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THE RECOMMENDATION FOR THE INTERNAL AUDIT IN THE LITHUANIAN INVESTMENT SECTOR

Summary: In the present article, we investigate recent developments in the internal audit and internal control processes in the Lithuanian investment service sector. We analyze the interaction of these areas in the management of investment companies, systemize the main tasks of the internal audit of mutual and pension funds and estimate the role of the internal audit in the risk management of investment companies. We also present the results of investment services market research, based on the data from Lithuanian Securities Commission and statistical information of the Statistics Department of Lithuania as well as the analysis of legislation system for investment companies.

Keywords: internal audit, internal control, investment sector.

1. Introduction

In the current global economy conditions, society has become actively interested in financial markets in order to use its possibilities in an effective manner, finance person's or company's activities, provide means for living or secure one's retirement. Investment sector companies, which implement financial transactions, mediate in sales and purchase of financial means or acquiring of insurance market products, and provide conditions for investment and saving activities play one of the major roles in this financing chain. The dynamic management of the investment sector companies requires proper supervision regulation; thus, it is necessary to systemize both external and internal regulation instruments, which are applied for assessment, analysis, development, and improvement of the sector companies' activities. The instruments are expressed as consistent development and proper functioning of an appropriate and effective internal audit and internal control system. Therefore, in the light of present topicalities, it is important to examine the internal control system and the internal audit role in certain activity of investment sector companies to assess the suitability and effectiveness of the system.

Many foreign authors have dealt with the problem in industrial and commercial companies; however, the problem of an internal audit organization to assess the development of the internal control system and the efficiency of its operations in investment sector companies has not been analyzed.

The purpose of the research is to develop consistent methodology of an internal audit for the assessment of the internal control systems in investment sector companies. The methods of the research are the following: an analysis of scientific references and legislative acts, assessment, comparison, specification and summarizing of information.

2. Internal audit relationships with the internal control and external audit

An internal audit is one of the key sources of economic information, which provides the management of a company with the information on various company risk management problems and guidance needed for the implementation of operational, current, and long-range solutions. The effective activity of any company and positive financial results are impossible without an internal audit.

An internal audit is an in-house unaffiliated independent control, which enhances a thorough testing of the company's activities, objective assessment of internal control, process management and risk management in order to assist the company's management in adopting sound management decisions and maintain the continuity and development of the company's activity. Figure 1 presents the key functions of an internal audit.

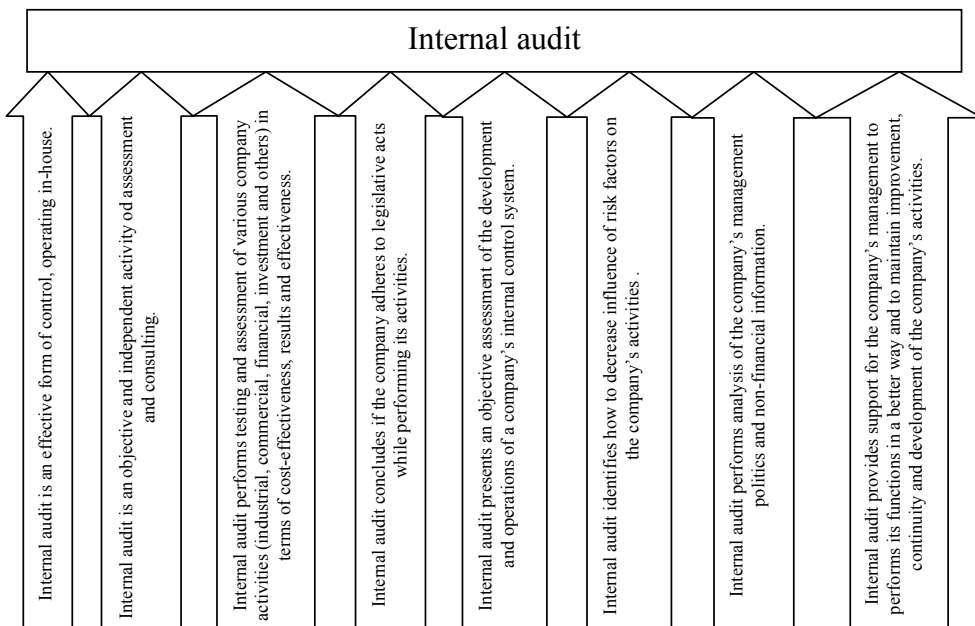


Fig. 1. Key functions of internal audit

Source: authors' own work.

The main source of dispute and disagreements while analyzing the significance and functions of an internal audit arises from their connections with the internal control system. The majority of authors claim that the company's internal control system should not be regarded the same as an internal audit due to the fact that an internal audit assesses whether the internal control system is developed appropriately and whether it functions effectively [Bartaska 2005; Czerwinski 2005; Goodwin-Stewart, Kent 2006; Guptor 2006; Idzikowska 2003, James 2003; Lakis 2007; Mackevičius 2001; Polanski 2007, Rupsys, Staciokas 2005]. However, other authors suggest that an internal audit is a part or an element of the internal control system [Knapickienė 2008; Palubinskienė, Makara 2004].

The Law on Internal Control and Internal Audit of the Republic of Lithuania (2002) also points out that an internal audit is a part of the internal control system which is aiming at maintenance of improvement of a public legal entity activities. According to Knapickienė [2008], provided that an internal audit was not included in the internal control system, the system would turn into an open management system, i.e. a system without feedback. Undoubtedly, the connection of an internal audit and the internal control system should not be denied; however, these are two absolutely separate forms of control, which have their own functions. An internal audit deals with development and functioning of the internal control system, its appropriateness and effectiveness, to be more exact, it questions whether the system guarantees that the company's goals are met [Mackevičius 2001]. The status of the internal control system, in turn, has a direct influence on the scope, tests and procedures of an internal audit.

While analyzing the connection of an internal audit with internal control, it is important to assess the internal audit connections with an external audit as well; the topic which also has not received much coverage. The majority of authors have given a detailed examination of differences between these kind of audits, their advantages and disadvantages; however, there was very little attention devoted to the common audit field, which is the focus of both internal and external auditors (see Figure 2). The common audit field is the area of links between an internal and external audit. It provides ground for co-operation in order to acquire mutual use, discover more evidence, which would prove or deny the status of a certain object.

The major purpose of an external audit is to provide, as objective as possible, the assessment of an internal audit, when an internal audit is connected with an external auditor's assessment of risk. The external auditor, having performed the assessment of the internal audit activities, can adopt a more sound professional decision regarding the utilization of the internal auditors performed risk assessment in his or her work and alter the nature, timing, and scope of further external audit procedures accordingly [610 ISA 2009].

Therefore, the internal audit, external audit and internal control system compose a harmonious, consistent, and absolutely open company management system with an active feedback function (see Figure 3).

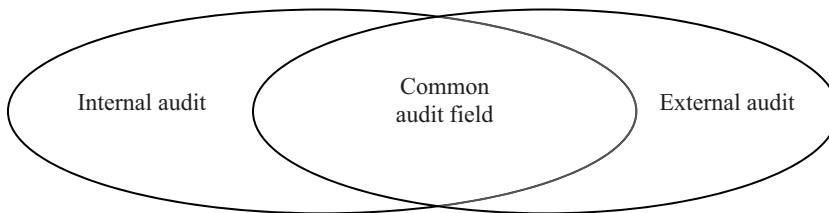


Fig. 2. Internal audit and external audit connections

Source: the study based on Mackevicius [2001].

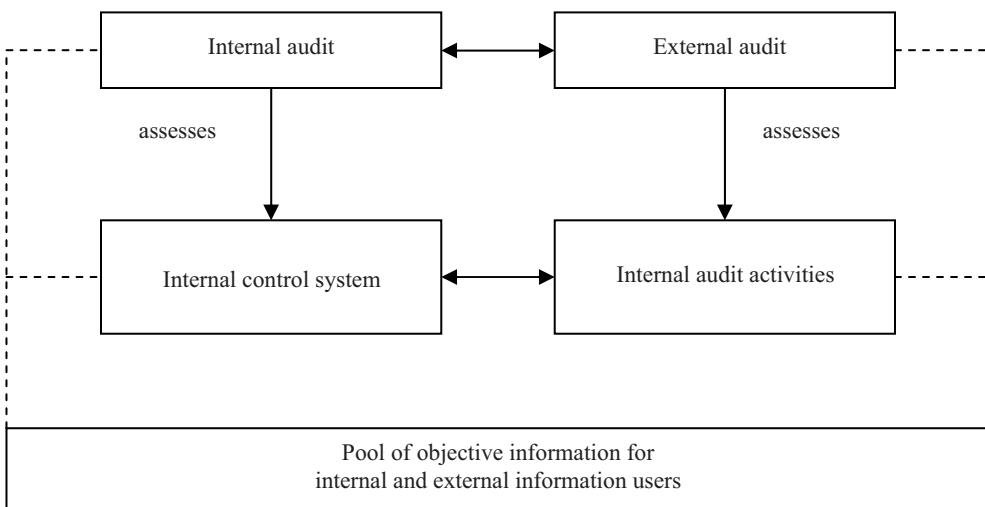


Fig. 3. The interconnections of the internal audit, internal control system and external audit

Source: authors' own work.

As can be seen in Figure 3, connections among the internal audit, internal control system and external audit are resilient. The task of the management system elements is common: it is to provide internal and external information users with objective information on the company’s financial status, activity results, and cash flows to help the management of a company adopt sound management decisions, forecast business prospects, preempt probable errors and frauds, and meet company’s goals.

3. The assessment of the internal audit and internal control system status in investment sector companies

According to the Law on Collective Investment Undertakings (2003), only a private or public limited liability company that holds a licence for the activities of

Table 1. Types of investment sector companies

Types	Description of investment sector company group
Pension fund	Pension assets, held by the right of joint ownership by natural persons participating in pension accumulation in compliance with the Law on Reform of the Pension System, the management of which has been transferred to a pension accumulation company and which are invested under the pension fund rules
Pension fund for the accumulation of part of the state social insurance contribution	A II pillar pension fund which accumulates an established part of a state social pension insurance contribution. The assets of this fund are managed by a pension accumulation company
Supplementary voluntary pension accumulation pension fund	A III pillar pension fund which accumulates voluntarily paid pension contributions. The assets of a III pillar pension fund are managed by a pension fund management enterprise
Pension accumulation company	A management enterprise or an insurance company holding a licence or permit issued by a supervisory authority to pursue pension accumulation activity provided for by the Law on the Accumulation of Pensions within the territory of the Republic of Lithuania
Financial brokerage enterprise	It is an undertaking holding a license to provide investment services. A legal person whose regular business is the provision of one or more investment services to third parties and/or the performance of one or more types of investment activities on a professional basis
Management enterprise	It has the right to engage in the principal activities which comprise the management of unit trusts/common funds and companies with variable capital and to provide the following additional services if they are provided for in the licence issued to it and if it engages in the said principal activities
Financial advisor company	A financial advisor company shall have the right to provide the investment services (reception and transmission of orders, provision of investment advice) regarding transferable securities and securities of collective investment undertakings, provided the company does not store funds and financial instruments of clients and cannot become a debtor of the clients due to this
Investment management undertaking	The undertakings which specialise in the management of financial instrument portfolios of other persons may use in their name the words “investment management undertaking” or other combinations and derivatives of these words
Investment company with variable capital	Only a company holding a licence for the activities of an investment company with variable capital issued by the Securities Commission may engage in the activities of investment company with variable capital
Closed-ended investment company	Only a public limited liability company holding a licence for the activities of a closed-ended investment company issued by the securities commission may engage in the activities of a closed-ended investment company

Source: compiled by the authors, according to *Statistics of Financial Enterprises* [2008] and *Kolektyvinio investavimo subjektų įstatymas* [2003].

a management company issued by the Securities Commission shall have the right to engage in the management of common funds and/or investment companies with variable capital and only a public limited liability company that holds a licence for the activities of an investment company with variable capital issued by the securities commission may engage in the activities of an investment company with variable capital.

Investment sector companies are diverse; they provide miscellaneous services and have different activity goals and scopes (see Table 1).

Investment sector companies play a very important role in terms of society. Their mission is to ensure that interests of the investment funds co-owners' and investment companies with variable capital shareholders' interests are safeguarded. The requirements for the investment sector companies activities are connected with the reliability of the companies under license activity and quality of their services. In order to maintain their reliability, a requirement to act in a fair manner in terms of participants and the market, as well as maintain attentive, professional, and guarded activities is posed. Another significant principle is to attempt to avoid conflicts of interests and, in case they emerge, maintain fair treatment of the participants. The requirements are to be assessed as settlement of certain principles and not as a specific company activities organization scheme, the precision of mechanism of which could be established and assessed.

General organizational requirements posed for investment sector companies denote that the companies have to "approve, implement and sustain proper internal control, aiming to maintain compliance of decisions and procedures in all financial brokerage company levels", and not "implement internal control" in general. The legislative act which regulates the activities of an investment sector company establishes that the companies are required to own and implement proper policy and the procedures for the decrease of legal risk that an internal control has to carry out its functions independently and has to enhance not only the classical internal control functions, but also such exceptional areas as the implementation of the principle "know your client", and maintain development and provision of fair and thorough information or commercial. The regulations emphasize the role of an internal audit in this type of company's activities. It is noted that an internal audit has to be separated from other investment sector company's functions and has to act independently. Its mission is to test and assess suitability and effectiveness of systems, internal control instruments and agreements used in the investment sector companies; provide advice regarding the accomplished activity results and check whether the advice is followed; and provide reports connected with the internal audit issues.

Even though the need for strong internal audit systems is highlighted in the legislative acts, in practice the activities of the internal audit in Lithuanian investment sector companies are not regulated sufficiently. There is no set periodical external assessment of the internal audit activities and there are no strict determinative requirements for qualification of internal auditors, which could affect the quality of

internal auditors work. Furthermore, there is no specific methodology for internal audit developed in the investment sector, so the internal auditors implement their activities based on their experience and professional competence.

One of the most neglected fields of an internal audit in the investment sector is audit planning. Internal audit plans are either not compiled in many of the companies or compiled in a rush; therefore, they are superficial and impractical. Often the plans are not used – they are often corrected or are not complied with. It is still thought that the scheduling of the plan is a relict of service control system; thus, the majority of the internal audit departments of companies work in an unplanned manner – they only follow the directions of management. This greatly aggravated the activities of the internal audit department and limits internal auditors independence.

4. Recommended methodology for the internal audit consistency in the internal control systems assessment

The sequence of the internal audit execution should be adequate to the ordinary internal audit methodology. However, specific and risky functions of investment sector companies influence the selection of substantive internal audit procedures and evaluation of audit risk. Also an internal audit can be implemented in various modes. Firstly, it depends on the type, size, and management structure of a investment sector company. However, in any case it has to follow a consistent manner. It is advisable to distinguish separate stages of an internal audit, which would reveal the consistency and systematic behavior of an audit: 1) audit strategy; 2) audit planning; 3) collection and assessment of information; 4) testing; 5) preparation and submission of the auditor's report. Certainly, more stages may be pointed out, but it is important that each of them is comprised of specific activities, their score, deadlines, responsible persons, their responsibility, prepared audit tests, procedures and proper audit working documents. All audit stages have to compose a thorough auditing process, which would enhance objective assessment of the internal control system and the utilization of external audit information. A thorough internal audit process is shown in Figure 4.

The internal audit strategy has to be developed in such a way that it would comply with the goals set for companies as well as their internal and external environment. The strategy has to foresee the key risk areas for the company, which have to go under close scrutiny. The internal audit strategy has to be directed towards an objective assessment of the internal audit control system, maintenance of close co-operation with an external audit and assistance to the management of the company in achieving the set activity goals.

The internal audit planning has to maintain sufficient amount of attention for the key audit areas, for foreseeing likely problems and make the audit be implemented expeditiously. At this stage, the auditor shall develop a general audit plan and audit programmes. The general audit plan is a unity of foreseen instruments and tasks,

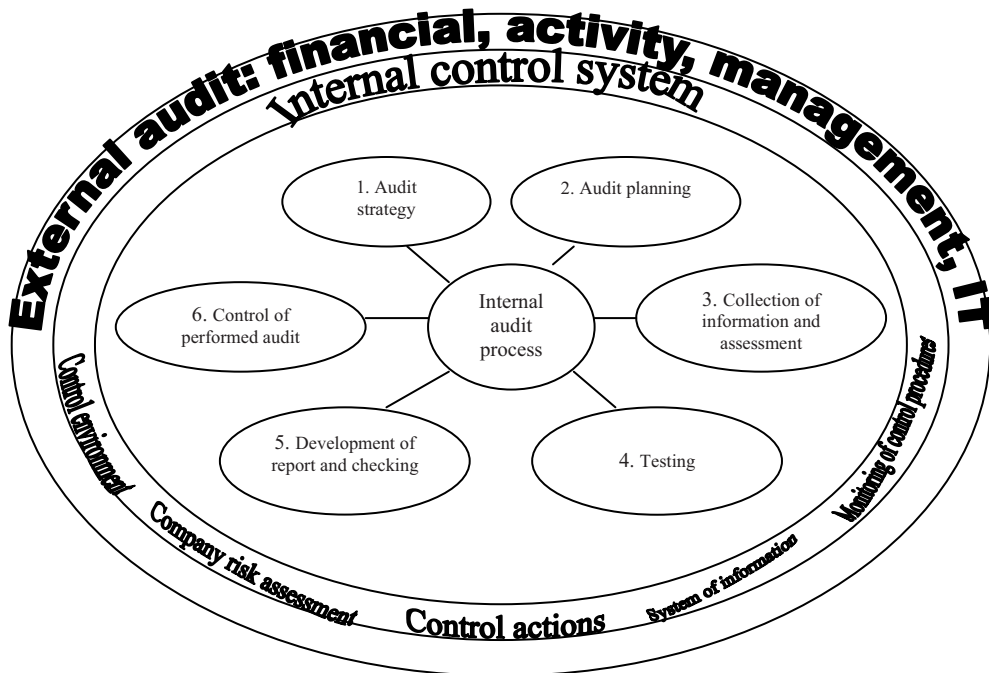


Fig. 4. Recommended methodology of a consistent internal audit for investment sector companies

Source: authors' own work.

which assists in a thorough, effective, and timely execution of the audit. The audit programmes are compiled for specific audit objects with an indication of the nature, time, and scope of audit procedures, necessary for the implementation of a general audit plan.

During the stage of information collection, the internal auditor has to collect information based on the purposes and scope of the audit. The purposes of an audit require collecting only such information which would help to achieve audit goals for a specific activity field. The scope of an audit requires collecting information which is characteristic of a certain activity field. It is beyond purpose to collect subsidiary or surplus information which shall not be used to summarize and assess activity results. The collected information has to meet at least three criteria: sufficiency, reliability, and usability. The information has to be collected during procedures similar to those used by external auditors. These include testing, questioning, approving, analytical procedures, and others. During the collection of the information, the internal auditor has to consider whether it is beyond purpose to use additional audit tests and procedures to meet the set audit purposes.

The stage of testing is one of the most complicated and requires most of the time during which both documents and assets are tested. Checking various documents is

a review and analysis of both internal and external papers, electronic or other medium recordings, and documents. During the testing of documents, the auditor has to make sure that all the documents are compiled properly, there are no mistakes or frauds in them, and they provide an expeditious sense of the accomplished transactions. The auditor can apply various ways of document testing: formal, logical, and arithmetical. Asset testing is testing of physical non-current and current tangible assets. The testing provides the auditor with reliable evidence that the asset does exist and have a status of a specific kind.

The development and submission of the auditor's report summarizes the auditor's complex work, which was implemented in the previous stages. The internal audit report has to include specific answers to these important questions: what objects (subdivisions, areas of activities and similar) were assessed; what tests and procedures were used for testing of the objects; what shortcomings, errors, inconsistencies were found and what their reasons were discovered; what conclusions are to be made; what the final conclusion is, and what advice for improvement of the company's activity, internal control system, accounting and accountability is. The internal auditor has to make sure that the discovered facts and conclusions of the prepared report would interest the management and prove useful for development of the company's activities. The internal auditors' reports have to become an essential, periodic, and useful source of information not only for the management of a company but also for other users.

The stage of control of the performed audit can be entitled "the state of the internal audit quality improvement". The activities of the internal auditor are perpetual. Having completed an audit, he or she commences another audit and monitors the results of the previous audits. He or she is interested in the way the company management perceives the results, conclusions, and advice of his or her implemented results. The internal auditor should clarify whether the management took specific steps to eradicate shortcomings, whether they proved to be effective, were performed on a timely manner, etc.

The recommended methodology for the internal audit consistency in the internal control systems assessment allows for an objective assessment of all the elements of the internal control system: the control environment, risk management, information system, control actions and monitoring of the control procedures. Objective and timely assessment of the internal control systems is of vital importance for the company's management so that they could ensure the detection and prevention of the errors and frauds, compliance with legislative acts and procedures as well as the continuity and development of the activities.

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ZAŁECENIA DŁA AUDYTU WEWNĘTRZNEGO W LITEWSKIM SEKTORZE INWESTYCYJNYM

Streszczenie: W artykule przedstawione zostały najnowsze osiągnięcia w zakresie audytu wewnętrznego oraz procesów kontroli wewnętrznej w litewskim sektorze usług inwestycyjnych. Zaprezentowano analizę współdziałania tych obszarów w zakresie zarządzania firmami inwestycyjnymi, usystematyzowano główne zadania audytu wewnętrznego funduszy inwestycyjnych i emerytalnych oraz oszacowano rolę audytu wewnętrznego w procesie zarządzania ryzykiem firm inwestycyjnych. W artykule zawarte zostały wyniki badań rynku usług inwestycyjnych przeprowadzone na podstawie danych Litewskiej Komisji Papierów Wartościowych oraz Urzędu Statystycznego Litwy, a także w oparciu o analizę aktów prawnych dotyczących firm inwestycyjnych.