

External and internal auditing in Estonia

Gert Schultz

Auditor at Financial Audit Department
National Audit Office of Estonia

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Themes:

1. Overall framework of auditing in Estonia
2. Public sector auditing
3. Financial Audit in National Audit Office of Estonia

1. Overall framework of auditing in Estonia

- Act of Auditing Activities, 2010
- Regulates the general principles of financial audits and internal audits.
 - Objective of an audit is to give assurance that client's past periods' financial data is accurate
 - The assurance is given based on evidence collected during an audit, in accordance with the international standards

How to become a financial auditor?

- Financial auditors have to be certified:
 - of high moral conduct: eg no criminal punishments, no misconducts as a manager for a company which has bankrupted, etc
 - appropriate higher education – economics, finance, business administration, etc
 - relevant experience for at least 3 years for FA or 2 years for IA
 - pass the exam: auditing standards, accounting, public sector (for public sector auditors), internal audit (for IA only), personal characteristics
- Certificate is given by the Minister of Finance
- The auditor gives an oath and must become the member of Board of Auditors.
- The certificate can be revoked if the auditor is found guilty of negligence performing his duties as an auditor or engagement in other unlawful activities.

Board of Auditors

- Co-ordinating body for financial auditing activities:
 - Supervision of auditors, including punishments and revoking of certificates
 - Evaluation of quality of audits (each auditor once over three years)
 - Collecting and evaluation of reports on auditing activities from auditors and audit companies
 - Advising on regulations concerning auditing and certification activities

Members of the board are auditors and audit companies*.

The regulation is prepared by the Ministry of Finance.

* Audit company is a company, which main activity is financial auditing, $\frac{3}{4}$ of legal representatives must be certified auditors.

How to become an internal auditor?

- Have to be certified, but very few have so far.
- Some exceptions:
 - For applying 2 y of experience
 - Have to pass only the internal audit part of the exam
 - No co-ordinating board, report to the Ministry of Finance
- Other requirements similar to financial auditors
- Internal auditors have their own representative body – Estonian Internal Auditors Union, but it has no such powers as Board of Auditors.

Maintaining the certificate

- Financial auditors:
 - Obligatory amount of training per year, 16 academic hours.
 - Reporting to the Board of Auditors about the activities: including stating the amount of auditing hours and fees.

Internal auditors:

- Obligatory amount of training per year, 20 academic hours for public sector and 40 academic hours for private sector internal auditors
- Reporting about the activities to the Ministry of Finance.



When the financial audit is needed?

Financial audit is a service for general public, the users of information are all people who might be interested in the company – customers, clients, partners, workers, etc.

Report is public.

Financial auditing must be performed each year in:

- Public companies – stocks/bonds publicly traded on stock exchanges
- Credit companies
- Insurance companies
- Municipalities with population over 10 000 or whose assets are over 20 million euros
- All ministeries

When the financial audit is needed? (2)

In addition companies with (at least two of the following):

- Revenues or sales over 66 million euros
- Assets 33 million euros
- Average number of employees over 1000

Or state owned companies, funds or other entities with (at least three of the following):

- Revenues or sales over 14 million euros
- Assets 7 million euros
- Average number of employees over 200
- At least 8 members of the board

When is the internal audit needed?

Internal audit is an internal service of the company or entity, the user of information is the management of the company.

- Scope and activities are determined by the management.
- Report is for internal use only.
- Some examples of activities include:
 - Evaluation of internal control system
 - Evaluation of the accuracy of information presented to the management
 - Performance evaluation of a process or department
 - Detection of fraud in the company or entity

2. Public sector auditing in Estonia

According to the State Budget Act the reports of state entities and consolidated annual accounts of state are audited by National Audit Office of Estonia (NAOE). NAOE can rely on reports from private auditors. Therefore:

- State accounting entities (ministries and agencies) are audited by NAOE.
- Municipalities are audited by private auditors.
- State owned foundations, non-profit organisations and companies are audited by private auditors.

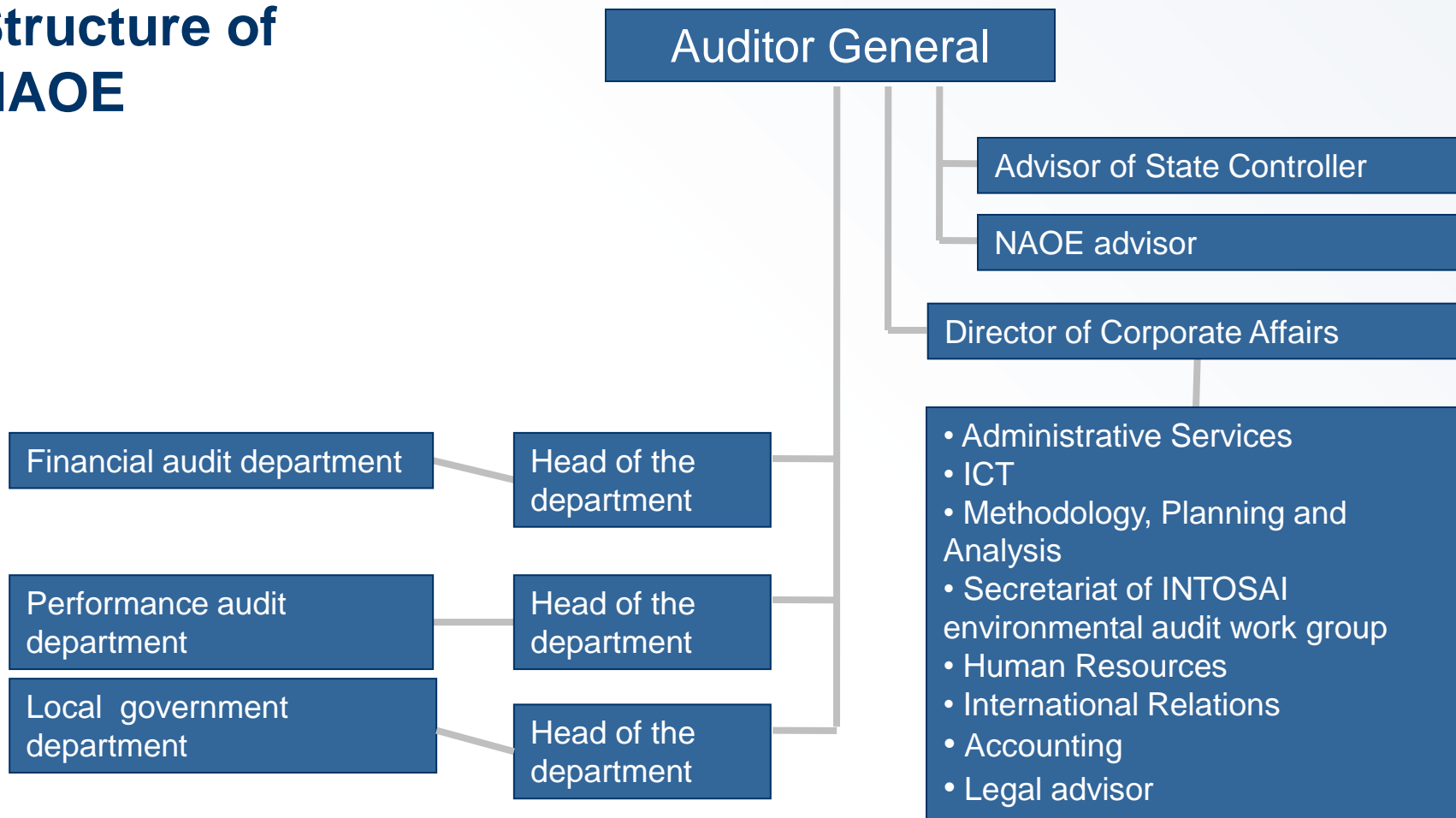
But NAOE can also audit all above mentioned in case they receive funds from the state budget, but only within the limits of those funds.

- Performance of municipalities cannot be audited by NAOE.

National Audit Office of Estonia

- NAOE is a constitutional entity – formation and general principles are stated in the constitution.
- Detailed objectives, obligations and rights are stated in the Act of National Audit Office.
- NAOE is an independent institution, which evaluates the use of public funds collected through taxes.
- According to the constitution reports to Riigikogu (the parliament).
- NAOE has no power to punish or prosecute, only makes observations and recommendations.

Structure of NAOE



Mandate of National Audit Office

- According to the National Audit Office Act, NAOE may assess the following:
 - internal control systems, financial management, financial accounting and financial statements of the audited entity;
 - the legality of the economic activities, including economic transactions of the audited entity;
 - the performance of the audited entity with regard to its management, organisation and activities;
 - the reliability of the information technology systems of the audited entity.



Performance Audit Department

- Investigates whether the use of funds by the public sector is economical, efficient and effective.
- Analyses problems of strategic level, in deep.
- Suggests ideas to resolve problems.
- Identifies the best administrative practices and contributing to spreading of them.
- NAOE can choose independently what and to what extent to audit.
- Main fields of activities: the natural environment, the economic environment, the area of social affairs and health, and the state's infrastructure.
- Examples: Activities of the Government in assessing the impact of its work and in reporting of the results of its work; Organisation of the assessment of the impact of legal acts

(Can be accessed: www.riigikontroll.ee > Publications)

Local Government Department

- Focusing mainly on local governments':
 - legality of the internal control systems
 - financial management
 - financial accounting and economical transactions
 - worthiness of information technology systems
 - legality and efficiency of use of the state assets given to cities and rural municipalities, targeted assistance granted from the state budget and funds allocated for performance of state functions.
- The department does not audit financial statements of the municipalities, private auditors do that.

3. Financial audit in NAOE

NAOE has to issue an opinion on Consolidated Accounts of Central Government and also consolidated financial statements of ministries.

The current scope of financial audits include:

- an opinion, whether the audited financial statements of the central government/ministry give true and fair view of the financial position and financial outcome of the central government/ministry;
- an opinion, whether the transactions of audited period are in compliance with State Budget Act and Annual Budget Act;
- in addition NAOE reports audit findings concerning the effectiveness of internal control systems and cases of non-compliance of other regulations, such as Public Procurement Act, State Assets Act.

Compliance audit in financial audits

- The subject matter and scope of the compliance audit is based on the professional judgement of the NAOE. Three particular laws and relevant subject matter that we focus on are:
 - The Budget Law,
 - The State Assets Act,
 - The State Procurement Act.

Principles for financial audits in NAOE

- The NAOE's Act, Auditors Activities Act and Auditing Standards give the main principles for conducting audits. These main auditing principles are specified in NAOE's Auditing Guidelines.
- NAOE's Auditing Standards and Guidelines are based on Public Sector Auditing Standards (ISSAI).
- Our goal has been to implement ISSAIs as much as applicable according to our mandate.



Financial audit department: some facts

- Department was recreated in November 2008
 - Financial audits started in year 2000;
- 28 employees, including head of audit department and 3 audit managers;
 - bachelor or master degree in accounting, business administration;
 - previous experience in field of accounting and auditing;
 - 2 certified public sector auditors so far (under new regulations of Auditors Activities Act
<https://www.riigiteataja.ee/tutvustus.html?m=3>): certification is required for audit managers in the department
- Approximately 20 audit reports per year;
- Mainly audits of financial statements and legality of transactions, additionally audits based on international agreements and special reports:
 - 90% of audits – objective, scope and deadlines are fixed in budgetary law.

History

- Financial audit in NAO started in year 2000:
 - audit managers and head of audit department came from private sector auditing firms, learning from private audit firms;
 - audit of single institutions, focus on accounting issues and budgetary report, not on financial statements;
 - adapting private sector financial audit methodology to public sector and implementing compliance audit.



History (2)

- In 2004 the Minister of Finance enforced General Guidance of the Public Sector Accounting:
 - general accounting principles for the public sector entities are based on full accrual principle;
 - compilation of consolidated financial statements.
- Accounting principles in public sector are based on Estonian GAAP and on International Public Sector Accounting Standards (IPSAS);
- Consolidated financial statements also include the budgetary execution report:
 - cash based reporting in budgetary reporting vs accrual based financial statements.
- From 2004 audits of consolidated financial statements of the state and legality of transactions:
 - audit work was divided between internal auditors and NAO
 - Internal auditors were responsible for auditing the financial statements of ministries
 - NAO was responsible for auditing the financial statements of the state

History (3)

- The reason for dividing the audit work between internal auditors and NAO was lack of resources;
- The main criticism regarding dividing of financial audit work:
 - the system where internal auditors had a function of external audit was in conflict with international auditing practise and raised questions about the independence of auditors' opinions issued within financial statements of ministries;
 - the inefficiency of the system, meaning that NAO and internal auditors were duplicating their work.
- Lesson learned:
 - co-operation with internal audit is recommendable, but the tasks of certified financial auditors cannot be delegated to internal auditing functions.
- Since 2010 the internal auditors no longer audit the financial statements of ministries.

Annual accounts of the state

Consolidated accounts of the public sector

Consolidated accounts of the governmental sector

Consolidated accounts of central government

State accounting entities

State owned companies,
state foundations

Local
governments

Bodies
governed by
public law

Bank of
Estonia, etc

Financial reporting to the parliament and public

- Financial statements of each ministry:
 - consolidated accounts include accounts of each ministry and its agencies;
 - 17 state accounting entities;
 - annual accounts include management report, balance sheet, income statement, cash flow statement, statement of net assets, appendixes and report on execution of the budget;
 - financial statements are prepared by 30 April and audited by 30 June in following year;
 - financial statements are audited by NAOE;
 - Financial statements are approved by the government and made publicly available on websites.

Financial reporting to the parliament and public (2)

- Consolidated Annual accounts of state
 - prepared by Ministry of Finance on the basis of the annual reports of state accounting entities;
 - draft of consolidated presented to NAOE on 30 June and audited by 31 August;
 - approved by the Government after receiving the audit report issued by NAOE;
 - presented to the Parliament and made publicly available after approval;
 - discussed in Parliament both in Finance Committee and in State Budget Control Committee.

Main findings and conclusions

- In 2000 the picture was very diversified
 - Depended solely on the qualification and motivation of chief accountant to prepare financial statements
 - Focused on budgeting and budget execution
 - No internal auditors
- Significant development since 2004
 - General Guideline of the Public Sector Accounting:
 - Consolidated financial statements – systematic approach
- Present situation is relatively stable
 - More and more compliance issues
 - More problems arising at agency level



Remarkable errors

- Accounting area –
 - Poor quality of inventories (stocktaking) – fixed assets, inventory, receivables,
 - Police penalties
 - Pension provisions
- Regularity area
 - St Petersburg church construction – prohibited loan,
 - Investments *versus* expenditures
 - Public procurements
 - State property – low rent prices

New tasks in financial audit

- Important changes took place in 2010:
 - task of auditing financial statements of ministries was taken from internal auditing function and assigned to NAO;
 - clear mandate for NAO to act as a group auditor,
 - as far as applicable NAO is obliged to follow professional standards, which are based on ISA-s;
 - public sector certified auditor – certification, which allows to conduct audits in public sector entities;
 - financial auditors in NAO have to pass the abovementioned certification;
 - financial audits conducted in NAO are subject to the quality control carried out by the Board of Auditors.

Certification of financial auditors in NAOE

- Certification system has been built up on the existing system in the private sector;
- However the certification system has been revised:
 - ISA, IFRS are subject of certification
- Examination for public sector certified auditor includes:
 - Special part of auditing (ISAs);
 - Special part of accounting (IFRS and Estonian GAAP);
 - Special part of legal acts (taxation, business law etc);
 - Special part of public sector context and public law.
- Certification is mandatory for signing the audit reports in NAOE;
- NAOE's internal decision - audit manager level has to pass the certification.



NAOE as the group auditor

- **Since 2011:** NAOE is the group auditor of consolidated state accounts. NAOE is also responsible for the direction and supervision of the audits performed by auditors of the components.

The role of group auditor

- NAOE has to fulfill the role of group auditor and we have set an ambitious goal to comply with ISSAI 1600;
- Our aim is to raise the awareness of private sector auditors auditing public sector entities that more emphasis should be paid on public sector context (incl expectations of parliament and taxpayers) and regularity issues while auditing financial statements;
- Working as a group auditor on state level adds additional tasks:
 - state owned companies, state foundations and bodies governed by public law are audited by private audit firms;
 - audit of compliance is obligatory in state owned companies and state foundations;
 - NAOE has to issue guidelines for private sector auditors on compliance audit.

The role of group auditor (2)

- The role of group auditor based on ISSAI 1600 includes:
 - understanding the Group and all of its components (ministries, agencies, public sector companies, state foundations etc)
 - regular communication with components auditors and understanding of components auditors work;
 - NAOE audit methodology differs from practices of components auditors in context of auditing compliance – need to prescribe audit procedures;
 - in some cases involvement in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.
- The financial audit department is fulfilling this task since September 2012.

Assuring quality

Quality reviews of audits are conducted once a year by private audit companies and by ourselves:

- gives us valuable feedback, how to comply with international standards on auditing;
- voluntary up till now; required in the future.

Training and methodology

Audit methodology has been developed in financial audit department by financial auditors, no separate unit for audit methodology:

- methodology updating in the beginning of every new auditing season.
- Continuous trainings play a key role in implementing any audit methodology:
- NAOE's in-house training program for auditors (for understanding the public sector and for performing compliance audit)
- but also in trainings organised by Board of Auditors, by Ministry of Finance
- on regular basis financial audit seminars in audit department;
- in the beginning of new auditing season lessons from previous season are discussed.

Challenges – compliance audit

- The main objective is to move towards reporting in the form of reasonable assurance opinions.
- So far NAOE has expressed opinion based on reasonable assurance only on the subject matter concerning budget law.
- Compliance Audit Guidelines are too general for direct implementation (comparing with financial audit guidelines):
 - requires lot of work in methodology development.
- Limitation of scope is necessary – only the most important laws, provisions and relevant subject matter are audited on the basis of reasonable assurance.

Challenges in implementing ISSAI-s

- Reforms in public sector accounting and reforms in public sector auditing are interdependent: implementation of accrual accounting and financial reporting based on IPSAS may require SAls to adapt their financial audit work.
- Training of staff is essential and competence of the applicants must be carefully measured in recruitment.
- Very time and resource consuming process.
- Professional judgement application is demandable.
- Auditing in compliance of all ISSAIs requirements is obligatory if you want to declare that your audit has been done in accordance with ISSAIs.

Thank You!

