ABSTRACT. There is no common requirement guiding the approaches taken by the European Union (EU) public sector internal audit cooperation with external audit. Relations between these audit systems have developed over time. There are countries with mandatory regulations of internal and external audit cooperation, in some cases cooperation bases on initiatives, to facilitate the auditing process and avoid duplication of work. The aim of this research is to compare the Latvian public administration internal audit and external audit cooperation approach with approaches of the European countries and evaluate each country’s internal audit relation with external audit. The methodology includes a comparative study of European countries’ public sector internal audit and external audit cooperation from European Union Compendium report, researchers’ reports, the existing normative acts, analysing cases and other scientific findings. The main results of the study will highlight where improvements might be required or where changes are necessary.

KEY WORDS: internal, external audit, public sector.

INTRODUCTION

Many entities establish internal audit functions as a part of their internal control (International Standard on Auditing (ISA) 610). ISA 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor’s understanding of the entity and its environment and identification and assessment of risks of material misstatement. International standards for the professional practice of internal auditing standard 2050 - Coordination “The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts”.

A very important question/problem is how can internal auditors and external auditors work together better for a more productive and efficient external audit within the constructs of the requirements of country government?

The aim of this research is to compare the Latvian public administration internal audit and external audit cooperation approach with approaches of the European countries and evaluate each country’s internal audit relation to external audit.

The main results of the study will highlight where improvements might be required or where changes are necessary.

DISCUSSION

Explanations of International Standard on Auditing (ISA) are wider when compared with International Standards for the Professional Practice of Internal Auditing. In accordance with The International Standards on Auditing (ISA 610), “Using the work of Internal Auditors” we can find Requirements, Determining whether, in Which areas, and to What Extent the Work of the Internal Audit Function Can be Used to Provide Direct Assistance:

1) determining whether Internal auditors can be used to provide direct assistance for purposes of the audit;
2) determining the nature and extent of work that can be assigned to Internal auditors providing direct assistance.

Also we can find another statement in the ISA 610: “The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor’s use of the work of the internal auditors.”

Under this heading we find issues relating to the nature and scope of the work, objectivity of the internal audit function, timing and other practical matters (Bonicci, 2010).

According to the International Standards on Auditing (ISA 610), internal and external audit should complement each other the ‘modern’ approach to financial control aims at drawing assurance from internal audit. For this reason, it is important that linkages be developed between the external and internal audit functions, in particular:
1) Consultation concerning the choice of subjects to audit; minimising resource requirements and maximising impact; avoiding duplication of effort; exploiting synergies;
2) Ongoing contacts to secure greater insight for risk assessment and in decisions concerning stratification;
3) Assessing the potential for even closer cooperation of internal and external audit.

Internal audit plus external audit is not equivalent to a single audit, but to two complementary audit exercises, both intended to enhance the management of EU funds. They are two functions which can benefit from each other’s work. It is important to nurture closer linkages between the two so that this potential may be exploited while respecting each entity’s independence (Bonicci, 2010).

To ensure the effectiveness of an organisation’s risk management framework, the board and senior management need to be able to rely on adequate line functions – including monitoring and assurance functions – within the organisation. ‘Three Lines of Defence’ model as a way of explaining the relationship between these functions and as a guide to how responsibilities should be divided into:

1) the first line – functions that own and manage risk;
2) the second line – functions that oversee or specialise in risk management, compliance;
3) the third line – functions that provide independent assurance, above all internal audit.

As a third line of defence the **internal audit function** will, through a risk-based approach, provide assurance to the organisation’s management, on how effectively the organisation assesses and manages its risks, including the manner in which the first and second lines of defence operate (Guidance for boards and audit committees, 2010). Nevertheless, **external auditing** can be considered as a fourth line of defence, providing assurance to the organization’s management regarding independent view of the organization’s financial statements.

External auditors, regulators, and other external bodies reside outside the organization’s structure, but they can have an important role in the organization’s overall governance and control structure. This is particularly the case in regulated industries, such as financial services or insurance. Regulators sometimes set requirements intended to strengthen the controls in an organization and on other occasions perform an independent and objective function to assess the whole or some part of the first, second, or third line of defence with regard to those requirements. When coordinated effectively, external auditors, regulators, and other groups outside the organization can be considered as additional lines of defence, providing assurance to the organization’s shareholders, including the governing body and senior management. Given the specific scope and objectives of their missions, however, the risk information gathered is generally less extensive than the scope addressed by an organization’s internal three lines of defence (IIA, 2013).

“Although external audit and internal audit have some complementary relationships, coordination of their activities is essential. Internal audit’s evaluation of the internal control systems provide significant
information for the external auditor’s assessment of control/ risk affecting the financial statements. The ideal situation is when the external and internal auditors meet periodically to discuss their scope of work, methodology and audit coverage.”(Guidance for boards and audit committees, 2010).

The North American Pulse of Internal audit survey (102 auditors) was completed in November 2014; respondents in publicity-traded companies that reported experiencing somewhat or greatly increased scrutiny since 2013 are noted in Fig. 2. More than half of respondents said they anticipated an increase in the number of hours of their main functions, 38% expected the number of hours to stay the same, and 65% of respondents said that they expected an increase in audit fees but 29% expected the fees to stay at the same level (Interesting Roles…, 2015).

The reliance on an internal audit function from the point of view of external audit is determined by the following factors: objectivity of the internal auditor, competence and work performance in relation to financial audit related activities (Swinkels, 2012).

Independence of internal audit also involves clear demarcation of responsibilities in relation to external audit. There is a possible case for constructive cooperation (Diamond, 2002):

1) proper coordination, minimizing duplication;
2) access to each other’s plans;
3) periodic meetings;
4) exchange of audit reports;
5) mechanism to ensure common understanding and sharing of methods;
6) sharing of training, exchange of staff.

CASE STUDIES

Baltic States countries. External audit institution reflects traditional audit function. Unfortunately, there has often been confusion in the separation of roles of both internal and external institutions. While lines of reporting have been different – the Internal audit to the Ministry of Finance and external audit to the legislature – some overlapping functions are evident (Diamond, 2002). In different ways, all countries organize internal audit and external audit cooperation - meetings once a year in Latvia, in two levels in Estonia and with sharing audit experiences in Lithuania.

<table>
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<tr>
<th>Country</th>
<th>Internal audit and external audit cooperation</th>
<th>Legislation</th>
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<tr>
<td>Estonia</td>
<td>With National Audit Office in 2 levels: Ministries IA units and Ministry of Finance</td>
<td>2005- IA coordination service</td>
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<td>2006 – “Blueprint for the IA of authorities with executive power”</td>
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<td>2010 - Auditors Activities Act of Estonia, 2013</td>
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</tbody>
</table>
Country | Internal audit and external audit cooperation | Legislation
---|---|---
Latvia | The State Audit Office arranges meetings with IA once a year | 2002-2008 Internal audit law 2010- new Internal audit law and regulations-standards requirements 2013- last Internal audit law- improving the regulatory framework
Lithuania | Based on legislation. Sharing audit experiences | 2003 - Law on Internal Control and Internal Audit 2003- Standard Charter of IA Unit; IA methodology; IA guidelines
Malta | Informal cooperation | Internal Audit and Financial Investigations Act, Ch 461 updated in 2005, 2007
United Kingdom | Cooperation by sharing strategies, plans and working practices to optimize audit coverage and reducing the audit burden on the organization | 1960, 1970- changes 1980- Treasury established a central unit to oversee the quality and caliber of internal audit across government. The previous Government Internal Audit Standards have been superseded from April 2013 by the Public Sector Internal Audit Standards
Poland | Internal audit reports are available to external auditors, they should inform each other of any bad management or fraud | Since 2002 Act on Public Finance concerning public internal control was updated in 2005, 2006, 2009

Source: Author’s construction based on Compendium... (2014).

For this research the author chose the countries which were included in a previous research about internal audit methodology approaches for continuing research.

**Estonia case.** Internal and external audit cooperation with National Audit Office in two levels: Ministries internal audit units and Ministry of Finance.

**Latvia case.** Internal audit provides external audit with the internal audit unit’s strategic plan, annual plan and annual report. External auditors arrange meetings with internal auditors once a year, at which the detected shortcomings, audit priorities for the coming year and possible areas of cooperation are discussed. In 2013, internal and external auditors agreed on necessary actions to be taken to further improve cooperation.

**Lithuania case.** Cooperation based on legislation, sharing audit experiences, common training programs, joint meeting organized by the Audit Committee of parliament, cooperation agreement between different associations, established working groups dealing with development of the existing methodologies, internal control issues etc.

**Malta case.** Informal relations, auditors share information and working papers for evaluating the effectiveness of internal control. In evaluating the effectiveness of internal control, external auditors can use the work of internal auditors, sharing information about annual plans.

**United Kingdom case.** Internal audit and external audit are encouraged to cooperate by sharing strategies, plans and working practices to optimise audit coverage and reduce the audit burden on the organisation.

**Poland case.** The duty of cooperation is determined by normative acts, audits use Internal Audit Standards in the Public Finance sector Entities. Internal audit reports are available to external auditors, they should inform each other of any bad management or fraud, the head of internal auditors should avoid duplications for effectiveness.

European Union Compendium from 2014 shows that there are quite some differences, but overall relations between internal audit and external audit can be formal or informal relations, auditors use legislation or Standards, auditors arrange experience sharing.

The author suggests including internal and external audit cooperation procedures in a common internal audit procedures manual, usage of standards and guidelines for the public sectors in the EU Member States.

**CONCLUSIONS**

1. International standards for external auditors and internal auditors work define main principles for effective work and using of each other’s reports and information.
2. Relations between internal audit and external audit have to change and informal relations must be formal and mandatory on both sides.

3. Unfortunately, there has often been confusion in the separation of roles of internal audit and external audit. While lines of reporting have often been different – the Internal audit to the Ministry of Finance and external audit to the legislature - some of audit functions are the same in both institutions.

4. All countries organize internal audit and external audit cooperation in different ways – having meetings once a year in Latvia; in two levels in Estonia and with sharing audit experiences in Lithuania.

5. In evaluating the effectiveness of internal control, external auditors can use the work of internal auditors in Malta. Both institutions cooperate by sharing strategies, plans and working practices to optimize audit coverage and reduce the audit burden on the organization in the United Kingdom. Internal audit reports are available to external auditors, they should inform each other of any bad management or fraud, the head of internal auditors should avoid duplications for effectiveness in Poland.

6. There are not a great deal of differences, but overall relations in six European countries between internal audit and external audit can be formal or informal relations, auditors in all six European countries use legislation or Standards, auditors arrange experience sharing.

7. Author suggests including internal and external audit cooperation procedures in a common internal audit procedures manual, usage of standards and guidelines for the public sectors in the EU Member States.

8. Latvia and all these countries need to focus on the good things that they have done and learn from them, countries need starting cooperation between the countries to have a set of EU Standards for the Public Sector.

LITERATURE


10. International standard on Auditing ISA 610 (Revised 2013), Using the Work of Internal Auditors and Related Conforming Amendments. IAASBM March, p.22.


