



CONCEPT PAPER ON
**COOPERATION AMONG
PUBLIC SECTOR AUDIT AND
FINANCIAL INSPECTION ENTITIES**

May 2017

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Contents

PREFACE	1
ACKNOWLEDGEMENTS	3
ACRONYMS AND ABBREVIATIONS	4
EXECUTIVE SUMMARY	5
1. INTRODUCTION	7
2. FUNCTIONAL ARRANGEMENTS	9
2.1 Internal Audit	9
2.2 External Audit	10
2.3 Financial Inspection	11
2.4 Internal Control	12
3. INSTITUTIONAL ARRANGEMENTS	15
3.1 Internal Audit	15
3.2 Supreme Audit Institutions (SAIs)	16
3.3 Financial Inspection	17
3.4 Managing change	18

4.	KEY FEATURES OF THE ROLE AND WORK OF INTERNAL AUDIT, SAIS AND FINANCIAL INSPECTION ORGANIZATIONS	19
5.	MAIN AREAS OF POTENTIAL OVERLAP AMONG THE INTERNAL AND EXTERNAL AUDITS, AND FINANCIAL INSPECTION FUNCTIONS	23
6.	THE BENEFITS AND RISKS OF COOPERATION	25
7.	A COOPERATION FRAMEWORK	26
7.1	Types of cooperation	26
7.2	Principles of good cooperation	28
7.3	The need for formal agreements between institutions	29
	ANNEX: DEVELOPING A COOPERATION AGREEMENT	30
(A)	Key issues to consider when preparing a cooperation agreement	31
(B)	High-level cooperation agreement	34
(C)	Detailed cooperation agreements	38

Preface

This publication is a product of knowledge sharing and collaboration among members of the Internal Audit Community of Practice (IACOP) of the Public Expenditure Management Peer-Assisted Learning (PEMPAL) network.

The PEMPAL network, launched in 2006 with the assistance of the World Bank, is a regional body that aims to support reforms in public expenditure and financial management in 21 countries in Central Asia and Central and Eastern Europe by promoting capacity building and exchange of information. The IACOP, one of the three Communities of Practice around which the network is organized, has representatives from 23 countries of the Europe and Central Asia region.

The mission of the IACOP is “to offer support to its member countries in establishing a modern and effective Internal Audit system that meets international standards and best practices, and is a key for good governance and accountability in the public sector.”¹ Majority of IACOP member countries aspire to transform their traditional public sector control systems from ex post centralized external financial control, that is the Inspection function, to contemporary internal control systems that foster transparency and strengthen the management of public funds. They are facing significant challenges as they seek to simultaneously develop the main control functions and ensure an appropriate balance among them in a modernized public sector control system. Therefore, in its 2016 – 2017 Strategic Action Plan, IACOP identified the Relationship of Internal Audit with Financial Inspection and External Audit (RIFIX) as a priority area, and its members agreed to develop a concept paper on RIFIX within two years.

1 Source: PEMPAL 2015 Annual Report

This publication fulfills the objective set by the RIFIX Working Group and demonstrates the commitment of the IACOP to improving Public Financial Management (PFM) in its member countries. IACOP continues to expand the line of knowledge products that started with publication of the *Good Practice Internal Audit Manual* in 2012², followed by the *Good Practice Continuing Professional Development Manual Template*³, the *Internal Audit Body of Knowledge*⁴, *Risk Assessment in Audit Planning Guide*⁵, and the *Quality Assessment Guide for Public Sector Internal Audit*.⁶ The quality of these materials reflects an underlying extensive collaborative process, which includes participation of practitioners and policymakers in member countries. The IACOP hopes that users will find it valuable in the establishment of effective collaboration among public sector internal and external audit entities and financial inspection bodies.

May 2017

2 https://www.pempal.org/sites/pempal/files/attachments/audit-manual_final_eng.pdf

3 <https://www.pempal.org/sites/pempal/files/attachments/cdp-good-practice-eng-.pdf>

4 <https://www.pempal.org/sites/pempal/files/attachments/publishing-bok-eng.pdf>

5 https://www.pempal.org/sites/pempal/files/attachments/rap_guide_eng.pdf

6 https://www.pempal.org/sites/pempal/files/knowledge_product/pempal_iacop_quality_assessment_guide_eng.pdf

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Specifically, IACOP would like to recognize the following key contributors:

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Acronyms and Abbreviations

COSO	Committee of Sponsoring Organizations of the Treadway Commission
CHU	Central Harmonization Unit
FI	Financial Inspection
IA	Internal Audit
IACOP	Internal Audit Community of Practice
IIA	Institute of Internal Auditors
INTOSAI	International Organization of Supreme Audit Institutions
ISSAI	International Standards of Supreme Audit Institutions
PEMPAL	Public Expenditure Management Peer-Assisted Learning
RIFIX	Relationship of Internal Audit with Financial Inspection and External Audit
SAI	Supreme Audit Institution
SOE	State-owned Enterprises

Executive Summary

This publication explores the need for internal audit to collaborate with other public sector organizations given the unique circumstances that exist in many Public Expenditure Management Peer-Assisted Learning (PEMPAL) member countries.

Auditing, a component of the Anglophone model of financial management, is relatively new in many PEMPAL member countries, which operated under the Francophone model of financial management. Internal and external audits are now recognized as key elements of strong financial management in the public sector, and demonstrate the need for both internal and external financial checks or inspections of the practices used by budget holders to implement the budget.

One might expect that the evolution of new internal and external audit functions would be accompanied by changes in the way that budget implementation is controlled. However, in practice, the financial inspection function continues to exist in many PEMPAL member countries and in other countries that follow the Francophone model of financial management.

Audit shares many similar characteristics with financial inspection, for example, independence of management, review of financial transactions, and reporting results. As a result there is scope for overlap and duplication of efforts and consequently benefits may be derived from coordination and cooperation.

IACOP recognizes that there are formal and informal means to facilitate cooperation and that they can range from relatively simple coordination of activities to more involved ways of working together. This spectrum of cooperation indicates that audit and inspection functions may cooperate effectively at different levels of formality and effort.

In establishing guidance on cooperation, IACOP endorses and promotes the four principles of cooperation developed by the International Organization of Supreme Audit Institutions (INTOSAI), namely, commitment, consultation, communications and confidence. These principles are equally applicable to cooperation between internal and external audit, internal audit and financial inspection, or external audit and financial inspection.

It may be helpful for cooperation to be formally recognized in an agreement between two or more of these institutions. For countries that wish to explore formal agreements, this publication outlines options for developing cooperation agreements at the country level and provides suggested wording that could be used. In doing so it recognizes the opportunities and challenges faced by public sector governance organizations that choose to participate in the process.



Introduction



The features that characterize the role of state institutions involved in audit and financial inspection reflect:

- the historical development of Public Financial Management (PFM) and administration in a country; and
- developments in international standards and best practices in auditing and internal control.

For this reason, the type of audit and financial inspection functions and institutions that exist in each country, as well as the rules and regulations that govern their operations, vary from one to another.

Internal audit has existed in many countries for a long time and is a key feature of the Anglophone model of public financial management. However, it was not part of the Francophone model, which forms the basis for public financial management in many of the countries that are PEMPAL members. Under the Francophone model, financial controllers or inspectors were responsible for verifying that public expenditure was incurred in accordance with the regulations governing the use of the budget. Over the past 15-20 years many countries that operated under the Francophone model have introduced internal audit in their countries. In addition, many of these countries have sought to introduce an external audit function to replace the external financial inspection work previously undertaken.

The introduction of internal and external audits in parallel to the already established traditional role of financial inspection has led to a need to clarify the roles and responsibilities of the institutions that carry out these functions. Also, it has created the necessity to promote mechanisms for effective cooperation and coordination among the three functions where they exist in a single country.

While there are international internal and external audit standards that include guidance on the relationship between these two functions, there are no international standards that govern the work of financial inspection bodies or their relationship with internal and external audit.

Therefore, the purpose of this publication is to enhance understanding of, and facilitate good practices that strengthen the relationship among internal and external audits, and financial inspection entities. It focuses on the need for the internal audit function to cooperate with other public sector organizations to avoid overlap and duplication and improve relationships. In doing so, it considers the particular circumstances that exist in many PEMPAL member countries and gives an overview of the different functions and institutional arrangements, key features of their work, and areas of overlap. After a brief discussion of the benefits and risk of cooperation, this publication describes types of cooperation framework and provides practical guidance on how they can be created.

Functional Arrangements

2

This section presents definitions of the functions of internal and external audit, financial inspection and internal control followed by short commentaries that give further insight.

Internal Audit

2.1

The Institute of Internal Auditors (IIA) defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.⁷

The **IIA** defines 2 main types of engagement:

- **Assurance Services**

An objective examination of evidence for the purpose of providing an assurance regarding an entity, operation, function, process, system or other subject matter. The range of assurance services engagements include financial, performance, compliance, system security, and due diligence engagements.

- **Consulting Services**

Advisory and related client service activities that are performed at the specific request of an engagement client, and the nature and scope of which are agreed with the client. Internal auditors should remain objective when providing consulting services and should not assume management responsibility. Examples of consulting services include counsel, advice, facilitation, and training.

⁷ Institute of Internal Auditors. 2017. *International Professional Practices Framework*.

Commentary

Internal auditing developed as an integral part of the system of internal controls during the 20th century. As organizations in both the public and private sectors increased in size, Chief Executive Officers (CEOs) could no longer maintain personal oversight of the system of internal control. Therefore, they created small units that were independent of line managers and reporting to them alone to advise on whether controls were operating as planned. Traditionally, the focus of internal audit was on compliance with procedures (the controls that should be in place) and financial matters. The focus of internal audit has expanded beyond compliance with regulations and reviews of financial systems to encompass advisory work on control, risk management and governance. It now also includes audit of the economy, efficiency and effectiveness of income and expenditure.

As internal auditing evolved, its role has been codified in standards first issued in the United States of America by the IIA, which are increasingly used globally. It is now generally accepted that internal auditing should be conducted in accordance with established standards related to planning, execution and reporting. For countries that have decided recently to introduce internal audit there is documented good practice that can be used to help outline how it should operate, including guidance on the relationship with external auditors.

A further and fairly recent development has been the creation of audit committees to ensure the effectiveness of internal audit and reinforce its independence from line management by providing the CEO with expert advice on the effectiveness of the internal audit function. Audit committees also play a role in promoting good coordination between the internal and external auditor.

2.2 External Audit

An external audit is an audit that is carried out by an entity that is independent of the audited entity in accordance with an identified set of auditing standards. The International Standards of Supreme Audit Institutions (ISSAI) issued by the International Organization of Supreme Audit Institutions (INTOSAI) describe three broad categories of public sector external audits.

- **Financial audit** focuses on determining whether an entity's financial information is presented in accordance with the applicable financial reporting and regulatory framework. This audit is accomplished by obtaining sufficient and appropriate audit evidence to enable the auditor to express an opinion as to whether the financial information is free from material misstatement due to fraud or error.⁸
- **Performance audit** is an independent, objective and reliable examination of whether government undertakings, systems, operations, programs, activities or organizations are operating in accordance with the principles of economy, efficiency and effectiveness and whether there is room for improvement.⁹
- **Compliance audit** is the independent assessment of whether a given subject matter complies with applicable authorities identified as criteria. Compliance auditing is conducted by assessing whether activities, financial transactions and information comply, in all material respects, with the authorities that govern the audited entity.¹⁰

Commentary

The Supreme Audit Institution (SAI) of a country generally performs external audit of public sector budget financed entities. They may also carry out external audits of State-owned Enterprises (SOEs) and local authorities. Section 3.2 provides details on SAI's institutional arrangements.

Financial Inspection

2.3

Financial inspection (FI) seeks to protect public financial interests through conducting ex post financial inspections to identify occurrences of violations of the legislative acts regulating the budget, economic or accounting activities, as well as indication of frauds. FI institutions carry out ex post financial checks through examination of documents and other evidences of the financial and management activity of state institutions and SOEs. These institutions monitor and follow up irregularities and impose administrative penalties as necessary. While they are not responsible for prosecuting misconduct, they provide evidence as appropriate to the relevant prosecuting authorities.

8 ISSAI 200 *Fundamental Principles of Financial Auditing*

9 ISSAI 300 *Fundamental Principles of Performance Auditing*

10 ISSAI 400 *Fundamental Principles of Compliance Auditing*

Commentary

The FI function has its roots in highly centralized government systems with detailed budgets where the Ministry of Finance (or in some countries the Prime Minister's Office) retains a central inspection role as part of the overall system of internal control. The main role of FI is to review or inspect the budget expenditures of budget holders of state government bodies, and other organizations that receive funds from the budget, to verify that budgeted funds have been spent in accordance with the law. The focus is to ensure that budgeted funds have been spent without violating the legal and regulatory framework or in a fraudulent and irregular manner.

2.4 Internal Control

COSO's 2013 Internal Control – Integrated Framework defines internal control¹¹ as a **“process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.”**

This definition reflects certain fundamental concepts. Internal control is:

- **Geared to the achievement of objectives** in one or more categories - operations, reporting, and compliance
- **A process** consisting of ongoing tasks and activities - a means to an end, not an end in itself
- **Effected by people** - not merely about policy and procedure manuals, systems, and forms, but about people and the actions they take at every level of an organization to affect internal control
- **Able to provide reasonable assurance** - but not absolute assurance, to an entity's senior management and board of directors
- **Adaptable to the entity structure** - flexible in application for the entire entity or for a particular subsidiary, division, operating unit, or business process.

This definition is intentionally broad. It captures important concepts that are fundamental to how organizations design, implement, and conduct internal control, providing a basis for application across organizations that operate in different entity structures, industries, and geographic regions.”

¹¹ The discussion of the internal control definition in this section was selected directly from the COSO 2013 *Internal Control – Integrated Framework*.

FIGURE 1: THE THREE LINES OF DEFENCE MODEL OF INTERNAL CONTROL



Commentary

COSO's definition of internal control encourages senior management of public sector institutions to take responsibility for internal control by implementing the five components of internal control in order to:

- promote the right control environment (**Control Environment**);
- ensure that risks to the achievement of objectives are assessed and responded to in a timely manner (**Risk Assessment**);
- put in place control activities necessary to address risks to the achievement of objectives (**Control Activities**);
- promote strong systems of information and communication to ensure that those responsible for implementing internal controls have the information they need (**Information and Communication**); and
- ensure that internal controls are monitored and that internal control deficiencies are reported to those who can take action to address them (**Monitoring**).

The work of oversight functions, for example internal audit, that exist inside public sector organizations is a key element of internal control under the monitoring component. Increasingly, internal audit is described as the third line of a "Three lines of defense" risk management and internal control model (see Figure 1). FI institutions and the SAI are outside this model as they are external oversight bodies. However, they are key parts of the overall public sector governance arrangements in countries where they exist.

12 FI institutions and SAIs are sometimes referred to as a fourth line of control but they are not part of internal control as classically defined. In some instances, FI institutions can provide a second line of defense but only with respect to the internal control responsibilities of their parent bodies.



Institutional Arrangements

3

The institutional arrangements for implementing the functions described above may differ across PEMPAL countries. For example, financial inspection may be carried out by an institution formed by, and reporting to, the Minister of Finance or the Prime Minister. Alternatively, the Supreme Audit Institution (SAI) may conduct this activity. In the case of internal audit, a unit created within a public sector organization and reporting to the senior manager usually undertakes this function. However, a centralized unit that covers a number of organizations may provide internal audit services.¹³

Internal Audit

3.1

Internal audit units are typically created within each public sector organization and report to the head of the organization concerned. However, some public sector organizations may be too small to justify a separate internal audit unit. This can lead to the creation of other arrangements to share internal audit services across a number of institutions. In some countries there are also centralized internal audit institutions that provide internal audit services across the entire public sector.

Central Harmonization Units

Many PEMPAL countries have created a central unit responsible for providing the overarching legal framework, guidance, training and advice related to internal audit in the public sector, which are often called a Central Harmonization Unit (CHU). CHUs are also responsible for overseeing the implementation of new approaches to internal control in line with international best practice.

¹³ A central IA unit reports only to the CEO of the entity being audited.

Commentary

The CHU is usually the only entity at the central government level that is competent to represent the general views of internal audit units in discussions with FI institutions and the SAI. Therefore, these units have an important coordinating role in establishing and promoting cooperation between internal and external audit and financial inspection bodies.

3.2 Supreme Audit Institutions (SAIs)

An SAI is the institution in a country that carries out the highest level of independent oversight of central government finances, and is an integral part of the overall public sector governance arrangements.

SAIs are organized in two main ways, namely, as a collegiate body or as a monocratic institution that is led by an Auditor General. The model of a collegiate body derives from the traditional (French) establishment of the Court of Accounts as an independent judicial control function over the accounts of the state. In many countries where the Court of Accounts still exists the judicial and audit functions are combined. However, most contemporary Courts of Accounts/Audit Offices provide opinions on State budget accounts to Parliament based on the audits undertaken, and often no longer have judicial powers.

Although most SAIs conduct external audits, some SAIs only carry out examinations that are similar in nature to financial inspection. This is often a reflection of the way that budget authority is provided by Parliament either based on the Francophone or Anglophone model.

- **Francophone model** - budgetary authority is provided to large numbers of budget holders in each public sector organization. The role of financial inspection by an SAI is therefore to provide budgetary discharge (or budgetary closure) for individual budget holders. This is typically done on a cyclical basis, for example biennially, so that an inspection may cover a number of years since the institution was last inspected, unlike the annual audits under the Anglophone model.

- **Anglophone model** - budget authority is provided to the head of each public sector organization and then further delegated by the head of the institution to subordinates. The role of external audit by an SAI is to provide an annual audit opinion on the financial statements of each organization (or the public sector as a whole). An unqualified audit opinion represents the budgetary discharge for the budget holder.

Commentary

The global trend promoted by multilateral development banks such as the World Bank and political and economic unions like the European Union (EU) has been to encourage a shift of SAI functions towards external audit. Courts of Accounts are increasingly encouraged to provide audit opinions on the annual accounts of government.

Financial Inspection

3.3

Financial inspection institutions are usually separate entities created within, and reporting to, the Ministry of Finance. In some countries the entity may report directly to the Prime Minister.

Commentary

Financial inspection institutions have many features in common with audit institutions. They are usually independent of the bodies they inspect, focus on the review of financial transactions, examine the extent to which inspected bodies comply with financial rules and regulations, and issue reports on their findings emphasizing areas of non-compliance.

The major differences between FI and audit bodies relate to disciplinary and penal powers, reporting lines and the scope of activities conducted. FI institutions have powers to levy penalties on individuals who fail to comply with financial rules and regulations whereas auditing bodies do not have such authority. Furthermore, the reporting lines of FI and audit bodies are different, that is financial inspection usually reports to the Minister of Finance, while internal audit reports to the head of the audited entity and SAIs report to Parliament. Finally, audit bodies usually have a wider mandate to examine economy, efficiency and effectiveness of public expenditure.

3.4 Managing Change

The financial management arrangements in the public sector are constantly evolving to meet changes in best practice. For example, changes to the financial management system in France over the past 10 years have led to a shift away from the traditional Francophone model towards the Anglophone model of financial management. In addition, COSO issued new guidance in 2013 that constitutes best practice in terms of internal control.

Where PEMPAL countries are transitioning from a Francophone to an Anglophone model of financial management, the long-term role of financial inspection will often require review. This is essential to ensure that there is a balance between the roles of internal audit and financial inspection that enhances (and does not reduce) the accountability of individual Ministers to Parliament, which is a key element of the Anglophone model.

For SAIs that have made, or are making, the transition from an external financial inspection function to an external audit function there can be significant challenges in retraining staff to work as auditors. In addition, there are expected shifts in the relationships between financial inspection and internal audit over the short to long term.

Initially the SAI will have more in common with the FI organization and they could share forward plans in terms of the organizations both institutions intend to inspect. Also, the manner in which both institutions carry out financial inspection activities will be very similar. However, as the SAI transitions towards external audit it will have less in common with the FI body. Since they will be conducting different types of reviews, there will not be the same need to share forward plans. Increasingly, the SAI will need to engage more with internal auditing primarily because audit standards require external auditors to review internal controls of which internal audit is a component. External auditors may also want to place reliance on the work of internal auditors in forming their opinion on the financial statements.

Key Features of the Role and Work of Internal Audit, SAIs and Financial Inspection Organizations

4

The institutional arrangements for implementing the functions described above may differ across PEMPAL countries. For example, financial inspection may be carried out by an institution formed by, and reporting to, the Minister of Finance or the Prime Minister. Alternatively, the Supreme Audit Institution (SAI) may conduct this activity. In the case of internal audit, a unit created within a public sector organization and reporting to the senior manager usually undertakes this function. However, a centralized unit that covers a number of organizations may provide internal audit services.¹³

TABLE 1: MAIN FEATURES OF INTERNAL AUDIT, SAI AND FINANCIAL INSPECTION INSTITUTIONS/FUNCTIONS

Features	Internal Audit	Supreme Audit Institution	Financial Inspection
Powers derive from	Head of the organization that established the internal audit unit and the Audit Committee if it exists	Parliament or Judicial law	Ministry of Finance or Prime Minister
Reports to	Head of organization that established the internal audit unit and the Audit Committee if it exists	Parliament or the public (through publication of decisions)	Minister of Finance, Prime Minister or Government Council/Cabinet of Ministers

Features	Internal Audit	Supreme Audit Institution	Financial Inspection
Must be independent of	Line management in Ministries	Government	Head of the organization controlled
Can rely on the work of others	Yes	Yes	No
Can issue penalties/ fines	No	Possibly, if it is a judicial institution	Yes
International standards exist	Yes. Issued by the IIA	Yes. Issued by INTOSAI (ISSAI)	No
Standards govern work	Yes, if internal audit is mandated to follow standards	Yes, if SAI law requires SAI to follow standards	No
Provides opinion on financial statements	No	Yes, if carrying out external audit	No
Examines financial transactions	Yes	Yes	Yes
Provides annual report to Parliament	No	Yes, if carrying out external audit If not carrying out external audit it may provide a report on the outcome of financial inspection work.	Not usually
Conducts ex ante reviews of systems and processes	Yes	No	No

Features	Internal Audit	Supreme Audit Institution	Financial Inspection
Risk-based planning	Yes	Yes (usually)	Possibly
Scope of examination	All areas of the public sector organization's work	<p>If carrying out external audit work is required to provide an opinion on the financial statements</p> <p>If not carrying out external audit conducts cyclical review of all financial transactions and finance related processes</p> <p>Policy implementation reviewed during selected performance audits</p>	All financial transactions and finance related processes
Coverage	Based on internal audit strategy and risks	<p>If carrying out external audit issues annual audit opinion on financial statements.</p> <p>If not carrying out external audits the coverage is usually cyclical with the aim to review all budget holders over a number of years.</p> <p>Cyclical performance audit</p>	Cyclical with the aim to review all budget holders over a number of years
Approach	Systems based audit	<p>When carrying out external audits there are different approaches depending on the type of audit undertaken:</p> <ul style="list-style-type: none"> - Financial Audit - Regularity Audit - Performance Audit. <p>If not carrying out external audit:</p> <ul style="list-style-type: none"> - Review of compliance with regulations 	Review of compliance with regulations

Features	Internal Audit	Supreme Audit Institution	Financial Inspection
Purpose of any review of internal controls	To provide assurance to management on the effectiveness of controls	<p>When carrying out external audit the SAI may determine whether controls are operating effectively to reduce direct substantive testing</p> <p>If not carrying out external audit the SAI may review controls to identify areas of non-compliance and violations of regulations</p>	To identify areas of non-compliance and violations of regulations
Role in relation to fraud and corruption	<p>May identify areas of possible fraud and corruption from audit work</p> <p>May also carry out audits in areas of high risk of fraud and corruption</p>	May identify areas of possible fraud and corruption from other work	<p>Inspection may be planned to examine areas of high risk of fraud and corruption</p> <p>May identify areas of possible fraud and corruption from other controls work</p>
Results of work	<p>Assurance</p> <p>Recommendations for action by management</p>	<p>When carrying out external audit provides audit opinions (qualified and unqualified) and other reports to Parliament</p> <p>When not carrying out external audit - corrections and sanctions</p>	Corrections and sanctions



Main Areas of Potential Overlap Among the Internal and External Audits, and Financial Inspection Functions

5

The information in the preceding section shows that there is potential for overlap in work across the three functions and their related institutions, and in fact some level of overlap is inevitable. It is worth noting that overlaps may not cause problems. For example, audit standards allow the external auditor to place reliance on the work of others (including internal audit) provided that the external auditor is satisfied that this work has been done to an appropriate standard.¹⁴ The key areas of possible overlap are:

- **The audit or inspection of one public sector institution by three separate entities.**

A single budget holder may be reviewed by FI, IA and the SAI over the course of a single period. This is due to the cyclical or risk based coverage of inspection and internal audit functions, and the range of substantive testing that may be required for external audit work.

- **The review of the same financial transactions by different entities.**

Financial transactions may be subject to both financial inspection and audit. It is also possible that different institutions will come to different conclusions on the validity of individual financial transactions. For example, a financial inspector may conclude that a transaction is in violation of one regulation but an auditor may conclude that the transaction is valid, accurate and complete in all material respects.

¹⁴ ISSAI 1 *Lima Declaration*, Section 3.3 states, "As the external auditor, the Supreme Audit Institution has the task of examining the effectiveness of internal audit. If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and internal audit."

- **All institutions may identify cases of potential fraud and corruption.**

Internal audit may focus on the effectiveness of systems of internal control in combatting fraud, whereas FI may focus on identifying signals and indicators of actual cases of fraud and corruption. SAs and internal audit may also identify cases of fraud and corruption when carrying out other work (i.e. audit or other assignments not focused on fraud and corruption). None of the institutions is responsible for the actual prosecution of cases of fraud and corruption and these are usually passed to another institution.

- **The examination of systems of internal control.**

Although the objectives of each may differ, all three functions may examine aspects of internal control.



The Benefits and Risks of Cooperation

6

Effective cooperation is one way in which the three institutions can avoid the overlaps and duplications noted in section 5.

The benefits of cooperation include:

- Exchange of ideas and knowledge;
- Strengthening each institution's ability to promote good governance and accountability;
- More effective audit and inspections formed by a clearer understanding of respective audit roles and requirements;
- Less disruption to the audited entity;
- Better understanding of the risks facing the organization leading to more focused audit and inspection efforts and better advice to management;
- More coordinated audit and inspection activity;
- A better understanding by all parties of the results of each other's work that can be used to inform future work plans and programs; and
- More opportunity to use the work of others.

There are also risks such as:

- Possible loss of confidentiality, independence, and objectivity;
- Potential conflicts of interest across the three parties;
- Dilution of responsibilities;
- The lack of common standards for the work undertaken by different institutions;
- Misinterpretation of conclusions when using each other's work;
- Possible difference of opinions on the subject matter; and
- Premature communication of the findings of another organization.

7 A Cooperation Framework

IACOP recognizes that there are formal and informal ways of promoting cooperation among the three functions that are the subject of this publication. They can range from relatively simple coordination of activities to more active ways of working together. The available spectrum of cooperation means that audit and inspection functions may cooperate effectively at different levels.

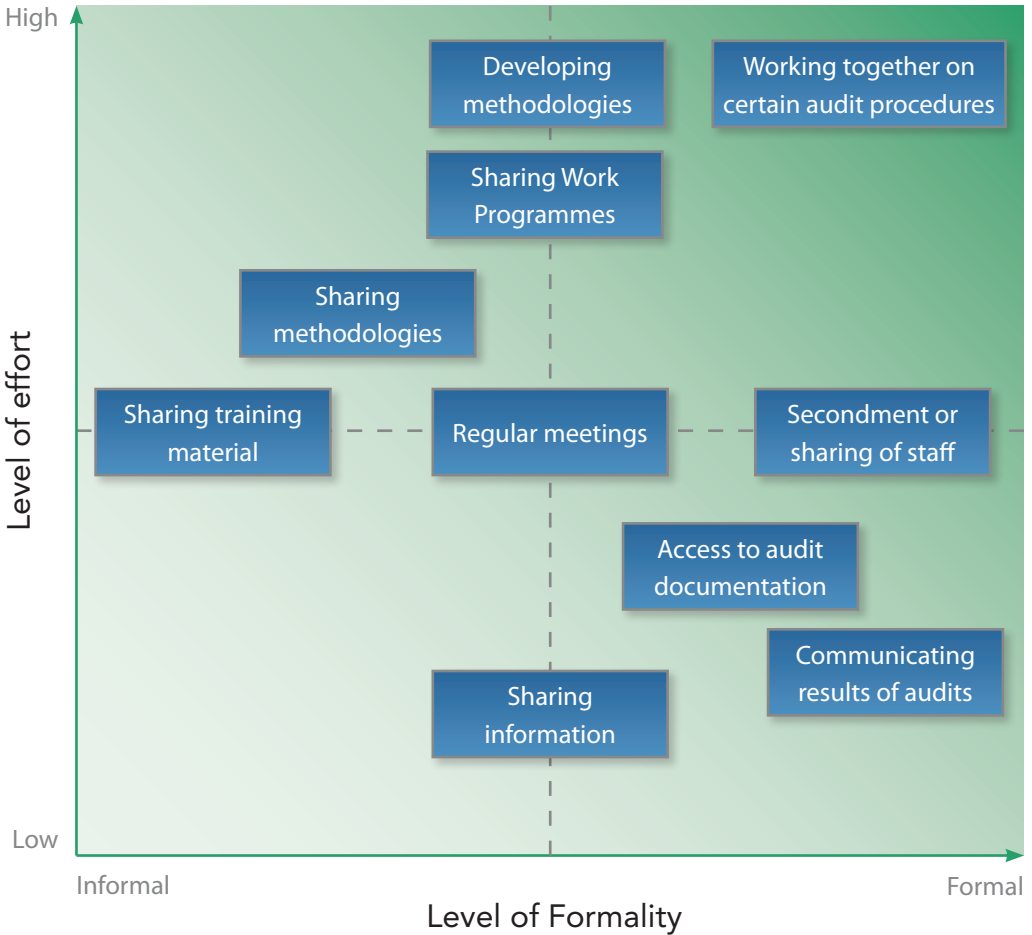
7.1 Types of Cooperation

A range of options for cooperating include:

- Communication and coordination of audit strategy and audit planning (such as joint planning sessions);
- Regular meetings between auditors of IA, SAI and FI;
- Arrangements for the sharing of information (including consultation procedures);
- Communication of the results of audits/inspections to each other;
- Organizing common training programs and courses;
- Developing methodologies;
- Sharing training materials, methodologies and audit work programs;
- Granting access to audit documentation;
- Secondment or sharing of staff (e.g. training on the job);
- Use of certain aspects of each other's work to determine the nature, timing and extent of audit procedures to be performed;
- Collaborating on certain audit procedures, such as collecting audit evidence or testing data;
- Widely involving the CHU in the processes of coordination between IA, SAI and FI.

Cooperation may be carried out informally or formally and with different levels of effort. Figure 2 shows various means of cooperating, degrees of formality and the levels of corresponding effort that may be required.

FIGURE 2: METHODS OF COOPERATION AND CORRESPONDING DEGREE OF FORMALITY AND EFFORT REQUIRED



Activities that feature in the top right quadrant of Figure 2 are more likely to benefit from formal cooperation agreements, whereas activities in the bottom left quadrant would not. Some activities such as meetings could sit in all four quadrants depending on how the meetings are organized and the subjects that need to be covered. While some activities may take little additional effort, such as communicating the results of audits, there are good reasons to ensure that they are done formally, for example to ensure the confidentiality of the information disclosed.

7.2 Principles of good cooperation

IACOP endorses and promotes the four principles of cooperation developed by INTOSAI, which are commitment, consultation, communications and confidence¹⁵. These principles are equally applicable to cooperation between internal and external audit, between internal audit and financial inspection, as well as well as between external audit and financial inspection.

- **Commitment.** Effective cooperation among internal audit and financial inspection organizations, and SAIs can only be achieved if all parties are willing and committed to developing coordinated and effective audit and inspection services. Although they each have their respective roles, responsibilities and accountabilities, these roles often overlap and effective co-operation demands a willingness from all parties to work flexibly to ensure that work is properly coordinated in these areas. Cooperation is likely to be most successful where all parties take an active role in promoting cooperation and are willing to undertake changes to help bring it about. In short, commitment is an attitude of mind.
- **Consultation.** Regular consultations between the three institutions provide the basis for identifying opportunities for beneficial cooperation and the mechanisms to help bring it about. Consultation will provide clarification of ambiguous issues and will ease their work.
- **Communication.** Communication is a two-way process. Regular and open communication between the three institutions is essential to the success of co-operation. Communication that is open and transparent will build trust between IA, SAI and FI when conducting audits and inspections. Formal communications can take the form of meetings, for example to share plans and/or risk assessments. Informal meetings can also be used to promote better understanding of the roles of all three parties. The procedures to facilitate effective cooperation should ideally be agreed by all parties and summarized in a commonly approved document.
- **Confidence.** All parties should have confidence in each other's work when there is a need to collaborate. Whenever the SAI or FI body uses the findings and reports of internal audit they need to be confident that the standard of work undertaken is appropriate and acceptable.

¹⁵ INTOSAI GOV 9150 *Coordination and Cooperation between SAIs and Internal Auditors in the Public Sector*, http://www.issai.org/media/13353/intosai_gov_9150_e_.pdf

Many organizations cooperate without the need for formal agreements between the institutions, where cooperation is informal and requires limited effort from the parties involved. However, it may be beneficial for the cooperation to be formally recognized where cooperative work requires significant inputs from each institution (for example, a commitment to work together on audit activities) or involves sharing confidential information (such as audit work programs and reports).

The Annex explores options for developing different types of cooperation agreements and provides some suggested wording that might be used.

Annex

Developing a Cooperation Agreement

The member countries of PEMPAL have different legal and regulatory frameworks, as well as distinctive institutional arrangements for audit and financial inspection. Therefore, it is not practicable for IACOP to create a single template of a legal agreement that could be used by each country.¹⁶ IACOP decided instead that it would be beneficial to establish a model that could be followed by countries when preparing such agreements.

In practice cooperation agreements are likely to be of two broad forms:

- A high-level or “framework” cooperation agreement, which is negotiated at a public sector wide level by the main institutions with the authority to do so.
- A lower level or “detailed” cooperation agreement, which is negotiated for a single public sector entity.

The high-level framework agreement could be negotiated among all three functions or bilaterally between any two.

The IACOP guidance on developing cooperation agreements is provided in three parts:

- Part A presents key issues to be considered when preparing a cooperation agreement.
- Part B considers what might be included in a high-level framework cooperation agreement between an SAI, FI and the CHU (representing IA units across the country). It also provides examples of the language that could be used for certain cooperation activities.
- Part C describes what might be included in a lower level detailed cooperation agreement between any two of the parties. It outlines some worked examples of the type of cooperation activities that may benefit from a detailed cooperation agreement.

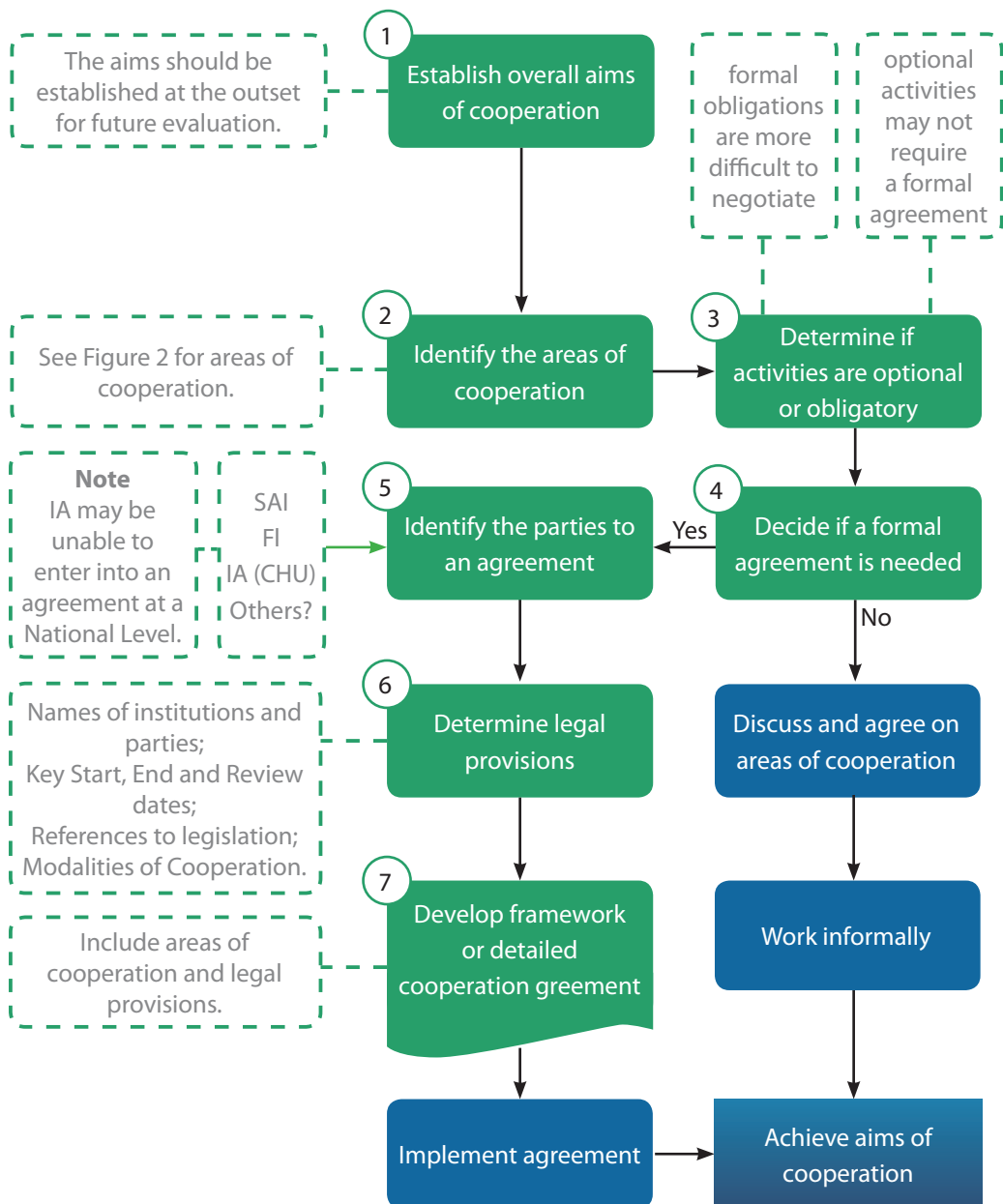
¹⁶ The IACOP RIFIX working group made attempts to develop such a template and were unsuccessful due to the large number of variables involved.

Key issues to consider when preparing a cooperation agreement

A

There are some key issues that need to be considered when preparing a cooperation agreement, which can be regarded as a series of steps outlined in Figure 3.

FIGURE 3: STEPS IN DEVELOPING A COOPERATION AGREEMENT



There are questions that must be answered for steps one through six and these are presented in Table 2 along with guidance comments. Additional notes on preparation of framework or detailed cooperation agreements are provided in Sections B and C, respectively.

TABLE 2: QUESTIONS TO ASK BEFORE PREPARING A COOPERATION AGREEMENT

Question	Comments
<p>1. What are the proposed areas of cooperation?</p>	<p>The most important first step is to identify the areas where cooperation is proposed.</p> <p>The desired area of cooperation needs to be determined before deciding whether a formal cooperation agreement is needed.</p>
<p>2. What are the overall aims and benefits of the proposed cooperation agreement?</p>	<p>As with any proposed use of public sector resources, the aims and expected benefits of proposed cooperation activities should be established at the outset. This will facilitate subsequent review of whether they have been successfully achieved.</p>
<p>3. Are cooperation activities optional or obligatory?</p>	<p>Consideration of whether cooperation is optional (something the entity can do if it so wishes) or obligatory (a formal obligation on one of the parties to do something) is critical.</p> <p>In general, it is more difficult to develop a cooperation agreement if it places formal obligations on each of the parties.</p>
<p>4. Is there a need for a formal agreement?</p>	<p>It takes time to prepare and agree to a formal cooperation agreement between two or more parties. All parties need to consider whether the type of cooperative activities proposed justify the time involved in preparing an agreement.</p> <p>For example, if the intention is for each party to meet informally 3 or 4 times each year to discuss their planned work program, then there is probably no need for a formal agreement.</p>

Question	Comments
<p>5. Who will be the parties to the agreement and are all parties able to enter into a formal cooperation agreement?</p>	<p>Cooperation agreements have to be signed by people with the power to enter into legal agreements. Consider the following:</p> <ul style="list-style-type: none"> • An internal audit unit within a public sector organization is unlikely to be a separate legal entity since it reports to the Head of the institution. In this case, the institution or the CHU on behalf of the internal audit unit may need to be the parties to any cooperation agreement. • A financial inspection unit may be an integral part of the Ministry of Finance where only the Minister may enter into any cooperation agreement.
<p>6. What specific legal provisions need to be included?</p>	<p>There will usually be a need for sections of the agreement that focus on the legal issues. Namely:</p> <ul style="list-style-type: none"> • The parties to the agreement. The names of individuals and the entities that are entering into the agreement. • References to the legislation that enables the parties to enter into an agreement. • Provisions related to the operating modalities of the agreement. Key provisions include when it starts, ends, will be reviewed, and what governance arrangements are to be established.

B

High-level cooperation agreement

This section explores the nature and scope of a high-level framework cooperation agreement covering all three functions of internal and external audit, and financial inspection.

Who would be the parties to an agreement?

The parties to a framework agreement covering all three functions are likely to be:

- The SAI of the country (this will usually be the head of the SAI or a nominated official operating on behalf of the head of the SAI);
- The Minister (or nominated official operating on the Minister's behalf) responsible for FI;
- The Minister (or nominated official operating on the Minister's behalf) responsible for the CHU (or equivalent government entity responsible for setting policies for IA).

There may also be other audit institutions in the country, for example those with specific responsibilities for auditing European Union funds that could also be a party to a framework agreement.

Usually, it is not practical for individual Heads of IA units to enter into a high-level framework agreement, nor would it normally be cost-effective for the other two institutions to enter into a large number of separate framework agreements with each IA unit. As a result of this, a "framework" agreement is likely to be entered into by the CHU acting on behalf of all the IA units in the country.

What types of cooperation would the agreement cover?

The overall goal of a framework agreement would be to reduce overlap and duplication of the activities of the three functions, to promote general standards of cooperation between the entities, and to encourage the sharing of information on the outputs of different functions.

A high-level framework agreement could also be used to provide the legal authority for certain information to be transferred from one institution to another. For example, to establish an obligation for internal audit reports to be sent to an FI institution. It could also refer to national standards or laws related to access to information by the SAI to serve as a reminder to other entities of the relevant standards and laws.

Possible language that could be used in a high-level framework agreement

Examples of the type of language that could be used in a tripartite agreement are provided below and cover aims, benefits, principles of cooperation, and cooperative activities.

- **Aims.** The aim of this agreement is to improve the overall effectiveness of public sector auditing [and/or inspection] by ensuring that there is effective coordination and cooperation between the various institutions involved.
- **Benefits.** The parties to this agreement recognize that there are significant benefits to the coordination and cooperation among public sector auditing and inspection institutions. These include but are not limited to:
 - Increasing the efficiency of audit / inspection activities;
 - Reducing the burden on the inspected/audited organizations by avoiding overlap of the performed audits/inspections;
 - Reducing the likelihood of unnecessary duplication of audit work (economy);
 - Improving the way that audit and inspection work is planned and implemented;
 - Improving and maximizing audit and inspection coverage based on risk assessments and identified significant risks;
 - More effective audit and inspections based on a clearer understanding of respective audit roles and requirements;
 - Strengthening respective mutual ability to promote good governance and accountability practices, and enhancing management understanding of the importance of internal control; and
 - The exchange of ideas and knowledge.

- **Principles of cooperation.** The parties to this agreement acknowledge that cooperation will be built on commitment, consultation communication and confidence.

Commitment (participation, engagement)

- All parties are willing and committed to developing coordinated and effective audit and inspection services.
- All parties are willing to work flexibly to ensure that work is properly coordinated.
- All parties will take an active role in promoting cooperation and are committed to undertaking changes to help bring it about.

Consultation (engagement, equal treatment)

- There will be regular consultations between the three parties to provide the basis for identifying opportunities for beneficial cooperation and the mechanisms to help to bring it about. This will take the form of an annual meeting between the parties to review the effectiveness of cooperation during the past 12 months and to propose practical actions as necessary to improve cooperation between the three parties. This may include suggestions for changing the terms of this agreement.

Communication (transparency)

- All parties are committed to regular and open communication that will build trust between the institutions.
- Formal meetings will take place once every six months to share views and strategies.
- More frequent informal meetings will also be used to promote better understanding of the roles of all three parties.

Confidence (trust)

- All parties should have confidence in each other's work when there is a need to work together.
- All parties recognize that the SAI must comply with auditing standards when it wishes to rely on the work of an internal audit unit. These standards require the SAI to perform procedures to obtain assurance that the internal auditor has exercised due care. The SAI may therefore review the work of the internal auditor to satisfy itself as to the quality of that work.

- **Cooperative activities.** Cooperative activities shall be jointly decided in writing from time to time by the parties involved and may include:

Planning stage

- Exchange of information/documentation (including annual audit plans and information related to an entity's performance, for example, performance indicators and results of performance reviews);
- Development of methodologies (covering the development of audit procedures and the process for assessing risks); and
- Use of certain aspects of each other's work to determine the nature, timing, and extent of audit procedures to be performed, and which may include sharing information on the risks of fraud and corruption.

Fieldwork stage

- Collaborate on certain audit procedures, such as collecting audit evidence or testing data, and also documentation of the entity's systems and operational activities.

Reporting stage

- Share reports once these have been produced; and
- Follow up of audit findings and recommendations.

Outside of individual work assignments

- Host joint events to exchange expertise, for example discussions, trainings, cooperation meetings, seminars, and round tables that may cover topics such as Public Governance, Risk Management, or the effectiveness of internal controls.

C

Detailed cooperation agreement


IACOP envisages that detailed cooperation agreements would relate to a specific area of government activity and would therefore be entered into by either the SAI or the FI institution with specific internal audit unit(s). The first of two worked examples below demonstrates how an SAI might wish to cooperate with internal audit units in carrying out a performance audit of procurement policy.

Worked Example 1: Involvement of internal audit units on an SAI procurement audit

An SAI decides to undertake a performance audit of the public sector procurement process. The work will involve sampling public procurement in five public sector organizations, three of which have internal audit units. The SAI chooses to approach all three units to seek their agreement to work together with the SAI to review procurement processes in the three organizations.

The agreement would specify the (i) aims of the work proposed; (ii) the expected inputs from the SAI (for example, the preparation of a common questionnaire to be used by each internal audit unit); (iii) the expected inputs of the internal audit unit(s) such as documentation and review of the effectiveness of internal control or to provide certain performance data relating to procurements); (iv) the timeframe during which the work is to take place; (v) how internal audit findings should be reported to the SAI; and (vi) how the final report will be shared with internal audit.

The second worked example considers the procedures that would be followed when an SAI places reliance on the work of IA units. It would not be necessary to enter into a formal agreement to establish the concept of reliance on the work of IA as this is provided for in the external auditing standards.



Worked Example 2: Framework agreement establishes process for cooperation between IA units and the SAI

The SAI and the CHU decide to include in a framework agreement the processes by which the SAI when carrying out an external financial audit will place reliance on the work of internal audit. The framework agreement specifies the following:

When the SAI intends to place reliance on the work of internal audit it will inform the relevant internal audit unit of the documentation it requires to undertake the overall assessment. This will usually include a request for copies of strategic and annual plans, staffing details, and all (or a selection of) final internal audit reports. The internal audit unit will provide this information within 14 days of a request. It will also allow the SAI access to carry out a selective review of the documentation produced in support of the audit findings (this will usually be carried out at the office of the internal auditor).

In these circumstances there would be no need to establish a bilateral agreement between the SAI and the internal audit unit. The SAI would simply reference the framework agreement as the basis for the actions required of the internal audit unit.

Who would be the parties to an agreement?

The parties to a detailed cooperation agreement would be:

- The SAI of the country (usually the head of the SAI or a nominated official operating on behalf of the head of the SAI) or the Minister (or nominated official operating on the Minister's behalf) responsible for financial inspection; and
- The Minister (or nominated official operating on the Minister's behalf) responsible for a single internal audit unit. This would probably be the Head of the IA unit.

What types of cooperation would the agreement cover?

The aim of a detailed cooperation agreement is to agree on practical ways of working together on a specific area of government activity. Therefore, it is difficult to provide a list of all possible areas of cooperation.

In general, it would be rare for all three parties to be involved in a detailed cooperation agreement. These agreements are most likely to be initiated by an SAI seeking to work with, or rely on the work of, internal audit. There are no specific standards related to cooperation between financial inspection and internal audit. However, FI institutions may want to establish detailed cooperation agreements with internal audit in relation to the review of financial systems and transactions, where it is not possible for the FI body to meet desired cycles of coverage.

