Executive summary of the public audit report

ARE THERE CONDITIONS IN PLACE FOR THE EFFECTIVE FUNCTIONING OF THE INTERNAL CONTROL SYSTEM IN THE PUBLIC SECTOR

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DEFINITIONS AND ABBREVIATIONS

The COSO model – a comprehensive framework for internal control, developed by the Committee of Sponsoring Organisations of the Treadway Commission[1].

Institution – an institution engaged in public administration – a collegial or individual entity of public administration, authorised to pass normative administrative acts, or an establishment engaged in public administration – a state or municipal budgetary establishment, authorised to implement public administration[2].

INTOSAI guidelines – the INTOSAI GOV 9100 standard "Guidelines for Internal Control Standards for the Public Sector".

INTOSAI organisation – the International Organisation of Supreme Audit Institutions, which aids supreme audit institutions adapt to increasingly stricter requirements, and encourages the dissemination of experience and innovation in the field of audit[3].

Law – the Law on Internal Control and Internal Audit of the Republic of Lithuania of 10 December 2002 No. IX-1253.

ISPPIA – the International Standards for the Professional Practice of Internal Auditing, approved by the Institute of Internal Auditors[4].

Internal Audit Office, or **IAO –** a structural subdivision (unit or department) of a public legal person, established for the purposes of implementing internal audit in said legal person[5].

Internal control – a system of all types of controls, developed by the head of a public legal person to ensure the legitimacy, efficiency, effectiveness and transparency of said public legal person, as well as the implementation of strategic and other actions plans, the protection of assets, the comprehensiveness and reliability of reports and information, the compliance with contractual and other obligations to third parties, and the management of related risk factors[6].

Public legal person – a legal person engaged in the management, use and disposal of state and municipal assets[7].

Entities of the public sector – the state, municipalities, state resource funds (including the State Social Insurance Fund and the Compulsory Health Insurance Fund) and municipal privatisation funds, tax funds, state and municipal budgetary establishments, and other entities engaged in the implementation of public administration functions specified by the law[8].

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1 INTOSAI GOV 9100 standard "Guidelines for Internal Control Standards for the Public Sector", Page 1.

2 Law on Public Administration of the Republic of Lithuania of 17 June 1999 No. VIII-1234 (as amended by the Law No. XI-823 of 11 June 2009), Article 2, Paragraphs 5 and 6.

3 Available on the Internet at: https://www.vkontrole.lt/page.aspx?id=3.

4 As amended by the Law of 1 January 2013.

5 Law on Internal Control and Internal Audit of the Republic of Lithuania of 10 December 2002 No. IX-1253 (as amended by the Law No. X-806 of 14 September 2006), Article 2, Paragraph 6.

6 Ibid., Article 2, Paragraph 7.

7 Ibid., Article 1.

8 Law on the Accountability of the Public Sector of the Republic of Lithuania of 26 June 2007 No. X-1212, Article 2, Paragraph 23..

SUMMARY

The internal control system of the public sector is designed to determine and manage the risk factors of an institution, ensure that activities be implemented as intended, achieve common goals, function effectively and provide quality services of the public sector in a timely manner. An effective system of internal control aids both the heads and employees of institutions to achieve results in a consistent and strategic manner, and provide public benefits at an acceptable cost. In turn, this increases public trust in the public sector.

Internal control is not a separate process that exists alongside other activities of an institution. Rather, it is a dynamic and complex activity on the part of the employees and management, integrated into the functioning of the institution, and implemented by continuous adaptation to changes. It encompasses the key processes of management, namely – planning, implementation and monitoring. A system of internal control must be adapted to a particular institution and comprised of five elements: a control environment, risk-assessment, control activities, communication and provision of information, and monitoring.

Audits carried out by the National Audit Office in previous years have shown that institutions of the public sector fail to consistently ensure that results of their activities would create added value or lead to specific effects. Effective systems of internal control aid institutions in improving their results.

Accordingly, as a contribution to the improvement of the public sector, we have carried out a systemic audit to assess whether the conditions necessary for the implementation of an effective system of internal control are in place. During the audit, we have examined the following:

- the capability (or lack thereof) of legal regulation to provide the public sector with a basis for developing, maintaining and assessing an effective system of internal control;
- whether the methodological management and monitoring implemented by the Ministry of Finance, which encompasses the analysis of the state of financial control and the assessment of internal audit offices, contributes to the improvement of the system of internal control;
- whether the systems of internal control of institutions encompass the principles of effective internal control of the public sector, set by the recommended good practices.

The audit was carried out in 14 ministries and the Vilnius and Kaunas city and Kaunas district municipalities, where we reviewed documents and talked to the managers, employees responsible for the implementation of the function of control monitoring, and internal auditors. In addition, we have submitted questionnaires to the heads of 244 institutions (including ministries and selected municipalities), 155 of whom replied. We have questioned the heads, or, when they were unavailable – auditors, of 119 internal audit offices, 92 of whom replied.

Rather than attempting to retrospectively reveal the appropriateness of the internal control of the public sector, and assessing the functioning of the systems of internal control of institutions, we have focused on whether the systems of internal control of institutions conform to the internationally recognised good practices: the INTOSAI Guidelines for Internal Control Standards for the Public Sector, as well as international internal audit standards. We have analysed data from 2015, and, in some cases, also data from 2016 or earlier years.

The existing provisions of the Law on Internal Control and Internal Audit[9] and the implemented legislation fail to provide the institutions of the public sector with the basis for developing, maintaining and improving systems of internal control, which conform to international good practices. The legal framework fails to encompass the key elements of the system, namely: a control environment, risk-assessment, and communication and provision of information; control is limited to financial control, and monitoring – to internal audit. There is no institution responsible for the establishment, methodological development and monitoring of the entirety of the requirements of internal control. The heads of public sector institutions are not obligated to select the policies related to the system of internal control, implement an analysis of said system, and provide public reports on the developed or improved internal control.

Having assessed the evidence collected during the audit, we present our conclusions and recommendations, which, if implemented, would lead to the provision of conditions necessary for improving the systems of internal control, which would ensure the reliability of management information, the validity of decisions and their helpfulness to institutions in achieving the best results by implementing available resources.

CONCLUSIONS

1. The existing Law on Internal Control and Internal Audit and the implementing legal acts contain the following deficiencies:
    - 1.1. No clear definition is provided of the key elements of the system of internal control – the control environment, risk-assessment, and communication and the provision of information. The established provisions regarding financial control only partly encompass the activities related to control, and internal audit only partly encompasses monitoring. This fails to provide institutions with the conditions necessary for the development of effective internal controls, and fail to encompass the recommended principles of good practice specified in the Guidelines for Internal Control Standards for the Public Sector, even though the implementation of the system of internal control in Lithuania was based on good practices (Section 1.1).
    - 1.2. No institution is specified as responsible for the development, methodological management and monitoring of the requirements of the entire system of internal controls; state policy necessary for the effective functioning of internal controls is not being developed and implemented. Legislation only regulates financial control and internal auditing, which is why the Ministry of Finance has been assigned to methodically manage only financial control and internal auditing (Section 1.2).
    - 1.3. The heads of institutions are obligated to account only for a part of the system – financial control, even though they are responsible for the development, functioning and improvement of the entire effective system of internal control (Subsection 1.2.1).
2. Since the requirements applicable to the annual analyses of the state of financial control do not clearly specify the conditions necessary for evaluating a specific state on a scale of very

[9] Law on Internal Control and Internal Audit of the Republic of Lithuania of 10 December 2002 No. IX-1253 .

good to poor, the results of institutions may not reflect the actual condition (ministries and the audited municipalities evaluate them very differently; six of them are incapable of clearly specifying the basis for filling out the reports on the state of financial control, some provide incorrect or inconclusive information, and the internal auditors of five others think that it is not justified, information hasn't changed for many years). The generalised results of the state of financial control, prepared by the Ministry of Finance, are submitted only to state institutions and municipalities, but not to the Seimas, the Government or the public. This leads to a lack of data on the state of financial control of the entire public sector (Subection 1.2.1).

3. The responsible employees of the Ministry of Finance analyse and assess the compliance of the activities of offices with legislation in accordance with the requirements for the external assessment and analysis of internal audit offices, which means that the effectiveness of the functions of audit is assessed only partially. For this reason, there is a lack of information on the effectiveness of internal auditing in determining the level, having assessed the following aspects: internal audit strategy, structure, personnel, the audit process, technology, etc. Every year, the Ministry of Finance submits the generalised results of internal audit assessment and analysis, and the determined deficiencies regarding the assurance and assemblage of autonomy to the Seimas Audit Committee and the Government. These repeat and remain unchanged since 2011 (Subsection 1.2.2).

4. The training of internal auditors to raise their qualification level, coordinated by the Ministry of Finance, should be improved in order to better meet the needs of internal auditors, because the internal auditors of eight ministries and one of three municipalities desire practical training, and the auditors of six ministries think that the training that is being organised provides knowledge necessary to receive the certificate of an internal auditor. Having reviewed the training programmes, we have determined a lack of practical training, e.g., how to plan audits, assess risk-management or ensure the quality of audit, etc. (Subsection 1.2.2).

5. The implemented analysis of the systems of internal control of institutions has shown that it is necessary to improve the legal framework, such that it would conform to the international good practice for the public sector, because:

   5.1. The control environment fails to provide a sufficient basis for the assurance of appropriate discipline and the raising of qualification level in institutions (13 ministries and one municipality are yet to approve ethical rules applicable to employees of institutions working in accordance with contracts of employment; no training is provided to the managers regarding the system of internal control, which is why the heads of all 17 audited institutions failed to raise their qualifications in the area they are responsible for; the results of employees working in accordance with contracts of employment in 16 institutions were never assessed). This speaks to the failure of providing the managers with the conditions necessary for the development of appropriate systems of internal control and a positive attitude on the part of employees (Section 2.1).

   5.2. Not all institutions are implementing assessments of risk – the significance of risk, its likelihood and potential effects, and tolerable risk are not being assessed; no risk-management plans are being developed; no cost-benefit analysis is implemented when selecting measures (one ministry has determined risks regarding the entities assigned to the area of management, and has planned measures for mitigating those risks; two ministries are developing partial risk-management plans, while eight ministries and one municipality are not; four ministries and one municipality are implementing partial cost-benefit analyses (e.g., related only to some projects or activities), while five ministries and two municipalities are not). The failure to implement such measures makes it difficult for institutions to select effective controls for managing the key determined risks (Section 2.1).

5.3. In 11 ministries and two municipalities, controls are being implemented without at first defining the key processes aimed at the main activities of the institutions in question. Their approved procedures or rules encompass the implementation of functions (general internal administration, the management of personnel, finances, information and assets, public procurement, etc.). For this reason, institutions may have excessive control measures aimed at activities that are not of the highest importance (Section 2.1).

5.4. Even though institutions implement both internal and external information and communication, 11 ministries and two municipalities fail to implement assessments of the effectiveness of these processes, which leads to a lack of data necessary for their improvement (Section 2.1).

5.5. Most institutions (11 ministries and two municipalities) fail to assess the results of continuous monitoring, necessary for the manager to be able to make valid decisions aimed at improving internal controls, and for internal audit to assess them. Institutions fail to implement separate assessments of their systems of internal control, implementing only internal and external audits (Sections 2.1 and 2.2).

5.6. Audit results have shown that the controls of three ministries and one municipality, who had implemented quality management systems, are defined on the basis of the implemented processes, and risk assessment, information, communication and monitoring are determined more clearly. Therefore, quality management systems contribute to the effectiveness of the internal control of institutions (Sections 2.1 and 2.2).

6. The assessment of the systems of internal control of institutions – internal audit – should be improved, because:

6.1. Internal audit offices sometimes fail to comply with the Internal Audit Methodology: 22 of the 84 offices of state institutions failed to develop strategic action plans; the offices of five ministries and two municipalities failed to set priority actions; while others had sometimes failed to tied them with the goals of institutions. The Methodology does not contain defined requirements regarding the assessment of areas in need of auditing, which is why, in assessing risk, auditors rely on inequivalent assessment criteria, their comparative weights and quantities. Five offices assess risk less frequently than once a year. All of the aforementioned aspects are important in planning significant internal audits (Section 2.3).

6.2. Internal auditors sometimes fail to assess the systems of internal control at least once every three years (the internal audit offices of seven ministries and three municipalities), and implement assessments by selecting different entities and scopes of audit (selecting an entire institution, a subdivision, a subordinate establishment, or project; the offices of 12 ministries and two municipalities have failed to analyse all five elements of the systems of internal control). In some cases, internal audits failed to encompass the key areas of audit (in 2015, 65 percent of audits failed to implement risk assessments, 15 percent failed to audit the system of internal control, while the internal auditors of four ministries and three selected municipalities fail to implement audits of informational systems). In 2016, auditors of only half the ministries implemented systemic audits, encompassing subordinate and establishments and establishments related to the area of management. For this reason, internal audits may fail to reveal significant deficiencies of the systems of internal control (Section 2.3).

6.3. Internal audit consultation is not being developed as a preventative measure. While the auditors of nine ministries and 39 surveyed offices do implement consultations, they also fail to account for them and include them into action plans (Section 2.3).

6.4. Since the Internal Audit Methodology does not contain definitions of the criteria which determine the assessment of the level of recommendations (large, medium, small), internal auditors assess the significance of recommendations differently. The effect (benefits) of internal audit in contributing to the improvement of an institution's functioning is not sufficiently assessed (the offices of 13 ministries and one municipality assess the effect of the implementation of recommendations during a separate audit, while the offices of one ministry and two municipalities do not) (Section 2.3).

6.5. One third of the internal audit offices lack the possibility to ensure the quality of internal audits (34 out of 92 internal audit offices fail to implement continuous internal reviews, conducted by a single auditor). Self-assessments, accompanied by sending questionnaires to the audited entities after the audit, are implemented by the offices of only three ministries and two municipalities (Section 2.3).

6.6. Since the requirement of the Law on Internal Control and Internal Audit to establish internal audit offices by reference to the number of posts fails to provide a basis for the implementation of comprehensive and systemic functioning of internal audit, there are cases where finances, human resources and expertise are dissolved. The methodology for determining the need for auditors allows for the determination of the number of auditors that is not based on factual need (Section 2.3).

7. Having analysed the results of audits carried out in 2013-2016, we have determined that the systems of internal control of public sector institutions are not sufficiently aimed at achieving results that are necessary for the state and public, but are rather aimed at maintaining the process. The weak control environment, risk-assessment, control-related activities, information, communication and monitoring of institutions may fail to ensure that implemented resources will lead to the achievement of superior results (Section 3).

RECOMMENDATIONS

To the Ministry of Finance

1. Initiate changes to the Law on Internal Control and Internal Audit to establish the following:
   1.1. the principles of an effective system of internal control of the public sector, recommended by the internationally recognised good practice, specify the elements of the system and the goals applicable to them (Conclusion 1.1);
   1.2. the responsibility of the Ministry for the determination, methodological management and monitoring of the requirements applicable to the entire system of internal control (Conclusion 1.2);

   1.3. the obligation of the heads of institutions to select the policy of the systems of internal control, adapted to the institution in question, implement system analysis that encompasses all of its elements, and declare the responsibility assumed by the heads of institutions for the development and improvement of said systems (Conclusion 1.3).

2. In the implementing legal acts:
   2.1. specify the requirements applicable to the elements of the system of internal control (Conclusion 1);
   2.2. update the internal audit methodology and specify that it was developed in accordance with international internal audit standards by applying them to the public sector and considering its specificity (Conclusion 6);
   2.3. define the process of monitoring the system of internal control (including financial control), implemented by the Ministry of Finance, and the submission of results to the Seimas, the Government and other institutions authorised to make decisions regarding the improvement of the system and the removal of related defects (Conclusion 2);
   2.4. specify the periodicity and criteria for the assessment of internal audit offices, carried out during the analysis and external assessment of the internal audit of the Ministry of Finance (Conclusion 3);
   2.5. extend the functions of the Ministry of Finance related to the internal control system training and the coordination of qualification-raising – involve the heads of institutions and individuals engaged in monitoring the system of control (Conclusion 5);
   2.6. ensure that the internal auditor training programmes be updated by reference to the need for internal auditors (Conclusion 4).

The Ministry of Finance has the right to develop draft laws and other legal act drafts[10], and the Government – the right to legislative initiative in the Seimas[11]. For this reason, we have contacted the Government and requested it to ensure the submission of the draft Law on Internal Control and Internal Audit to the Seimas.

[10] Regulation of the Ministry of Finance of the Republic of Lithuania, approved by the Order No. 1088 of 08 September 1998 (as amended by the Order No. 899 of 26 August 2015), Paragraph 8.1.19.

[11] Law on the Government of the Republic of Lithuania No. I-464 of 19 May 1994, Article 20, Paragraph 1.