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A COMPARATIVE ANALYSIS OF THE EU PUBLIC SECTOR INTERNAL AUDIT METHODOLOGY AND REQUIREMENTS

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Abstract

There is currently no standard or requirement guiding the approaches taken by the European Union (EU) Public Sector internal audit. Therefore, the approaches taken by each country, although having some similarities are different.

The aim of this research is to compare the Latvian state administration internal audit approach with approaches of the following specific European countries: United Kingdom, Malta, Estonia, Lithuania, Latvia and Poland and evaluate each country's internal audit approach according to internal audit maturity determinants. The latter have been determined from literature, the Compendium report. Thereby, shedding light on the Latvian's internal audit approach maturity.

The methodology includes a comparative study of 5 European countries' public sector internal audit methodologies, by carrying out a documents analysis and evaluation of the existing normative acts, analysing cases and other scientific findings of internal audit methodology and legislation.

Authors recommend introducing a common internal audit procedures manual, standards and guidelines for the public sectors in the EU Member States. They believe that this will improve internal controls and internal audit data analysis around Europe.

The main results of the study will highlight the maturity of each of these countries' internal audit approaches and their pros and cons. It will also highlight where improvements might be required or where changes are necessary.

Key words: *internal audit, public sector, internal control*

JEL code: M42

Introduction

A professional, independent and objective internal audit service, whether using a centralised or decentralised approach, is one of the key elements of good governance in the public sector of county. Public sector internal auditors need to deal with both a broad stakeholder base and the increasing demands around the globe for better transparency and accountability among government agencies. This has boosted the demand for internal audits' services at a time when public sector internal auditors (..) are underfunded, compared to their counterparts outside the public sector. Despite these challenges, public sector internal auditors are concerned with their organisations' strategic risks and maintaining high-level standards (Piper A., 2015).

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New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

An effective public sector audit activity will strengthen governance by materially increasing citizens' ability to hold their public sector entity accountable.

The aim of this research is to compare the Latvian state administration internal audit approach with approaches of the following specific European countries: United Kingdom, Malta, Estonia, Lithuania, Latvia and Poland and evaluate each country's internal audit approach according to internal audit maturity determinants. Thereby, shedding light on the Latvian's internal audit approach maturity.

The main results of the study will highlight the maturity of each of these countries' internal audit approaches and their pros and cons. It will also highlight where improvements might be required or where changes are required. Thereby creating a level playing field on approaches taken on the Internal Audit of Public Sector within different EU states.

Research results and discussion

Different main internal audit principles and requirements

Phil Tarling (2013) highlights the vital role played by the audit committees in the effective internal audit process. Internal audit committees in each institution will ensure stronger monitoring.

Federation of European Risk Management Associations and European (FERMA, 2014) in the section roles and responsibilities of the Confederation of Institutes of Internal Auditors refers to effective risk management and controls and highlight that:

“The audit committee reports to the board of directors on the effectiveness of internal control and risk management systems based on information it acquires directly or with the assistance of the audit functions. Good audit committee practice includes review of all lines of defence in an organisation, including their interaction” (Guidance for boards and audit committees... 2010).

“Audit committee chairs and chief audit executives must have a clear understanding of expectations for internal audit. Have a detailed discussion of the personal expectations for the chief audit executives and those for internal audit overall – and address all expectations in the audit charter” (The audit committee and the CAE, 2013).

When public organizations are directly under control of political authorities or elected bodies, the situation is far more complex. In that case, the seniority of political governance plays a more prominent role: political institutions were established a long time before the public internal control concept emerged. Implementing public internal control based on good practice, needs modification of the balances between the elected bodies, the central or local governments (political level), and the management (executive level). If the Audit committee is derived from the elected body, the question of separation of powers arises between the lawmaker and the government. In that event, the political level controls the executive level of administration, which would then lead to a situation where it could be very difficult to find enough experts to fill the committees, notwithstanding also the political considerations that have to be taken into consideration (Chapon, 2012).

“Although external audit and internal audit have some complementary relationships, coordination of their activities is essential. Internal audit's evaluation of the internal control systems provide significant information for the external auditor's assessment of control/ risk affecting the financial statements. The ideal situation is when the external and internal auditors meet periodically to discuss their scope of work, methodology and audit coverage.” (Guidance for boards and audit committees, 2010).



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

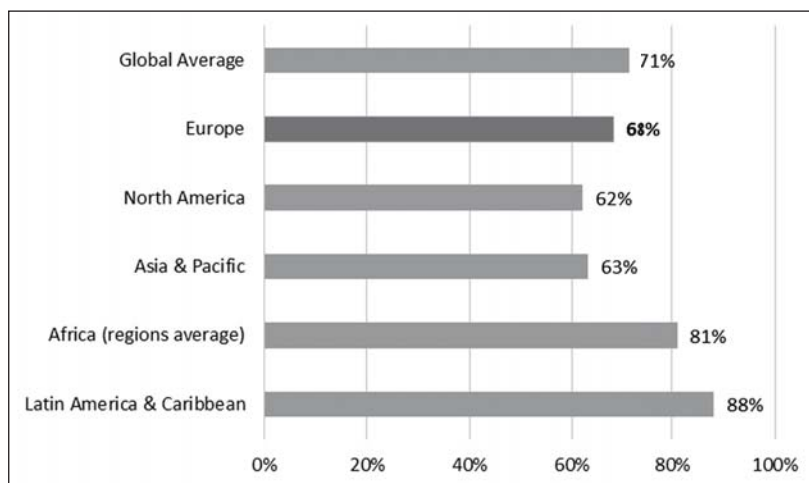
Authors' hypothesis that a common internal audit manual for European Union Member States public administration (public sectors) will improve common internal audit data analysis around Europe.

Where public organisations constitute two-digit percentages of GDP and cover a wide span of activities, the complexity of their organisation and their interdependencies present a number of challenges for their internal audit (Chapon, 2012, 5).

The majority of European Union Member States have an internal audit function, but this does not cover all public administration systems. The majority of countries that have an internal audit established the function in their laws or regulations. Most of European Union countries indicate that their internal audit activities are based on standards. COSO model, INTOSAI, and Standards for Professional Practise of Internal Audit have a significant role in the system development. Moreover, most internal audit systems do not cover all parts of the public sector or every part in the same manner (Compendium... 2014).

Public internal control systems differ from country to country as they have to fit into the respective overall governance arrangements with each of the constitutional stakeholders – government, parliament and the supreme audit institution – as well as the accountability arrangements that exist between these stakeholders. Within the government, internal accountability arrangements are also a determining factor, as is the content of accountability of those responsible for carrying out public tasks. A distinction can be drawn here between legal accountability for compliance with rules and regulations and managerial accountability for the use of public resources to achieve goals. Budgeting and accounting arrangements also have to be taken into account. (Analysis overview. Compendium, 2014).

Most of internal audit systems do not cover all parts of the public sector or every part in the same way. Even the coverage of the central government part varies from country to country.



Source: Author's construction based on Piper A., CBOK 2015 practitioner survey.

Fig. 1. **Internal Audit Mandated by Law in Public sector**

A global average from the Global Internal Audit Common Body of Knowledge (CBOK) 2015 Practitioner survey (14158 respondents from 166 countries, 25% from Europe, 19% from

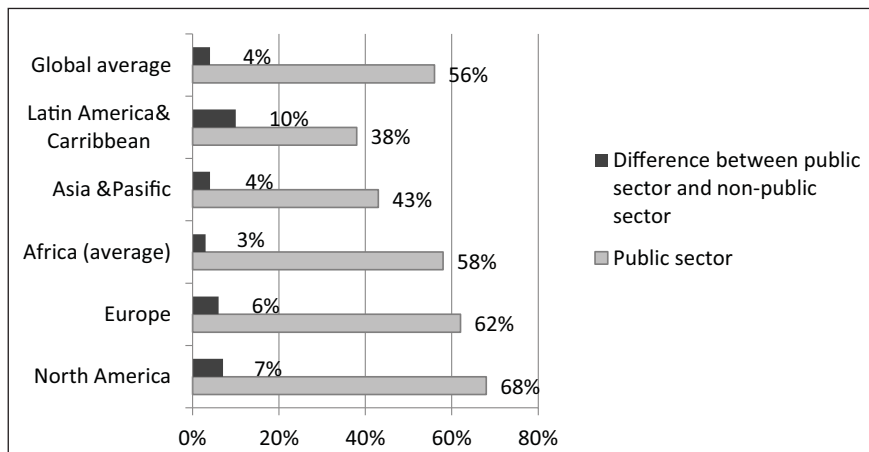


New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

North America, 14% – Latin America, 14% – Africa, 30% – Asia) about 7 out of 10 from a total 2572 respondents noted that the existence of their internal audit function is mandatory by law (Fig. 1).

There are still quite many (average 29%) countries around the world have no regulation for internal audit function, but they had a long history and traditions.



Source: Author's construction based on Piper A., CBOK 2015 practitioner survey.

Fig. 2. Use of IIA's Standards (Public sector compare to Non-Public Sector)

Across all regions, the public sector lags only slightly behind the non-public sector for use of Standards (Fig. 2). When the “use of all of the Standards” is analysed, more than half (56%) of public sector auditors say they use all of the Standards, which is only slightly lower than the global average 60% for the non-public sector respondents (Piper, 2015).

It can be noted from the Compendium report (2014) that, the majority of countries that have an internal audit established the function in national legislation or regulations. However, this is not the case in the United Kingdom, although it is nevertheless enshrined as a mandatory part of governance assurance arrangements within central policy rules, and de facto, every government department has an independent internal audit function. Similarly, Germany, did not establish this in their legislation or legal framework, but all Government departments follow the recommendations made by the Federal Ministry of Interior, in agreement with all other ministries. Some countries indicate that their internal activities are based on specified standards (Standards for the Professional Practice of Internal Audit, COSO model and INTOSAI).

Moreover, traditional compliance and financial audits are increasingly supplemented by various consultancy services and audits of performance that require professional and well trained internal audit staff. Very important in this case are competence and certification of internal auditors. Estonia and Lithuania are currently considering the introduction of national certification in order to meet the demands and needs of their public sector in a better way.

Also, it can be noted that the way member states have established audit boards or audit committees do not always follow the same criteria.

Relationships between internal audit and external audit have developed over time, and in some countries, they are formal and included in legislation, but they are equally often based



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

on initiatives taken by the audit organisations themselves, for example to avoid duplication of work and facilitate the process for the auditee. A common basic relation is described in Maltese contribution, where Auditors share information and working papers for evaluating the effectiveness of internal control.

None of the reports drawn up by European Union countries compiled information relating to quantitative data such as the number of auditors, performed audits, certified auditors etc. Making this data a standard requirement to be reported in the Compendium report form for all countries will allow for better analysis.

After considering all the sources mentioned above the authors chose the following five indicators for comparison of the Internal Audit of Public entities in the six sampled EU countries:

- 1) year of establish Internal audit function – to compare year, structure, first law, regulations;
- 2) laws and regulations changes – to compare how sustainable internal audit legislation is;
- 3) certification of internal auditors – to compare internal auditors competences;
- 4) audit committee existence – to compare growth of internal audit system;
- 5) Internal and external audit cooperation – to identify problems with duplication of work and facilitate the process for auditee.

This represents 24.1% from all 28 EU member States. The authors used a non-probability, convenience sampling, choosing three Baltic States: Latvia, Lithuania and Estonia as neighbour countries with similar historical and economic indicators, since one of the authors is from a Baltic State (Latvia). Malta and United Kingdom, Malta being a colony of the UK for a long period from the 1800 to 1974 and therefore having a large influence on the public entities structures and the economic and financial activity in the country, since 2 of the authors are from Malta and a random choice of a central European country Poland.

Baltic States case study

Baltic States countries, as noted by Diamond J. in 2002, like many central and eastern European countries, which were influenced by the old soviet system, have no tradition of internal audit. Rather, these countries inherited a control department in the Ministry of Finance, which operated as an investigative rather than preventative institution carrying out special investigations on alleged irregularities and fraud. Overlaid on this traditional audit function most republics have instituted an external audit institution unfortunately, there has often been confusion in the separation of roles of both institutions. While lines of reporting have been different – the Internal audit to the Ministry of Finance and external audit to the legislature – some overlapping functions are evident. (Diamond, 2002).

Estonia case

Compendium (2014) highlights internal audit have been done since 2001. The most important legislative acts and interpretations are:

- 1) The Government of the Republic Act (2000) lays down: the concept of Internal audit system, responsibilities, competencies;
- 2) The Auditors Activities Act (2010) specifies, among other things, the legal basis for internal auditors activity in the public sector and public interest entities, the elements of



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

- the system for monitoring the quality – internal and external assessment, monitoring by the Ministry of Finance and consulting by the Professional Qualifications Committee;
- 3) Regulation by Minister of Finance “Adoption of Internal Auditor professional practices standards” (2003) – the important internal audit principles that auditors are required to follow;
 - 4) Amendment to the Local Government Organization Act (2013) – conditions for implementation of internal audit system in rural municipality or city government and local government.

There have some more attempts to improve the professional quality of the internal audit profession in Estonia, but still the curricula of the internal audit profession has not been introduced on the levels of vocational or higher education in Estonia. Nevertheless, internal audit in Estonia has been Europeanized rather quickly despite its short history (Linnas, 2012).

Latvia case

The legal basis:

- 1) The Law on internal audits (2012) – internal audit system establish, coordination, the responsibilities of officials and internal auditors, tasks of the internal audit units, the principles underpinning the independence of the internal audit units, ethical principles;
- 2) Regulations of Cabinet of Ministers (2013) about internal audit process and internal audit evaluation and internal auditors certification;
- 3) An internal audit unit’s rules of procedure are approved by the head of the relevant body – lay down the status, aims, functions, tasks, essence of consultations, scope of work, structure and rights and responsibilities of the internal audit unit. Internal audit guidelines,

Internal audit provide and external audit with the internal audit unit’s strategic plan, annual plan and annual report. External auditors arranges meetings with internal audits once a year, at which the shortcomings detected audit priorities for the coming year and possible areas of cooperation are discussed. In 2013, internal and external auditors agreed on necessary action to be taken to further improve cooperation.

An Internal Audit Board operates in Latvia. A consultative body’s aim is to improve the quality of internal audits, introduce, and develop internal audit policy and methodology in public administration.

The increase and decline of Internal audit growth in Latvia during last more than ten years can be explained with the different economic conditions before and after global financial crises and requirements of International Monetary Fund (IMF) as well. IMF required Latvia against loans to develop its control system regarding money usage in the public sector (Bruna, 2014).

Lithuania case

Compendium (2014) and Vaitkevicius (2014) highlights the legal basis:

- 1) The Law on Internal Control and Internal audit (2002) – goals and procedures for functioning internal audit in public legal entity, responsibilities;
- 2) The Standard Charter of the Internal Audit Unit (2003 Government resolution);
- 3) The Rules of the Professional Ethics for Internal Auditors (2003 – Ministry of Finance);
- 4) The Standard Internal Audit Methodology (2003 – Ministry of Finance);



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

- 5) The Internal audit Guidelines (2003 – Inter-Departmental commission for coordinating the development of the Internal audit system). Guidelines serve as an additional and comprehensive reference to provide the internal auditors of the public legal entities with principles, concepts and recommendations, which are to support them in conducting their activities and in preparing the specific manuals on internal audit; audit Needs Assessment determines the level of sufficient staffing resources.

System for internal audit is decentralized, but internal audit system of municipalities and some public legal entities are centralized – 169 internal audit units, 400 internal auditors and 1500 internal audits per year cover the entire public sector including municipalities (Vaitkevicius, 2014).

Table 1

Internal audit legislation in Baltic States

Country	Establish Internal audit (year, structure, first law, regulations)	Law and regulations changes	Certification of Internal auditors	Audit committee	Internal and external audit cooperation
Estonia	2000 Ministry of Finance, Finance control department 2000 – first regulations Audits carried out since 2001	2005 – IA coordination service 2006 – “Blueprint for the IA of authorities with executive power” 2010 – Auditors Activities Act of Estonia, 2013	2009 – system for certification based on principles of IIA and IPPF Since 2011 – certification (CGAP)	Ministries do not have responsibility to establish an audit committee according to law	With National Audit Office in 2 levels: Ministries IA units and Ministry of Finance
Latvia	1999, Ministry of Finance, Internal audit department 1999. Regulations of Cabinet of Ministers	2002–2008 Internal audit law 2010 – new Internal audit law and regulations – standards requirements 2013 – last Internal audit law – improving the regulatory framework	Since 2011 new certification system one level – exam Obligatory for heads of IA Units or certificate from IIA	Audit board since 2000	The State Audit Office arranges meetings with IA once a year
Lithuania	2000 Ministry of finance Financial Control Methodology department Central Harmonising Unit 2000 Government resolutions regarding IA	2003 – Law on Internal Control and Internal Audit 2003 – Standard Charter of IA Unit; IA methodology; IA guidelines	2010 – new certification programme 6 level training modules (university professors and professionals) Certification – voluntary	Till 2009 was Inter-departmental Commission for coordinating the development of IA system Parliamentary Audit Committee deals broadly with issues related to the National Audit Office	Based on legislation. Sharing audit experiences

Source: Author’s construction based on Compendium, 2014.



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

In table one authors compare indicators in Baltic States internal audit development in public sector. Internal audit implementation started in 1999 in Latvia and in 2000 in Lithuania and Estonia with first regulations and formation of internal audit units, in all three countries responsible institution was Ministry of Finance. In Lithuania Central harmonization unit, in Latvia – Internal audit department and in Estonia – Finance control department. All Baltic States had 2–3 changes in internal audit legislation until 2014. Latvia and Lithuania have local training and certification system of internal auditors for public sector auditors, Estonia developed system for certification based on principles of IIA and IPPF. Different approaches are with audit committees establishment – In Latvia is one audit committee since 2000, in Lithuania was Inter-departmental Commission till 2009 and in Estonia no responsibility to establish audit committee. In different ways, all countries organize internal audit and external audit cooperation – meetings one a year in Latvia, in 2 levels in Estonia and with sharing audit experiences in Lithuania.

Malta, United Kingdom and Poland case study

Poland and Malta joined European Union in the same year 2004, but have different internal audit implementation systems. In Poland Financial Control and IA Coordination Department formed 2002, but in Malta in 2003 Internal and Investigations Department with Hybrid structure – two Directorates, the Internal Audit & Risk Management Directorate for entities with own Internal audit and the Internal Audit Central Harmonization Directorate for others. However, in large institutions and government, internal audit in some form has been around traditionally as long as it has been around in the United Kingdom. (Malta gained its independence from the United Kingdom in 1964; the country became a Republic in 1974. In Poland – since 2010 currently there are 17 audit committees in each ministry) the head of the Internal Audit Unit would ideally ensure avoiding duplication of the Supreme Audit Office and Internal Audit Unit activities, accesses coordination in terms of costs and effectiveness

Poland case

The Internal Audit Functions is governed by the following:

- 1) Public Finance act (2009) – basic issues concerning internal audit in the Public finance sector and proper regulations;
- 2) The Internal Audit Standards in the Public Finance Sector Entities (the International Audit Standards for the Professional Practice of Internal Auditing issued by Institute of Internal auditors are in force);
- 3) Guidelines – The Internal Audit Manual;
- 4) The Charter of Internal Audit in Public Finance Sector Entities;
- 5) The code of Ethics for Internal Auditors in Public Finance Sector Entities.

The head of the entity ensures conditions required for carrying out the internal audit procedure in an independent, objective and effective manner and, inter alia, organisational separateness of the internal audit function and continuity of the internal audit procedure in the said entity. The heads of public finance sector entities are responsible for the implementation and functioning of internal management and control mechanisms, procedures and internal regulations, such as an internal audit charter. A head of the internal audit unit reports directly to the head of the public finance sector entity and in the government administration offices, within the remit specified in



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

Table 2

Internal audit legislation in Poland and Malta

Country	Establish Internal audit (year, structure, first law, regulations)	Law and regulations changes	Certification of Internal auditors	Audit committee	Internal and external audit cooperation
Poland	2002 – Ministry of finance, Financial Control and IA Coordination Department	Since 2002, Act on Public Finance concerning public internal control was updated in 2005, 2006, and 2009	Since 2006 General auditor post, the examination board and the national certification process were abolished	In 2010 were established 17 audit committees in the public finance sector (in each ministry)	Since 2002, Act on Public Finance concerning public internal control was updated in 2005, 2006, 2009
Malta	2003 – Office of the Prime Minister, Internal and Investigations Department: (IAID). Hybrid structure – two Directorates the Internal Audit & Risk Management Directorate (IARM) for entities with own IA and the Internal Audit Central Harmonization Directorate (IACH) for others	Internal Audit and Financial Investigations Act, Ch 461 updated in 2005, 2007	International certification – voluntary	Not compulsory by law, However operates for those entities falling under the decentralized structure of IARM	Informal cooperation
United Kingdom	The main origins of the current system of accountability and audit in the 1860s	1960, 1970 – changes 1980 – Treasury established a central unit to oversee the quality and caliber of internal audit across government. The previous Government Internal Audit Standards have been superseded from April 2013 by the Public Sector Internal Audit Standards	International certification – voluntary	The Audit and Risk Assurance Committee is an independent committee of the board comprising independent non-executive directors.	Cooperate by sharing strategies, plans and working practices to optimize audit coverage and reduce the audit burden on the organization

Source: Author's construction based on Compendium, 2014.



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

a separate statute, to the director general. Any termination of the employment contract or any amendments to the payment and work conditions of the head of the internal audit unit require an approval of the competent audit committee. (Compendium, 2014).

Malta case

In the Public sector in **Malta**, the Internal Audit and Investigations Department provide its services through the four Directorates: the Internal Audit & Risk Management Directorate; Central Harmonization Directorate; Financial Investigations Directorate; and EU Funds Audits Directorate. The IAID is fully committed to assist the Maltese Government to make the best use of public funds in order to achieve the results that the Maltese and EU citizens rightly expect to see. (About the IAID, 2016).

The IAID is governed by the following:

- 1) The Internal Audit and Financial Investigations Act (2003) provides for the regulation of the internal and financial investigative functions, including the power to carry out effective independent internal audits and financial investigations. Providing for the necessary safeguards to ensure the protection of the financial interests of Government including the funds it may have received or will be required to manage under Malta's international obligations (About the IAID, 2016);
- 2) The Code of Ethics for Accountants of the Malta Accountancy Board, which is applicable to all local accountants and auditors;
- 3) The Internal Audit and Investigation Manual.

Both internal and external auditors need to gain more standing in each other's eyes. For this to occur, a number of steps may be taken that will also enhance both audit efficiency and effectiveness. Within a holistic spectrum of government audit activities, the key is for the two functions to be and to be seen as complementing each other, rather than as treading on each other's toes (Zammit, Baldacchino, 2012). According to the article the barriers between internal and external audit functions could be explained by the restrictive ingrained culture of certain public officers, the open-door policy that existed between the two offices, the informal communication between them was too informal and the external audit function could not make use of internal auditors' work, limited resources. What needed to be done is to formalize the relationship with better communication and ensure more readiness to consult retention of work records;

Researchers in Malta have studied the role, function and effectiveness of the Internal Audit and Investigations Department (IAID) (Bartolo M.) and have introduced internal audit of the National Statistics Office. Issues included the building up of a diverse team, independence, reporting lines, senior support and the auditor/ auditee relationship, the audit charter and plan the application of operational auditing and the issue of co-sourcing were also found relevant (Baldacchino P. J., 2015)

United Kingdom case

Public sector internal audit in United Kingdom have a long history and tradition. In reports, this country did not comment on the internal auditor's certification and most countries did not give information about internal audit and external audit cooperation.



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

Internal audit is not a regulatory requirement, but is enshrined as a mandatory part of governance and assurance arrangements within central policy rules. This means that every government department will have an internal audit function that is held at arm's length.

The Audit and Risk Assurance Committee plays a key role in ensuring that management's response and resolution of issues is satisfactory (Compendium, 2014).

United Kingdom internal audit regulations include Public Sector Internal Audit Standards, Audit and Risk Assurance Committee Handbook published by the Treasury.

Authors believe that there is the need for a common internal audit procedures manual, standards and guidelines for the public sectors in the EU Member States. They believe that this will improve internal controls and internal audit data analysis around Europe. From available data in Compendium of the Public Internal Control Systems in the EU Member States, each country give information without quantitative data.

The authors found that each country followed some kind of standard or a mixture of them and their focus/strengths depended on that country's specific requirements. However, each country had something to learn from the experience and work of the other. **Estonia** for example amended legislation with conditions for implementation of internal audit system in rural municipality or city government and local government. **Lithuania** started a certification program with training modules set by a diversity of university professors and practitioners. **Poland** has 17 audit committees in the public finance sector (in each ministry). **Malta** solutions for tackling the barriers between internal and external audit functions and the **United Kingdom** cooperation by sharing strategies, plans and working practices between internal audit and external audit to optimize audit coverage and reduce the audit burden on the organization can be something to focus on. **Latvia** and all these countries need to focus on the good things that they have done and learn from them, Latvia may be the forerunner in starting cooperation between the countries to have a set of EU Standards for the Public Sector.

Conclusions and recommendations

Internal auditors use formal and informal ways to achieve a relevant level of coordination and harmonisation. Traditional compliance and financial audits are increasingly supplemented by various consultancy services and audits of performance that require a professional and well trained internal audit staff. Not all European Union Member States have a common "basic" relationship between internal and external audit. The seniority of political governance plays a more prominent role. In fact, political institutions were established a long time before the public internal control concept emerged. Moreover, a basic component of today's work programme for most internal audit functions is the audit of financial information and financial management processes.

However, to ensure a level playing field within the EU on internal controls of public entities and to strengthen the services and processes, the authors believe that a common internal audit manual with common guidelines and standards for European Union Member states public administration with main components will improve internal control and internal audit data analysis. Furthermore, it is believed that the quantitative data available in the European countries annual reports form for all countries would ideally be increased to allow for more analysis that is effective.



New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

The authors found that each country followed some kind of standard or a mixture of them and their focus/strengths depended on that country's specific requirements. However, each country had something to learn from the experience and work of the other. Latvia and all these countries need to focus on the good things that they have done and learn from them, Latvia may be the forerunner in starting cooperation between the countries to have a set of EU Standards for the Public Sector.

Authors recommend introducing a common internal audit procedures manual, standards and guidelines for the public sectors in the EU Member States. They believe that this will improve internal controls and internal audit data analysis around Europe.

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New Challenges of Economic and Business Development – 2016

May 12–14, 2016, Riga, University of Latvia

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