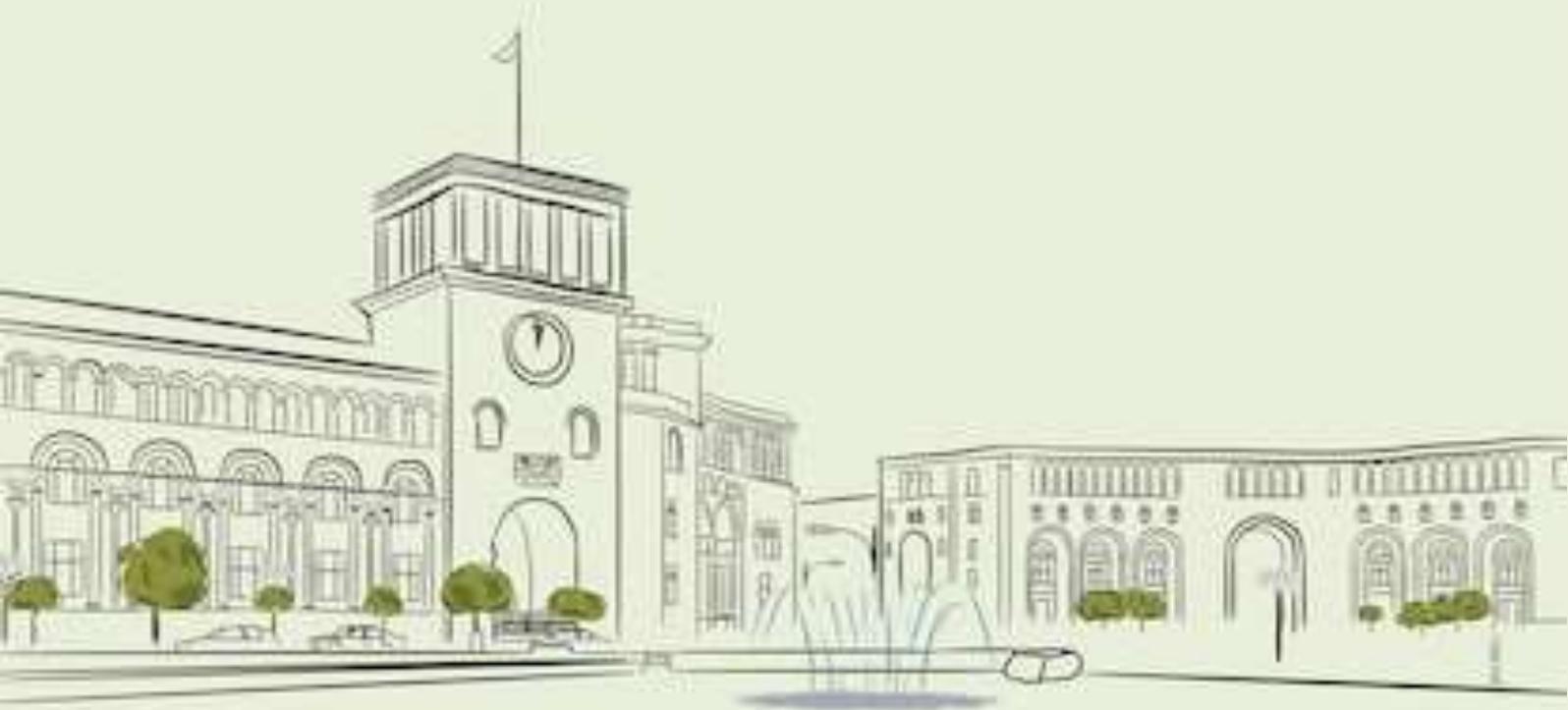


# Challenges of Internal Audit in Public Sector

June 2019



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# Summary

Internal audit is one of the cornerstones of effective governance that aims to improve the effectiveness of the organization. Internal audit was first established in private sector, it is widely utilized especially in the financial sector. Later it was introduced in public sector. A properly functioning internal audit system can play an important role in improving the effectiveness of public sector governance, the quality of services and accountability.

In Armenia, Internal Audit in the Public Sector has been widely implemented since 2013 with the adoption of the Law on Internal Audit<sup>1</sup>. By the end of 2018, the number of internal auditors working in public sector was 290, more than in private sector. During the same period, 102 internal audit units have been operating in state and local self-governing bodies, and another 136 functions have been outsourced in rural communities.

Although public sector internal audit (where it has been established) has its unique challenges everywhere, in Armenia there are local problems in addition:

1. the pivotal question is probably what the Government expects from the Internal Audit (it should not be a punitive tool like other control services);
2. another key issue is the creation of professional Internal Audit Committees, which is the cornerstone of ensuring Internal Audit independence;
3. low level of funding in the Public Sector and overall non-competitive remuneration do not allow for the recruitment of qualified auditors as well as for responding to new risks such as IT and cyber security risks.

This document addresses these and other issues and proposes solutions based on international best practice.

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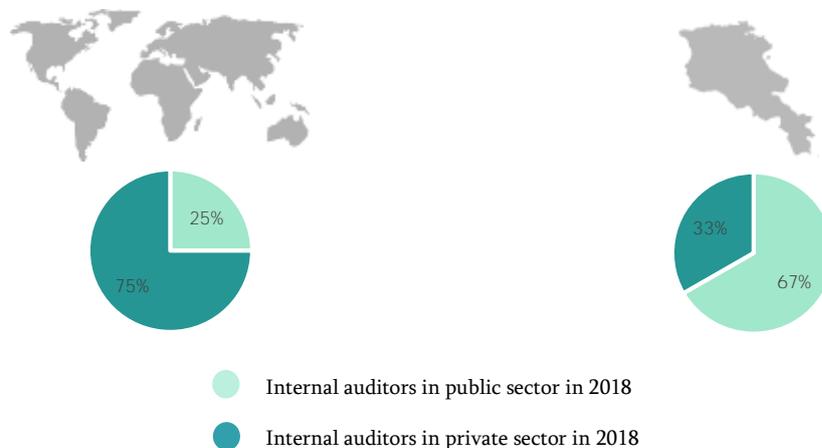
<sup>1</sup> The title of the Law is misleading, as it refers only to the Public Sector Internal Audit (excluding Central Bank)

# 1 Internal Audit in Public Sector

Internal audit is one of the cornerstones of effective governance that aims to improve the effectiveness of the organization. Internal audit was first established in private sector, it is widely utilized especially in the financial sector. Later it was introduced in public sector. A properly functioning internal audit system can play an important role in improving the effectiveness of public sector governance, the quality of services and accountability.

Attempts to establish Internal Audit in the Public Sector of Armenia have been made on a pilot basis since the early 2000s, except for the Central Bank, where the Internal Audit function was introduced in 1996. Internal Audit was widely implemented in the Public Sector since 2013 with the adoption of the Law on Internal Audit. By the end of 2018, the number of internal auditors working in public sector was 290. For comparison, there are 180 members at the Institute of Internal Auditors of Armenia (not all of them work as internal auditors).

**Exhibit 1. The proportions of internal auditors in public and private sectors in the world and in Armenia are very different**



Source: The Global Internal Audit Common Body of Knowledge, Annual Report of the Public Sector Internal Audit System of the Republic of Armenia for 2018 and IIA-Armenia data

In 2018, there were Internal Audit functions in 56 state and 46 local self-governing bodies, as well as in 136 rural communities, where internal audit was outsourced to private companies. This is a very large scope in a sphere where both the level of understanding and the level of knowledge and experience are low. It should be noted that in the private sector, internal audit was introduced in banks and insurance companies in 2005 by the request of the Central Bank (there were 21 banks and 6

insurance companies at the time), while in the non-financial sector the pioneer was ‘Armentel’ following the parent company policy. According to the IIA-Global CBOK<sup>2</sup> study only one out of 4 internal auditors works in public sector worldwide, while the number of internal auditors in the Public Sector in Armenia is twice as much as in the private sector (**Exhibit 1**). In fact, the Internal Audit in private and public sectors in Armenia have developed independently.

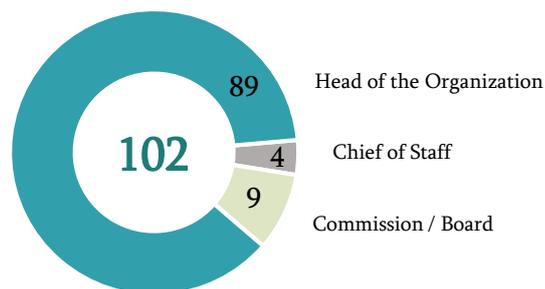
### Organizations in Public Sector

The Ministry of Finance is responsible for the implementation of internal audit in the Public Sector as an authorized body of the Government, which carries out the process of developing and introducing internal audit legislation and methodology based on international standards and successful experience, as well as ensuring system accountability.

The Public Sector is made up of government agencies, all state-controlled or state-funded agencies, enterprises, and other agencies that deliver government programs and products. These are:

- state (e.g. ministries, autonomous services, regional administrations, etc.) and local self-governing bodies (e.g. municipalities);
- state or community agencies and non-profit organizations;
- organizations with more than fifty percent state or community participation.

**Exhibit 2. In the Public Sector Internal Audit is mostly accountable to one person**



Source: Annual Report on the Internal Audit in Public Sector of the Republic of Armenia in 2018 and RA Law on Internal Audit

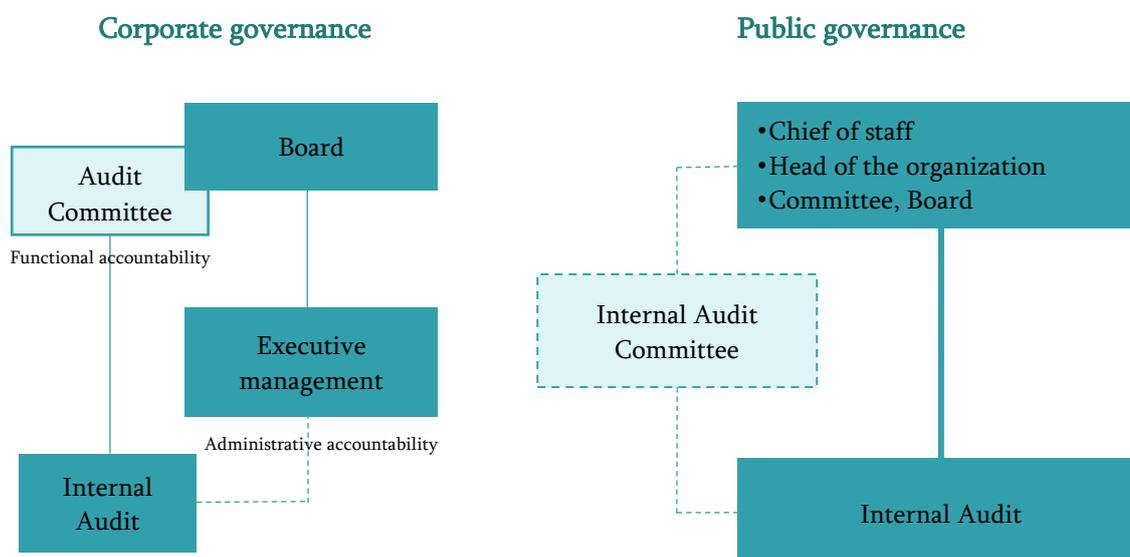
<sup>2</sup> The Global Internal Audit Common Body of Knowledge

## The position of Internal Audit in public administration bodies

Internal Audit is accountable to the Head of the Body, Committee, or Board, with some exceptions when it is accountable to Chief of Staff / General Secretary. **Exhibit 2** shows that in the Public Sector, Internal Audit is generally accountable to a single person, be it the Head of the Body or the Chief of Staff. The Committees and Boards, although collegial decision-making bodies, are nevertheless governed by the Head of the Body. Internal Audit's position in the organizational structure and its accountability greatly influence its independence and objectivity.<sup>3</sup>

This independence gap is meant to be closed by the Internal Audit Committee, which must consist of at least 3 members who must have 3 or more years of internal audit experience.<sup>4</sup> In public administration bodies where there is a Collegium, the function of the Committee may be overtaken by the Collegium. As a result, the professional requirements do not apply, and conflicts of interest are evident. In fact, the Collegium, which usually is comprised of the Head of the Body and his/her Deputies, is not a collegial decision-making body but rather an advisory body, and cannot replace the Board or the Internal Audit Committee.

### Exhibit 3. Internal audit has different accountability in Corporate and Public governance



Source: International Standards on Internal Audit, RA Law on Internal Audit

**Exhibit 3** shows the position of Internal Audit in Corporate governance and Public governance environments.

<sup>3</sup> Supplemental Guidance: Public Sector Definition, IIA-Global

<sup>4</sup> Order of the Minister of Finance, February 23, 2012

Best practice of **Corporate governance** suggests that the Company's top governing body is the collegial Board of Directors that oversees the operations of Executive Management, moreover, the CEO cannot combine the role of the Chairman of the Board (which has been implemented in the banking system of Armenia). The Audit Committee is one of the Board's specialized subcommittees that assists the Board in its oversight of the executive. The Audit Committee reports to the Board and is the liaison between External and Internal Audit and the Board. The Exhibit also shows that Internal Audit has double reporting line: administrative to the Executive Management and functional to the Audit Committee. This is a very unique model that we do not see for other functions. Functional accountability means approving the annual internal audit plan and discussing audit reports. It also assumes the appointment of the Head of Internal Audit and the approval of the internal audit budget, which allows ensuring maximum independence of Internal Audit.

**The purpose of functional reporting is to ensure the independence of Internal Audit**

The **Public Governance** environment is unique, there are no oversight Boards, and the Head of the Body is fully responsible for the decision making. In this case, the Internal Audit is in a difficult situation; there is no functional accountability, at best it can serve as a second line of defense<sup>5</sup>, i.e. a risk identification unit reporting to the executive (by law the highest public servant in our country is the Chief of Staff / General Secretary, but in fact the decision maker is the Head of the Body). International experience suggests that independent or semi-independent Internal Audit Committees are set up in developed countries to fill this gap (unlike in private sector where the Audit Committee coordinates External and Internal Audit, there is no External Audit coordination in the Public Sector, that is why it is called Internal Audit Committee). In addition, the mechanisms to appoint/dismiss the Head of Internal Audit ensure a higher level of independence and protection.

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<sup>5</sup> IIA position paper: the three lines of defense in effective risk management and control

## 2 Unrealized Purpose of the Internal Audit

The pivotal question is what the Government expects to get from the Internal Audit. Seeing the level of importance of Internal Audit today, one can say that it does not serve its purpose and has become a self-contained activity.

### Audit vs. Control?

The goal of internal audit is to support the accomplishment of the organization's objectives by providing recommendations to improve operations. It helps the organization to achieve its objectives by systematically evaluating governance, risk management and control processes. It should be noted, that internal audit activity introduced in the former USSR countries is not in line with modern principles. There was no internal audit in the USSR, there were and still are inspection/control bodies whose primary responsibility is to detect fraud. Currently we have the Audit Chamber, Inspectorate for Financial and Budgetary Supervision, State Supervision Service, which have some cross functions with each other as well as with Internal Audit. However, Internal Audit should be more collaborative than the aforementioned bodies due to its goal.

### Standards vs. Rules

Another problem that results from the Soviet legacy is the confusion of rules and principle-based standards. Audit is a principle-based function, aligned to organization's objectives, whereas supervision is a compliance function, which looks for incompliance. Having audit legislation based on international standards, at the same time governmental decisions and orders of Minister of Finance were adopted, which define rules in addition and contrary to the principles.

#### WHAT TO DO? Clarify the purpose

It is important to demonstrate the importance of Internal Audit by specific actions after discussing at the highest level together with industry experts the role of Internal Audit, clarifying and separating it from other control functions.

Rules-based audit should be revised, and only principles should be left.

# 3 Formation of the Internal Audit Committee

The key role of the Internal Audit Committee is to ensure the independence and oversight of Internal Audit function. On one hand, the role of the Internal Audit Committee is extremely underestimated, on the other hand, there are no sufficient experts in the country with relevant experience.

## The role of Internal Audit Committee

Internal Audit Committee has crucial role in ensuring independence and objective accountability of Internal Audit. Taking into consideration that most of state and local self-governing bodies are governed single-handedly, the role of this Committee in the Public Sector is extremely important. In fact, in the absence of a Board, it should perform the oversight function of the Board, and the Government may play an important role here. In this context, it is important to revise the principles of Committee formation to ensure its independence and professional capacities<sup>6</sup>.

## Lack of experienced people

The key to the effective work of the Audit Committee is to involve independent members with the necessary qualifications and experience, which, given the initial level of development of this institute in the country, is a serious challenge. International experience generally varies between fully independent or semi-independent Internal Audit Committees.

### WHAT TO DO? Involve independent experts

The Government may form a group of experts who will participate in several Internal Audit Committees as an independent member providing professional expertise.

To this end, it may be possible to collaborate with audit associations and companies, as well as with individual experts who have relevant experience as a member of the Board/Audit Committee.

It is important to ensure feedback and accountability. There should be annual meetings with Internal Audit Committee members to discuss progress and problems.

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<sup>6</sup> According to the Law on Internal Audit, the Internal Audit Committee is chaired by the Head of the organization

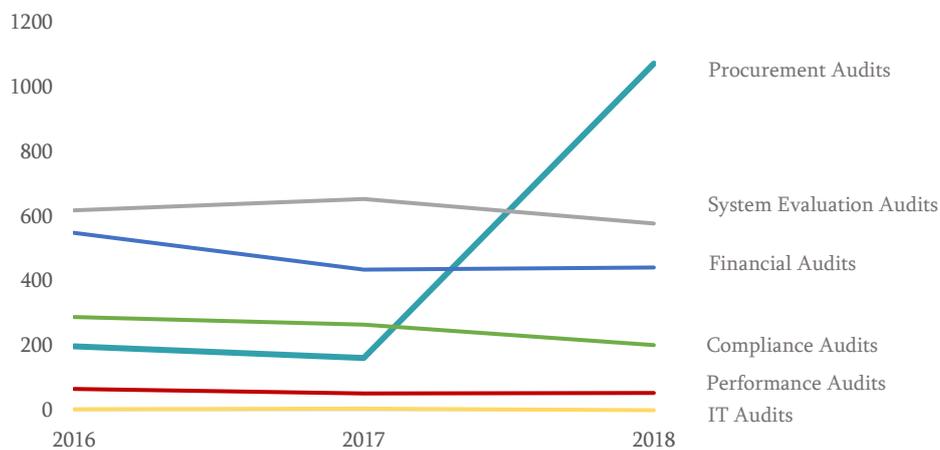
## 4 Insufficient Capacity

Problems of inefficiencies in the Public Sector could not have escaped leaving negative impact on the introduction of the internal audit system. While internal audit is aimed to enhance efficiency, a suboptimal internal audit may not achieve that goal.

### Remuneration and qualified staff

The low level of remuneration in the Public Sector seriously constrains recruiting qualified staff, to address the issue the current Government is taking steps in this direction. In the case of internal auditors the problem is further complicated because there are no sufficient specialists, and those in the market are paid significantly higher than other professions. As a result, Public Sector Internal Audit functions have recruited staff with no prior internal audit experience (experience in control bodies is more a problem than aid), poor or no command of English, which is the primary language of profession both for reading professional literature and obtaining international qualifications (CIA, CISA, ACCA<sup>7</sup>).

**Exhibit 4. Procurement audits predominate in performed audits**



Source: Annual Report of the Public Sector Internal Audit of the Republic of Armenia in 2018

<sup>7</sup> Certified Internal Auditor, Certified Information Systems Auditor, Association of Chartered Certified Accountants

## Knowledge and Skills

It follows from the abovementioned, that internal auditors in Public Sector have limited opportunities to develop the knowledge and skills required today to perform qualified internal audits such as international financial reporting standards<sup>8</sup>, COSO Internal Control and Risk Management Framework<sup>9</sup>, COBIT Information Risks<sup>10</sup> and ISO27001 Information Security Concepts, Cybersecurity Risks, etc. It is not surprising that in 2018 compliance engagements, including procurement engagements, made up 54%<sup>11</sup> of all audit engagements, and no IT audit engagements were performed at all. **(Exhibit 4):**

### WHAT TO DO: Set Priorities

It is clear that the Government cannot provide remuneration in line with private sector, however it should be revised. At the same time, other incentives may be considered, such as training, promotion, promoting publications and lecturing, and so on.

In cooperation with universities, the government may introduce a master's program in internal audit to educate required specialists.

Government should review the scope of Law on Internal Audit. Accordingly, the high number of Internal Audit units as well as outsourced functions in rural communities (which in fact have nothing to do with internal audit) should be reduced.

Instead, up to 5 high priority public administration bodies should be selected (it is desirable to include the Ministry of Territorial Administration) and with several years of direct focus on, develop capacities which can be later scaled up to other bodies.

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<sup>8</sup> IFRS, IPSAS

<sup>9</sup> Committee of Sponsoring Organizations - Internal Control Framework, Enterprise Risk Management

<sup>10</sup> Control Objectives for IT

<sup>11</sup> The reason is also the requirement of the Ministry of Finance for mandatory procurement audits, which is not in line with the risk-based audit principle.

# Conclusion

Public sector internal audit has an important mission to contribute to improving the quality governance in public organizations and increasing confidence in the system. The experience and results of introduction of the system in Armenia show that the implementation of international experience is not a mechanical action, it is not limited to the creation of legislation and job descriptions, but requires a serious change of mindset. The problems and challenges summarized in this document will be possible to overcome if the Government keeps the development of the system in focus, highlighting the need for step-by-step implementation, involvement of qualified specialists in Internal Audit Committees and Internal Audit functions, and collaboration with industry-recognized institutions and professionals.

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# About the Institute of Internal Auditors

The Institute of Internal Auditors was founded in 1941 in the United States (headquarter in Florida) as an international professional association that is the voice of the internal audit profession, a recognized authority, acknowledged leader and principal educator. There are more than 200,000 institute members and 150,000 certified internal auditors (CIA) worldwide.

## The Institute of Internal Auditors – Armenia

The Institute of Internal Auditors of Armenia was established in 2013 as a non-profit organization by individuals working in risk management and internal audit, to promote and develop the internal audit profession in Armenia. Since the foundation, the Institute has been a recognized partner of the Institute of Internal Auditors Global in Armenia. Since September 2015, IIA-Armenia is also an affiliate member of the European Confederation of Institutes of Internal Auditing (ECIIA). Currently, more than 180 specialists are members of IIA-Armenia, with the majority working in the financial, telecommunication and consulting sectors. Since the formation in 2013, the total number of members of the IIA-Armenia has increased six fold.

Today, the Institute of Internal Auditors of Armenia is a well-established professional body representing the internal audit profession in the country. Membership creates new opportunities for professional development and elevating status. Members can enjoy a range of benefits, such as participation in trainings, conferences, continuing professional development meetings, news and access to the library. Members also benefit from IIA-Global opportunities such as discounts on international certification exams (CIA, CRMA, QIAL).

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