

## AUDIT OF FUNCTIONS AS A TOOL FOR STATE DURING GLOBAL CRISIS

**Magone Iveta (Магоне Ивета)**  
**Vorončuka Inesa (Ворончука Инеса)**

*In the paper the process of auditing of functions in Latvia under conditions of crisis has been evaluated. The number of academic publications regarding the audit of functions is low and later findings need to be added to it as such. Auditing of functions as such is considered as performance audit and therefore the best practice thereof can be found in INTOSAI and other performance auditing standards. In the research its authors provide assessment regarding their experience in auditing of functions in Latvia, evaluating it in respect to the best practice. In addition to the academic value the paper also possesses practical values, for it can be used as source of information in other states in case of necessity for auditing of functions on the top level of state administration. Latvian experience is useful in correct organization of auditing of functions and also points out to methodological errors of the audit, the things that should not be done.*

### INTRODUCTION

Audit as such is very multishaped. Most frequently audit is associated with financial statement audits are information technologies audit, in separate cases also matching audit in international business a.o. [25] [27] [28] [29]. However, the opportunities provided by audit are much wider than usually applied. One of such opportunities is audit of functions which can be applied both in the public sector and in business sector [10] [16]. Its essence is to assess breakdown of structure and functions of an organization and to find a solution for more effective completion of functions [23] [26]. Audit of functions is not a widely used term; only a few authors note that such type of auditing exists [10]. These authors propose their methods of provision thereof, however, they do not refer particularly to any of the generally accepted practice methodologies or standards. The authors review auditing of functions in the public sector only. Mainly only two types of audit are recognized in the public sector - financial audits and performance audits [3] [4]. Financial audit only has slight relation to the audit of functions, for example, it is possible to evaluate the financial resources spent for provision of a certain function. But methodology of performance auditing fully complies with methodology of the audit of functions. In this case it can be based on the fact that objectives of both the audit of functions and performance audit are aimed at inspection of three indicators – economy, efficiency and productivity. Both audits have the same academic base, audit evidence methods and evaluation criteria which in both cases are more subjective than in the case of financial audits [15] [17] [18] [20]. Therefore the academic base of performance audits and international standards should be used in evaluation of the audit of functions. International performance standards are used also as the basis in development of the order of auditing of functions in Latvia. Performance audits are usually performed by the Supreme audit office [5] [8] [9]. However, Latvian and other European state experience shows that such audits are also provided by business sector auditors [16] [21]. It means that, irrespective of the fact that auditing methodology is more closely related to public administration, it can be provided by business sector auditors as well. Thus a healthy competition among auditors is created. Audit of functions is also referred to as value for money audit, effectiveness audit a.o.

Scholastic problem of the article – the academic environment has next to no scholastic publications regarding auditing of functions, there are only a few articles on this issue available. Novelty – the article possesses more than scholastic value – it has some practical meaning as well. The facts stated in the article can be useful for other states that need to review efficiency of their public functions. Object of the research – the process of Audit of functions in Latvia under conditions of global crisis. Target of the research – to reveal the positive and negative aspects of such audits and to provide recommendations for improvements in the process of audit of functions. Objectives of the research, firstly, to explain the mechanism of auditing of functions in Latvia. Secondly, to provide evaluation as to where the best practice should be taken over by other states and to show things to be avoided. Method of the research – monographic method as well as analysis of normative and other documents have been used in the work.

Why are such audits of functions necessary and important especially during crisis? The excess public administration expenses should be indicated as the main reason [2]. A large part of the public expenses is made up by unnecessary public functions and excess amount of the employed persons. Latvia serves as a particular example thereof. This is noted by foreign publications on global level, stating that Latvia during the global crisis has suffered more than any other country [6]. The authors did a comparison of the people employed in public sector vs. business sector, indicating general trends in the world (see Table No. 1).

**Table No. 1 Comparison of Public sector and business sector employees (collected by the authors) [14]**

	Latvia	Ukraine	Australia	Bulgaria	Canada	Denmark	Estonia	Finland	Greece	Hungary	Ireland	Italy	Romania	Slovakia	Slovenia	Spain	Swiss
Public sector	31,9	21,5	16,3	26,0	20,0	32,3	23,7	26,5	22,3	29,2	17,7	14,4	18,4	22,8	27,9	14,6	15,1
Business sector	68,1	78,5	83,7	74,0	80,0	67,7	76,3	73,5	77,7	70,8	82,3	85,6	81,6	77,2	72,1	85,4	84,9

As one can see in the chart from the reviewed states, speaking of the number of public sector employees, Latvia comes as number two following only Denmark with merely a 0.4% lower ratio. The average number of public sector employees of all countries shown in the chart is 22.4%. This figure includes employees of all levels and types of administrative institutions. Taking into account the fact that there is a high amount of persons employed in Latvian public administration and large resources are spent for remuneration thereof, a discussion was held regarding types of functions to be done, the level of effectiveness of completion thereof. 1005 functions were accounted in Latvian public administration [21]. The most urgent issue was – how and who will assess the functions? R.Sack and M.Saidi in their paper carry out a detailed analysis of the process of auditing of functions, but many considerations need certain discussions, e.g., a discussion is held as to which is primary – a function or a structure [10]. In the conditions of global crisis such approach has slightly changed because the keystone now is maximum effectiveness of functions. The article consists of two parts – in the first part the process of auditing of functions is reviewed while the second part contains assessment of methodology of audit of functions.

### 1 THE PROCESS OF AUDITING OF FUNCTIONS IN LATVIA

As the global crisis grew more serious, intense measures had to be undertaken in Latvia in order to reduce expenditures of the state budget. In the second half of 2008 a coordination group was created for work on development of methodology of audit of functions and on January 27, 2009 the Cabinet of Ministers approved the order in which auditing of functions of public administration is planned and carried out and proposals on the audit are implemented, regulating the whole process of audit of functions and methodology of the audit [1]. The Cabinet of Ministers with a decree created a Commission of Audit of functions for the purpose of serving as the main supervisor of the process of auditing of functions in Latvia [21]. The Commission had to include the Director of the State Chancellery, secretaries of state or deputies thereof representing four Latvian Ministries, five representatives involved by the Cabinet of Ministers from – Saeima Public Administration and Municipal Commission, Association of Local and Regional Governments, Strategic Analysis Commission of the President of the State, Employer Confederation, Free Trade Union Confederation and one person recommended by non-governmental organizations. The authors point out that in addition to the responsible public officials representatives of non-governmental institutions are involved as well, which can be evaluated positively. However, the commission includes also secretaries of the state, which are the top administrative managers in the institutions and are fully responsible for effective completion of the functions. The authors point out that it would not be the best practice to supervise the process of audit performed in an institution managed by the same person. There are several standards that forbid auditors to do audits in the spheres of their own prior responsibility [12] [13] [15]. Hence the authors point out that instead of this it is required to involve scholars who are specialists in public administration and auditing. The second significant aspect which was confirmed by later practical experience in the work of commission as well was the lack of professional auditors in the commission. As proven by the practical observations, the commission wasted a lot of time in order to understand the essence of issues of the audit, incl. things an auditor may and may not inspect [22].

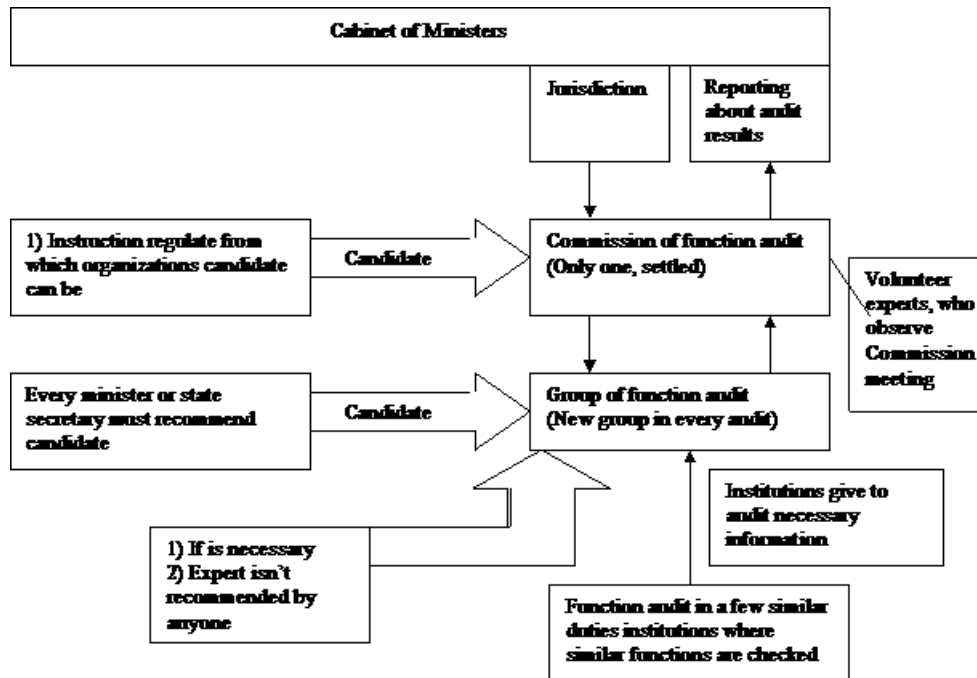
The main task of the commission of audit of functions is assessment of reports of audit of functions and supervision of groups of the auditing of functions. In addition, it is responsible for drafting of one-year plan for auditing of functions with consideration of all risks of public administration by February 1, on a yearly basis. Thereafter such plan is approved in the Cabinet of Ministers. Such plan shall include [1]:

1. targets, volume of the audit and subjects of the audit;
2. time of the audit;
3. institutions subjected to the audit;
4. indicative composition of the audit groups, auditing objectives and terms of audits.

The process of auditing of functions is ensured by the group of audit of functions. The process of development thereof differs from the process of development of function commission. The members of audit group and the heads thereof are proposed to the Prime Minister by a member of the Cabinet of Ministers (a Minister) or administrative

manager of a leading institution of the sphere (Ministry). The general schematic structural scheme of the audit of functions is reflected in Figure No. 2.

Figure No. 2 Structural scheme of auditing of functions in Latvia, collected by the authors [1]



All the results audit of functions are reviewed and approved on the level of Cabinet of Ministers (the top public administration).

The authors point out that a large role was allocated to the experts. This increased the openness of the process of audit of functions, as any person able to prove his/her abilities in the area of audit of functions could become an independent expert; social and professional organizations volunteered as well. Opinions of the volunteering experts regarding process improvements are heard out in the meetings of audit of functions commission. One of the authors is participating as a volunteering expert as well. The other category of experts is established with a special decree of the Cabinet of Ministers and they provide their advice to the audit group itself during auditing. Attraction of experts can be evaluated positively. Such experience can be seen in many foreign state controls [17] [18] [20]. The fact that there are no definitions as to who assigns such experts to the coordination group and what the key criteria to be set for an expert to be an expert are, is evaluated negatively.

However, requirements in respect to auditors in order to be included in the audit group are established. The potential auditor shall [1]:

1. have experience in a position in a Ministry or work experience in a leading position in private area – not less than three years;
2. have participated in similar audits in public institutions or have significant experience in the area of the due audit of functions;
3. possess knowledge and skills in any of the following areas – result oriented administration, control, communications, risk management, financial and human resource management;
4. possess the ability to work independently, to learn new areas and to draft proposals for decision making.

Furthermore, the auditor will be forbidden to participate in the audit of functions which is his/her core place of work.

The authors point out that a part of employees with experience in internal audits are involved in the auditing. However, all the heads of audit groups were persons not related to auditing and the remaining members of the audit group were not auditors as well. The authors point out that audits of functions in Latvia are performed already since 1999 [21]. These have been performed both by internal auditors of public administration as well as business sector auditors, who carried out auditing of functions as an outsourced service. The results did not bring any significant improvements to the public administration because the process was not sufficiently controlled. Therefore Latvian Government opted for a different approach, emphasizing experience and knowledge in performance management,

instead of auditing skills. It should be pointed out that criteria allow for assigning people that are not employed in the public sector as well – they can equally come from the business sector. Representatives from the business sector were involved in the information technologies audit.

Upon overall assessment of organization of the audit of functions, a large role here is played by the State Chancellery which is directly subordinated to the Prime Minister. It performs all preparation works for the audit of functions, prepares all technical documentation and actively engages in all events related to auditing of functions. Hence, irrespective of separate indications, in general the process of organization of audit of functions can be evaluated positively.

## 2 METHODOLOGY OF AUDITING OF FUNCTIONS

The best practice states that in all cases when evaluating efficiency the goal of the audit shall be determined. The goal of the audit of functions was determined as increased efficiency of public administration, reduced budget expenses, ensured expedient use thereof and keeping or improving quality of services in the Public administration institutions [1]:

- 1) to determine the functions or tasks completion whereof could be cancelled;
- 2) to review and clarify the functions and tasks, eliminating overlapping and doubling thereof among institutions or the business units thereof;
- 3) to assess costs of state budget programmes and results attained by the institutions;
- 4) to optimize the structure and number of employees, increasing work productivity and intensity of completion;
- 5) to assess the opportunities to decentralize functions of public administration, performing these on the public administration level suitable for the service receiver.

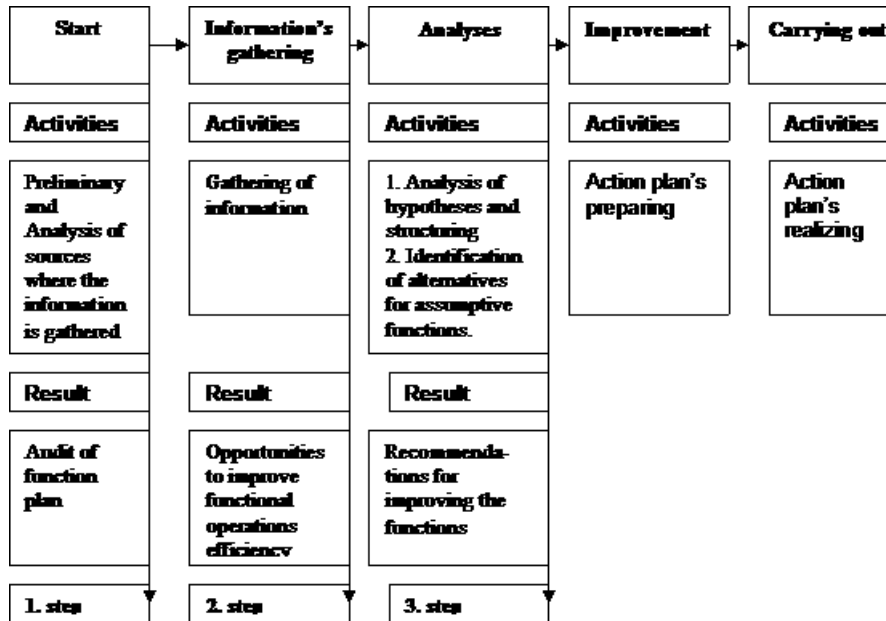
The authors point out that the main gain purely from the point of view of methodological auditing was the fact that audit of functions was carried out in several institutions of similar nature, where the functions may overlap on the public level, thus having the possibility to reduce use of resources. Hence the volume of audit was established nearly on the programme level.

For support of auditing of functions State Chancellery involved the business consultant SIA Ernst&Young which based the auditing process on the model SIGMA SIX, see Figure No. 3

The proposed approach does not significantly differ from the generally accepted requirements for auditing [11] [15] [18]. However, there are several issues that contradict with them. For example, analysis of hypotheses and structuring are indicated in the analysis process only, not in the stages of commencement of audit. Hence the authors consider that less attention is paid to the audit planning stage and more focus is set on auditing as such. The authors could agree with this because the specialists that were involved in auditing were not educated in the issues of audit planning and set the main focus on the audit. This in its essence is the right solution and complies with the situation of Latvia. However, it should be pointed out that the results of the second stage – “opportunities to improve functional operations efficiency” is disputable. The authors disagree with this breakdown because opportunities of functional improvements cannot and may not be determined in the stage of information acquisition because analysis only follows in the next stage. It means that a conclusion is made before the analysis itself.

However, the grand methodological failure of the audit of functions was the request to determine all initial key information needed for the audit from the institution to be audited itself. The auditors did not systematically inspect the provided information. It was recognized later as well that an auditor in point of fact relies on unverified information, thus quality of the audit can significantly decrease but risk of auditor increases [7] [22] [24].

**Figure No. 3 STEPS OF AUDIT OF FUNCTIONS by Ernst&Young [21]**



The authors point out that theory complies with practice in the issue of duration of the audit. In the case of Latvia it was established as 3 months, which contradicts with the best practice of other states, evidencing that at least 10 months are spent on such audits [11] [19]. This mistake has been corrected and now the auditing term for auditors is prolonged, not specifying a particular number of months but requiring regular reporting on the auditing of functions progress to commission.

The fact that all auditing reports use unified reflection of information is evaluated positively; it means that there was a defined audit reporting structure indicating [1]:

- 1.the target, objective and volume of the audit;
- 2.reflection of the situation determined during auditing as well as functions and tasks and risks of their completion;
- 3.audit conclusion and proposal implementation plan, indicating institutions responsible for such implementation and the terms thereof;
- 4.the proposals must be grouped according to set requirements;
- 5.objections of the audited institution etc.

Thus it in its base complied with the best practice of performance auditing. But the fact that the auditing groups document the work in accordance with instructions of the head of the group is evaluated negatively. It means that the heads of groups were people who had never before done auditing; hence their understanding on the right documentation of audit evidence was different.

## CONCLUSION

Latvian example can be used a tool to study organization of the audit of functions process – how the organizing and control mechanisms, distribution of responsibility are defined, determining an established order of reporting, performing uninterrupted supervision of the audit process, organizing audit of functions commission meetings in high quality etc. However, the fact that professional auditors, who would make this process a lot easier and would increase its quality, were involved in the auditing process too little, should be indicated as the negative aspect. For the purpose of financial auditing one needs to possess appropriate education and experience, as established by the international auditing standards, and such should be exercised in performance audits even more so. The issue of a more detailed inspection of auditing methodology in other states is worth further discussions. Latvia was in a worse economic situation than many other states, but it was able to complete all requirements of international creditors as the result of which expenses were reduced. However, the bureaucratic apparatus of the state has a tendency of regular increasing, hence it is a continuous improvement process where audit of functions will take one of the main roles. In such case it can be entrusted both to auditors of public and business sectors and they in turn should be ready to carry them out in high quality. Therefore scientists and auditors need to have further discussions regarding the best practice thereof.



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[Magone Iveta](#), University of Latvia Economic and Management Faculty, PhD student, auditor Aspazijas blv. 5, Riga, LV-1050 E-post: imag@latnet.lv

**Vorončuka Inesa**, University of Latvia Economic and Management Faculty, Dr.oec., Professor Aspazijas blv. 5, Riga, LV-1050