processes of the public internal control in Ukraine require not only implementation of the European approaches as to control function based on traditional native works on revisions and inspections, but modification of the basic nature of well-known concepts towards setting of new tasks for effective management objectives. The problem lies in the fact that external understanding of importance of development of risk-oriented internal control system of enterprises of the public sector and introduction of the internal audit service as a new (by its content) element of internal control based on the European model is not correlated with the needs of management itself. A traditional request of senior managements remain at the level on information on legality of financial and economic activities of subordinated enterprises, but not their aspiration for receiving independent evaluation of competency of management itself.

The article is dedicated to a search for consensus between implementation of traditional instruments of in-house control reformed based on the European model of internal audit on the basis of risk assessment and performance of tasks related to competence management evaluation in order to improve it.

Since January 1, 2012, in-house control of enterprises in the public sector has started to work based on new organizational and methodical norms. The forms of control, controlled objects and overall results of control (audit) activities have undergone substantial changes in the result of reorganization of control and auditing units into the units of internal audit [3,4].

New approved documents such as Resolution of the Cabinet of Ministers of Ukraine No. 1001 and Internal Audit Standards were adopted based on global standards that define construction of effective control function at management in the executive authorities or over the state-owned enterprise. Provisions of Article 26 of the Budget Code define clearly the obligation of introduction basic components of the European model of the PIFC – internal control and internal audit in the public sector bodies [1]. However, adoption of these documents does not mean

that absolutely new procedure of in-house control for the general government is introduced. By analysing adopted documents, it is possible to distinguish, in the first instance, new concepts, categories that the experts – auditors and executives – have not faced in their practice yet. Secondly, terms and requirements, which have new names, are well-known practice of the internal control essentially. Therefore, it is important to understand and to assess new standards of the approved documents in order to use them correctly.

Introduction of efficacy of internal control and internal audit through harmonization based on RESPONSIBILITY of a manager became the first and important concept, which could be named as ideological base for reorganization of control function.

Opposite to Ukraine, where the concept of responsibility is understood traditionally as a punishment for committed violation, this term is interpreted in the developed democratic countries as responsibility for that an organization reaches the appropriate level of economy, effectiveness and efficiency in compliance with determined tasks, i.e. the internal control system works according to these principles (appropriate level of accounting, financial discipline are ensured as well as process cost is estimated reliably, goals are defined correctly and risk control system is established); an organization ensures authenticity of financial, statistical and management accounting; guidelines and rules established by the legislation and management are performed [5, P. 12].

A manager bears general responsibility for development, formalization, implementation and monitoring of the internal control system (hereinafter referred to as «ICS»).

Thereby each employee plays important role in provision of internal control efficacy. However, a manager bears general responsibility for the internal control system and it cannot be delegated.

At the same time, internal control should cover all organization activities, it means that its organizational and functional structure must ensure separation of powers and responsibility between lower level managers and individual employees of the organization [6].

It could be objected – wasn't a principle of management responsibility realized earlier, or wasn't each fair manager aspired for building of effective internal control?

It is worth to mention the following as an answer: each manager was building the internal control system either based on traditional scheme available in the ministry or department, and, perhaps, it was effective, but only during social economy period,

or based on own opinion and understanding. Now new European norms require new approaches for internal control building, and these approaches take into consideration market competitive environment in which all organizations of the public sector are. These requirements have been adopted for the public sector managers in Ukraine in 2005 in the Concept for Development of Public Internal Financial Control up to 2017 and approved by Resolution of the Cabinet of Ministers of Ukraine of 24.05.2005 No. 158 [2].

This document represents a «road map» for the managers of organizations, which should organize the ICS based on mandatory elements defined in the Concept.

What are these elements and why do they become important now?

First, let us to describe the elements of internal control system specified in the Concept No. 158 – these are five (5) interdependent components such as control environment, risk assessment, control activities, information and communication, and monitoring. They were taken based on effective international standards and guidelines as to organization of internal financial control in the public sector. They were developed by the Institute of Internal Auditors (IIA) and INTOSAI (International Organization for Supreme Audit Institutions).

The above-mentioned five (5) elements of the ICS represent the COSO model known well among foreign experts; it was developed for the private sector and it is considered the most widespread for management of the enterprises. At present, this model was improved and consists of eight (8) elements (COSO II model) [5, P.17]. The component «risk assessment» in COSO I was divided into three (3) elements in a result of modification such as «event identification», «risk assessment» and «risk response» (or risk management).

Addition to the ICS's elements had place not only due to the achievements in the field of internal control, but the necessity to overcome financial problems which the world is facing.

The key focus of new COSO model is to provide a manager with recommendations as to necessity to define a list of events (risks) that may affect the achievements of strategic, tactical and operating objectives of an organization. Prioritization of these events helps the management to turn extra attention to the risks that require proper response and improvement of existing or development of new control activities. Therefore, the COSO I (or COSO II) is considered as a tool of risk management in the internal control system without which competent management under market conditions is impossible.

Therefore, the Concept No. 158 defines for all public sector managers a kind of the internal control system must be in the ministry, or department. This provision became important and topical just nowadays because Resolution No. 1001 has established new direction of control for the internal audit units – evaluation of ICS functioning effectiveness. This direction is determined as the key and most important.

At the same time, we would like to underline that assessment by internal auditors not of any existing ICS in the ministry or department, which was built based on the best local traditions, but assessment of organizations and functioning of five elements based on COSO I (specified in the Concept No. 158). Global standards assume only this control function to be effective in the public sector, because due to its elements interaction it is able to prevent risks and threats of market environment and to perform tasks effectively to achieve goals of organization activities.

However, based on analysis of regulatory framework and ministerial and departmental orders, the overwhelming majority of managers did not establish the ICS in the form discussed above.

Therefore, the majority of ministers, departments have faced today the same problems of implementation of internal audit function, which the European countries were overcoming during similar reformation of control. For example, when such reformation of the public internal control was taking place in Hungary, which started in 2002 with adoption of the appropriate law, first methods for internal audit were developed and practical implementation of new profession «internal auditor» began.

Simultaneously, existence of certain mistakes at the stage of implementation of internal audit functions had caused gaps in establishment of proper system of internal control which efficacy internal audit must evaluate. At the beginning of reforms, the main attention was concentrated on the functions of internal audit while proper implementation of internal control was not carried out.

In consequence of this, newly established services of internal audit did not have a field for activity and they were forced instead of carrying out evaluation of effectiveness of existing internal control system in the public sector bodies to build it themselves at the first stage.

Therefore, the focuses were shifted further on – standards and manuals for internal control were developed as well as educational programs on internal control and internal audit. At present, formation of internal control and internal audit in Hungary is carried out in parallel. The same

problems were seen in Poland, Croatia and other European countries. We shall be also involved in resolution of the same issues.

Since January 1, 2012 the principal of INDEPENDENCE of an internal auditor became the second important category in in-house control functioning at development of the internal audit unit. The idea of this principal is described in detail in Chapter 3 «Internal Audit Standards».

Historically, an internal auditor acted as an «internal auditor» which served a manager by carrying out audits in order to detect any errors and violations, and to implement the powers of influence. Pursuant to new European approaches, an internal auditor is considered, first of all, as a manager's adviser in terms of effective and rational use of assets, which is achieved by a manager through the functioning of all the elements of the internal control system, but not only through an instrument of errors detection and implementation of administrative discipline and punishment of the subordinated.

Indeed, as it is stated in the Internal Audit Standards [4], basic task of the internal audit unit is to provide a manager of the organization with objective and independent conclusions and recommendations with regard to:

- functioning of the internal control system and its improvement;
- management system improvement;
- prevention to the facts of illegal, ineffective and inefficient use of budget assets; and
- prevention to rise of errors or other shortcoming in the organization activities.

However, realization of independence principle and establishment of new interrelation cannot happen suddenly (for example, on the night of January 1, 2012 when Resolution No. 1001

became effective). Professional formation of high expert behaviour requires tremendous forces from internal auditor to master, to understand new knowledge and approaches of new profession. Realization of standards specified in the foregoing documents requires perception of these actions by the management of the ministers, departments, their units, and governmental authorities.

### Conclusion

Reformation of the internal financial control of enterprises in the public sector which is carried out in Ukraine based on implementation of the European standards of construction requires understanding in viewpoint of practical execution of traditional functions of control along with new functions related to assessment of management competence and efficiency of performance of government tasks imposed on an enterprise.

New concepts that were not used previously in regulatory documents related to the public sector control determine new directions for performance of control work by the internal audit units, in particular, performance audit, financial audit, and responsibility audit. Other rules are introduced now for presentation of the results of such audits as well as for audit report drawing up (3 kinds of report are assumed), planning based on risk assessment, monitoring carrying out, materiality guideline calculation, realization of the program for audit quality assurance and improvement etc. Some of these concepts are known well and used in the practice of internal audit of private enterprises. However, their implementation in the context of peculiarities of the public sector institutions activity has tremendous differences, which require adaptation and substantial researches.

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