

THE ASSESSMENT OF FINDING IN PERFORMED FUNCTIONAL AUDITS – LATVIA'S EXPERIENCE

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Abstract

Functional audits at the state administration of Latvia have been performed since 1999. Wider resonance they gained starting from 2007 when all state administration institutions were ordered to perform them regularly. The author of the research has analysed 22 functional audit reports, and 6 of them were related to business sector. The article's scientific problem is that, actually, there are no publications on functional audit performance and audit findings at the state administration.

Novelty – besides scientific value the article also has practical meaning. The facts stated in the article give assessment on possible benefits and at the same time warn about vain hopes revealing what should not be expected from such audits.

Objects – the author has analysed 6 business sector reports and 16 internal audit reports of structural units submitted by ministries of the Republic of Latvia.

Aim – to study audit statements and proposals and to evaluate the quality of their recommendations.

Tasks – firstly, to evaluate external auditors achievement against interior auditors achievement. Secondly, to give general indications to the management of institutions on what they can expect and gain from such audits.

Research methods – functional and performance audits are basically the same, and they are usually performed by the Supreme Audit Institution (SAI) where there are best specialists in this field. That is why besides scientific publications the author also has used SAI standards, including INTOSAI.

Research restrictions – the author was not able to give direct references to specific institutions and audit reports because such were the conditions in order to receive the information. The author basically used qualitative data analysis because the audit reports were radically different.

Result – although functional audits are related to evaluation of functions, the range of issues exceeded it. Function evaluation based on documents was accentuated in function analysis, and it was significantly beneficial only in some specific cases. Additionally, institution's interior control system, necessary improvements in processes, strategy and resultative indicators were analysed and evaluated. It showed that an institution itself should perform elementary improvements in its work before inviting auditors. The achievement of internal auditors and business auditors was different. On average the achievement of business auditors was more qualitative but also more expensive. The achievement of internal auditors can be divided in two parts – the ones who just generally compared the documents, which were not very beneficial, and the others who could serve as a perfect model on how functional audits should be performed because they had revealed the main problem issues.

Keywords:

Functional audit, Latvia, state administration.

Introduction

Latvia has embarked on the functional auditing since 1999, making shorter or longer breaks in the process. The year 2007 should be mentioned as a period of the highest activity in the functional audit conduct, when the Cabinet of Ministers gave instructions to have the functional audit carried out in all ministries and their subordinate agencies and the established facts reported to the Government (Ministru kabinets, 2007).

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are no publications on functional audit performance and audit findings at the state administration. Novelty – besides scientific value the article also has practical meaning. The facts stated in the article give assessment on possible benefits and at the same time warn about vain hopes revealing what should not be expected from such audits.

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Performance audit is advanced management tool that is becoming more and more sophisticated (Daujotaite and Mačerinskiene, 2008). Nevertheless, it should be stated that the published works about performance audit leave much to be desired. The persons writing about performance audit do not review the functional auditing aspects (Pollitt et al.,1999; Dittenhofer,2001; Lonsdale,2000) Detailed deductions about functional audit are available in the work by Sack and Saidi. (Sack and Saidi,1997). Some authors give a review of the functional appraisal occasionally for example, Function Analyses or Value Method sit sometimes called is the systematic process of identifying function and their associated costs, and assessing the necessity of those function based on established criteria for the product or service (Miles and Snow,2003).

General characteristic of the functional audit

Of the authors' 14 requests for information to the ministries, one ministry answered that it did not conduct such audit, two ministries supplied incomplete information, which was not usable for the analysis, and three ministers gave no information at all.

The functional audit in the ministries and their subordinate agencies is either carried out by an internal audit organizational unit or bought as an external service to be carried out by the business-sector auditors. The authors have analyzed 6 business-sector and 16 internal audit reports.

It should be pointed out upon evaluation of the auditors' approach to the functional audit that the business-sector auditors preferred conducting audit from the study of regulatory acts, i.e. evaluating external regulatory acts against the internal ones, and it was thereafter that they studied the financial matters. To examine weak points of the agency, they employed two approaches – *organizational slack* and *budgetary slack* (Busch, 2002). In turn, the internal auditors' operation

could be divided into two categories. In the first group, only internal regulatory acts were given to reciprocal analysis and/or financial statements were given to general comparison in dynamics by years. In the second group of auditing, the approach was individual and novelty in the settlement of problems made itself felt.

Resultant indicators of functional audit

One of resultant indicators of functional audit is the number and quality of recommendations (cf. Table 1).

Table 1. The costs of functional audit and the number of recommendations

(Authors' work papers, 2010)

	Recommendation (together all audits)	Min in one audit	Max in one audit	Audit cost EUR
Business auditor	234	12	76	11 895 - 63 382
Internal auditor	195	1	54	900 - 31 303

In the business-sector audit reports, recommendations were often unnumbered, due to which it was quite difficult both to have the recommendations accounted and put into practice.

The authors made a summary of the recommendations. The recommendations were processed not by number, but by essence. For instance, it is advised in the audit report to improve 7 internal regulatory acts, and there is a particular recommendation for each act. It is showed just once in the authors' table as a necessity to have the regulatory acts improved (cf. Table 2).

Table 2. The given categories of recommendations in 22 audit reports

(Authors' work papers, 2010)

Recommendation	Together	BA	IA
To improve statute of institutions	16	4	12
To improve inner and/or outward normative acts	15	5	10
To perform structural changes in institution	12	6	6
To improve the descriptions of employees' métiers	12	3	9
Is suggested for the institution by itself to create a qualitative system of fruitful indices	12	5	7
To improve the business process of the institution.	11	4	7
To improve the system of internal control	10	3	7
To define and qualify imparted services of institution.	9	5	4
To improve institution's strategic planning	9	4	5

To initiate processing of electronic documents, data and lead of data basis	9	5	4
To centralize the methodical lead in leading institution, but to delegate actual accomplishment	8	4	4
Is suggested to give the functions to other institutions.	7	4	3
Auditors work out the organizing structure for future or give concrete indications	7	5	2
To perform functions, which are definite in normative acts.	6	2	4
Not to perform functions, which aren't definite in normative acts.	6	3	3
To perform functions by essential, not formal	6	2	4
Not to perform doubling functions inside of institution.	6	4	4
To make structural units by unified principles	6	3	3
To reduce the number of employees	6	4	2
To improve the process of employees' tuition	6	3	3
To improve the communication between structures in the institution.	6	2	4
To improve the workload in regions, structures, by reducing or increasing the workload	5	3	2
To initiate the system of reporting for employees.	5	2	3
To improve the Intranet for work necessities	5	3	2
To perform detailed audit about one of area	5	2	3
To improve the system of salaries	4	2	2

BA- business-sector auditors reports
IA - Internal auditors reports

It follows from the table that the auditors advise reducing the number of employees of the agency. The business auditors do not link it to the efficiency, but advise reducing the number of employees performing the auxiliary functions (accountants, IT specialists, etc.) assigning their functions to the external service not making a calculation of eventual costs of such external service. The recommendations are not grounded with audit evidence, which contradicts the good practice (Canada, 2004; Australian, 2008). In turn, the recommendations in two internal auditors' reports to reduce the number of employees is actual and possible to improve the internal business processes, etc.

Apart from the recommendations given in the table, there were also such recommendations, which appeared just three times - to transform the legal status of the agency; to reduce the risk of corruption in the agency; to reduce inefficient use of the infrastructure; to introduce

the e-signature; to reduce the telephone communication and transport expenses; and it was also advised to increase the number of employees. And it was advised just once to increase their own revenues and to the management committee to improve its operation.

It could be concluded upon evaluation of the auditors' recommendations that most of the recommendations are of strategic significance for the agency. Those are the recommendations, which are related to the financial system, information system, performance control and evaluation system, system of planning, etc. (Aaker, 2001).

A general conclusion from the audit reports could be formulated as follows - when audits are conducted in comparatively small agencies with uniform lines of activity, for instance, 7 functions, and a small number of employees - up to 200, the auditors can distinguish the performed functions, advise better future models, appraise the coverage or nonperformance of the functions. But the auditors' contribution was restricted in most events, when the agency had many employees and was large or when its own functions were defined not clearly.

Eventual gains from the functional audit results

The best business-sector auditors made the functional audit linked to the agency's strategy analysis (COSO, 2004). It was noted in two audit reports that *"not a single document was stated during the audit, which would have outlined in any form whatsoever the long-term planning regarding..."*. And it was noted in the second report: *"The budget planning procedure is not transparent as far as the decision-making process is not documented and is not clear"*. The next important aspect detected by the auditors is the fact that particular Latvian regulatory acts do not correspond to the European Community regulations and/or the internal regulatory acts do not correspond to the external regulatory acts. The authors consider that the detection of such disparities is just sluggishness of relevant legal organizational units. And other aspects established by the auditors could be arranged by the agency itself, not engaging external auditors. For instant, to strengthen control and determine responsibility for implementation of the internal audit recommendations so that it were not written in the audit report: *The terms of implementation are delayed many times on the part of officials, even involvement of the management in the settlement of the problem is not sufficiently motivating.*

The auditors discovered opportunities for the information system operation improvement by way of introduction and update of databases and IT systems. It is consonant with the experience of other countries that all internal processes should be improved to the maximum in the electronic form, even having adopted

the best practice of the business sector (Gregory, 2005; Bititci et.al., 2000).

The authors point out that the auditors have also discovered an opportunity for saving on consultation services to the residents by bringing into line the service mechanism. For instance, it is estimated that there is different time of customer service in different regional structures - it takes 9.5 hours in one case or 28.3 hours in another. Similarly, the auditors detected the fact that the agency did not perform one of its functions at the time of audit, but the employees stated that 747 hours were dedicated to it. This is why the authors point out that the daily regular performance records are very important (Moloi and Mutula, 2007).

In another report, the auditors state that the risk of use of effective resources arises on nontransparent, unclear processes of the agency operation. *To have a summary, reports from different viewpoints are requested from all the supervised and subordinated agencies, including on the matters, which have not been financed by the agency. As a result, transparency and traceability of the spent assets is lost.*

It is evaluated positively that two possible models of further development of an agency with a number of development strategies were proposed in a certain audit report with an estimate of each proposed variant provided.

Contribution by internal auditors. While it could be said about business-sector auditors that the average audit report merit grade is sufficiently good, then in the events when internal auditors are professional and the degree of their knowledge about the state government system is high, their qualities are much higher than of the business-sector auditors. As the best example, internal audit reports of the Ministry of Agriculture and State Treasury should be mentioned, in which a detailed analysis of the budget building process in the agency is given with its link to the strategies of institution as it is determined by good practice (Schick, 2003). Although the internal auditor is comparatively limited in the expression of one's opinion, it should be admitted that they allowed themselves to point out more sternly to the existing problems of the agency than the business-sector auditors in the events when the internal auditors were professional. For instance, *no confidence has been gained in conversations with managers of the organizational units that the persons in charge for the program management shall enter actively enough into the evaluation of soundness of the extra required financial resources*, etc. Thus, the internal auditors have adhered to the two major auditing basic principles - objectivity and independence (Karapetrovic and Willborn, 2000).

Similarly to the business-sector auditors, the facts were established, which pointed out to indicators of poor operation of the agency. *No analysis of deviations of the*

resultant indicators was made at all in most events, or the control mechanism was slack or insufficient. High-quality resultant indicators make a public management problem throughout the world (Robert and Pollitt, 1994). It was also advised to improve the management accounting in order to realize how much each function comes to the state: *As at the audit moment, the accounting system ...does not give a clear view of the expenses charged to the subprograms.*

Risks or problems that are not settled during the functional audit

As an essential drawback in the *business-sector audit* reports, it should be noted that the auditors admit that information can be wrong, but nevertheless, they draw their conclusions on its ground. It was stated in a certain report: *"The auditors are not responsible for the documented results, as far as the employees involved in the audit have supplied certain untrue information"*. This is the text of another report: *"The conclusions on particular processes are made according to the questioned employees' declarations, which have been sometimes distorted deliberately"*. It could be concluded then that no good practice of reliable audit evidences is followed (Norway, 2005). Audit „talk” and texts are now dominated by a discourse of „audit quality” (Khalifa et.al., 2007).

Although it has been considered long since that the audit is related to the auditor's subjective opinion, (Wright, 1980) then it should be a more independent and grounded appraisal. It is not necessarily to paraphrase what is said by the managers and reflect it in the audit statement. For instance, there is such text in the findings: *"According to the agency managers' opinion, the number of employees is insufficient"*. In turn, there is the following text in the recommendations: *"According to the agency managers' opinion, the number of employees should be increased..."* It is stipulated by the good practice that the audit recommendations should be competent and constructive (Percy, 2001). It means that the auditors do not dispose of precise information about the required number of employees for the performance of relevant functions. Therefore, the auditor has not conducted an independent appraisal and not verified information supplied by the managers (Karapetrovic and Willborn, 2000).

Such audits do not present the added value, i.e. in order to determine where outputs from given inputs should be increased (Rahim and Athmay, 2008). The authors arrive at a conclusion that the business-sector auditors can advise reducing the number of performers of auxiliary functions, but, at reduction of the performers of basic functions, competence could be lacking or such service could be much more expensive. A contrary tendency was observed in the other audit reports, that

the load is sufficient or even excessive in the events, when not all positions of the list of staff were occupied. *The agency managers consider that the load is excessive and more employees are required.* The auditors did not give an answer to the question, whether it is the lack of employees or inefficient organization of the performance of functions or just a desire to improve unreasonably their supplied information.

In certain events, the auditors made an insufficiently high-quality analysis of the link of functions and costs. For instance, they evaluated arguments for assigning the agency functions to another agency (Finland, 2007).

The external auditor should be in a short time able to quickly establish problems, advise solutions and continue activities on the research of further problems; as a result, the audit quality could be affected (Coram and Woodliff, 2004). There is a risk that often no detailed study of the agency's essential matters is carried out. Therefore, the authors suggest that the agency managers (service customers) should determine at the contract conclusion, to what questions detailed, comprehensive and grounded answers must be given to be supported with grounded evidences. For instance, to rate the number of employees of a certain organizational unit. Such recommendations appear rather often, which start with the words *to evaluate in detail for the agency...*, *to estimate in detail for the agency...*, *to study in detail for the agency...* Although one of the INTOSAI demands is not to write excessively detailed conclusions on how the agency shall act in a definite event, (INTOSAI, 2004) nevertheless, the authors point out that the audit has a much greater added value, when definite recommendations are given. The judgments made during the audit should be rational (European Court of Auditors, 2007).

None of the audit reports makes use of the system auditing method, which is recognized one of the most comprehensive audit approaches, and, therefore, was based on reliable results (INTOSAI, 2004). It could be concluded upon evaluation of the audit reports on the audit customer's side that they contain much information and graphic presentations of different forms often provided with insignificant explanations. The authors consider that those could be drawn as exhibits.

Internal auditors' negative aspects in audit reports.

In the events when internal auditors conduct their audit just formally and only evaluate internal regulatory acts, fix the established discrepancies in their audit reports, such auditing is not efficient and the spent resources for the auditing are to be deemed the losses. That is why such auditors should improve continuously their performance (Burr, 1997)

Conclusion and future discussion

The authors point out that the agency could evaluate individually many matters not waiting for auditors, for instance, arranging its processes, verifying compliance with the regulatory acts, etc. At the same time, the authors agree with the statement that an agency conducting its audit by itself, without engagement of auditors is like a person diagnosing and curing one's diseases (Murray et. all., 2002). Nobody wants taking bitter medicines; that is why auditors are required for the settlement of the most significant matters. At the same time, there is a question deserving a further discussion - how to gain that the agency managers and politicians shall make their decisions based on the auditors' findings and put into practice the expressed recommendations.

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