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THE LEGAL NATURE OF INTERNAL AUDIT IN LIGHT OF THE REGULATIONS OF THE ACT ON PUBLIC FINANCES

Internal audit in the Polish legal system has only been functioning since 1 January 2002, and has been one way in which Poland has met its obligations towards the European Union.¹ The first legal regulations regarding internal audit were based on the implementations of other legal systems, despite the fact that these frequently failed to meet the requirements of Polish realities. It will come as little surprise, therefore, that in the short history of internal audit in Poland, there have already been several attempts to harmonise it and adjust it to better suit the Polish legal system, as a result of which the role and range of internal audit gradually underwent an extension. This coincided in time with changes in public financial statutes, though the latter were connected with organisational changes in the public financial sector and the implementation of new systemic solutions meant to strengthen and improve the transparency of public finances.²

An analysis of the issues determined by the subject of this article requires a certain categorisation of them, as well as a discussion about the institutions of significance for internal audit under Polish law.

1. THE NOTION OF INTERNAL AUDIT

As indicated above, internal audit was implemented into the Polish legal system with the Act of 27 July 2001 on the amendment of the Act on Public Finances, the Act on the Organisation of the Council of Ministers, the procedure to be followed in performing its functions and on the scope of functions to be carried out by the various ministers, the Act on the Departments of Governmental Administration, and the Act on the

¹ To achieve its aim of full membership in the European Union, Poland made a pledge to rationalise public expenses, to be concerned about the proper use of means coming from EU funds, as well as to counteract financial abuses. The basic activities that Poland was to undertake in order to achieve its obligation were determined on 16 July 1997, when the European Commission published a document on 15 March 1999 in Berlin. In the plan of action specified in the Agenda 2000 document, the European Commission stated that the organs of internal and external control have not reached a satisfactory level of efficiency, and they cannot be acknowledged as being compatible with commonly understood European norms – both on the level of member states and the European Community. The European Commission recommended that Poland implement an internal audit into public administration as an evaluation and counselling tool for managerial bodies, and a compilation of the methodology of drawing audit paths, as well as the application of the international financial control and internal audit standards, among other things.

² The Act of 27 August 2009 on Public Finances (Journal of Laws of 2009, No 157, item 1240).

Civil Service, which came into force on 1 January 2002).³ The need to implement internal audit in Poland resulted from the need to expand the instruments of control in order to strengthen transparency, rationality and responsibility for all the actions undertaken in this sphere of management and expenditure of public means (Jagielski, 2003, p. 13). However, the legislator's solutions did not meet with approval, and the main argument against raised the issue of the lack of explanation about the relation between internal audit and financial control (Ruśkowski, Salahny, 2010, p. 865 et seq.) The basis of those doubts may have arisen from the opinion that the legislator did not have full knowledge about the essence of the internal audit, and identified it rather with a form of internal (or external) control, as expressed by M. Sekuła, the then chairman of the Supreme Chamber of Control, who indicated that audit means nothing other than control (Sekuła, 2004). The existence of such relations between audit and control resulted in a blurring of audit targets and forms, because in light of regulations about public finances the auditor's interest should be directed either towards internal control, which is simply copying control tasks, or directed towards an analysis of financial reports, which is simply duplicating the activities performed by expert financial controllers. The legislator's superficial treatment of the audit resulted in it being misunderstood by the subjects obliged to perform it. What is more, the authorisation for the Minister of Finance to determine a specific form and manner of performing audit activities was included in the amended law. The regulation of the Minister of Finance in this matter was issued only on 5 July 2002,⁴ a full six months after the implementation of the internal audit institution into the Polish legal system. The chaos that prevailed in the units of the public finance sector during this time comes as no surprise. Summing up, during the first years of the internal audit becoming binding in Poland, it existed only as a financial audit, which led the legislator to begin working upon a draft new statute in 2003. The result was the Act on Public Finance, passed on 20 June 2005.⁵ According to Article 48 of this act, the internal audit was understood as the totality of activities including an independent analysis of management and control systems in a unit involving the procedures of financial control as a result of which the head of the unit is given an objective and independent evaluation of the adequacy, effectiveness and efficiency of those systems, as well as advisory activities including submitting motions aimed at improving the functioning of a unit. The justification of the draft act drew attention to the need to provide high quality operations of units in the public finances sector (Lipiec, 2008), the need to implement a rational economy of public means, and the need to adjust Polish legal regulations on public finances to the European Union standards (Pomorska, 2002, p. 13–14). In this last case, Poland made a pledge to the rational (primarily economical) use of public means, in particular to the proper expenditure of means coming from the European Union, as well as counteracting abuses in that matter (Winiarska, 2007, p. 51).

³ With the Act of 27 July 2001 on the amendment of the Act on Public Finances, the Act on the Organisation of the Council of Ministers, the procedure to be followed in performing its functions and on the scope of functions to be carried out by the various ministers, the Act on the Departments of Governmental Administration, and the Act on the Civil Service (Journal of Laws of 2001, No 102, item 1116).

⁴ The regulation of the Minister of Finance of 5 July 2002 on the specific mode of performing internal audit (Journal of Laws of 2002, No 111, item 973).

⁵ Journal of Laws of 2005, No 249, item 2104.

In the explanatory statement to the act, it was underlined that the internal audit in units in the public finances sector is directed towards protecting the financial interests of the European Union, and the basis for this protection should have been the resolutions of the Treaty establishing the European Community (TEC). Once again, therefore, the statutory definition of internal audit was flawed by its inadequacy in properly understanding the notion of audit, and the source of misunderstandings and doubts involved could have been the fact that the foundations for forming such a definition were the negotiations carried out in connection with Poland's accession to the European Union, which were directed mainly towards the financial control of Union means.

The separation of the notion of control from management should also be acknowledged as a significant default of the legislator, while it seems to be one of the elementary parts of the managing process. In this respect, one should agree with the opinion of B.R. Kuc who states that, "management cannot be separated from control, since control as a function completes the managing cycle and as a process infiltrates all of its areas: planning, organizing, motivating" (Kuc, Warszawa 2007, p. 352). More positively, the legislator implemented a division into assuring activities (understood as an analysis of management and control systems) and advisory activities, while the Act on Public Finances of 2001 defined audit exclusively as an analysis of financial economy.

The binding legal definition included in Article 272 of part 1 of the act of 2009 certainly concentrates upon the essence of audit to a greater extent. It defines the internal audit as an independent and objective activity aimed at supporting the minister managing the section, or the manager of a unit in achieving targets and tasks through the systematic evaluation of managerial control as well as advisory activities. In this way the legislator clearly indicated the role of the internal audit, and also the connection between the internal audit and the new institution of managerial control. Moreover, this definition is coherent with commonly acknowledged international definitions of internal audit,⁶ and the implemented modifications result only from the binding rules of legislative technique. In addition, the definition respects the division into the assuring and advisory activities, but also, in contrast to previous acts, underlines the significance of added value and the improvement of unit operations. Finally, from the contents of the new definition it follows that the internal audit is to support a unit in achieving determined targets through a systematic evaluation based on knowledge, as well as "(...) *perfecting efficiency of the process of managing risk and perfecting control and organization governance*" (Przybylska, 2010, p. 45). It is also significant that the subjective definition includes also criteria according to which there follows an evaluation of the system, and mainly it regards the adequacy, efficiency and effectiveness of managerial control in the section of government administration or a unit – Article 272 of part 2.

⁶ E.g. the definition of audit according to IIA of 2001 – Internal audit is an independent activity, objectively assuring and advisory, the aim of which is adding value and improving the operation of a unit. Audit helps to achieve targets through a systematic and disciplined attitude towards evaluation and perfecting the efficiency of processes of managing risk, perfecting the system of internal control and governance.

CHART 1 – DEFINITION AND RANGE OF THE INTERNAL AUDIT IN THE UNITS OF THE PUBLIC FINANCES SECTOR

The Act of 27 July 2001 about amendments to the Act on Public Finances (...)	The Act of 20 June 2005 on Public Finances	The Act of 27 August 2009 on Public Finances
<p>Internal audit is a totality of activities whereby the manager of the unit receives an objective and independent evaluation of the unit operating within the scope of financial economy with respect to legality, administration, expediency and reliability, as well as transparency and openness. The scope of the audit involves in particular:</p> <ol style="list-style-type: none"> 1) an analysis of accountancy reports and records in bookkeeping; 2) an evaluation of the system of accumulating and disposing of public means, as well as the administration of property; 3) an evaluation of efficiency and financial governance 	<p>Internal audit is a totality of activities involving:</p> <ol style="list-style-type: none"> 1) an independent analysis of the management and control systems in a unit including procedures of financial control mentioned in Article 47 of part 3, as a result of which the manager of the unit receives an objective and independent evaluation of the adequacy, effectiveness and efficiency of the systems; 2) advisory activities including submitting motions aimed at improving the unit's operations. 	<p>Internal audit is an independent and objective activity aimed at supporting the minister managing the section or the manager of a unit in achieving targets and tasks through a systematic evaluation of managerial control as well as advisory activities.</p>

2. THE SUBJECTIVE SCOPE OF INTERNAL AUDIT – UNITS OF THE PUBLIC FINANCES SECTOR ARE SUBMITTED TO AUDIT

The novelty in the act of 2009 was the specification of the catalogue of public finances sector units that were obliged to carry out an internal audit. On this basis, two essential groups of units obliged to carry out an audit can be distinguished. In the first of them, the legislator exemplifies the subjects obliged to carry out an audit, disregarding the amount of the budget – Article 274 of part 1. In the other group, the limits of public means conditioning the obligation for carrying out an audit in those units were indicated. This affects units in which the amount included in the financial plan of income (revenues) or the amount of expenses (costs) exceeded the sum of PLN 40,000 – Article 274 of part 2, as well as local government units if the incomes and revenues, or the amount of expenses and disbursements of the local government budgetary unit exceeded the sum of PLN 40,000 – Article 274 of part 3. In comparison with the previous regulation, the legislator deprived the Minister of Finance of the right to determine the limit of accumulated or disbursed public means.

CHART 2 – UNITS OBLIGED TO CARRY OUT AN INTERNAL AUDIT

Subjects obliged to carry out an internal audit under Article 274 of part 1	Units limited under Article 274 of parts 2–3
Internal audit is carried out in: 1) the Prime Minister’s Office; 2) the ministries; 3) regional offices; 4) customs offices; 5) treasury offices; 6) the Social Insurance Institution (ZUS), including the funds administered by it; 7) the Agricultural Social Insurance Fund, including the funds administered by the chairman of the Agricultural Social Insurance Fund; 8) the National Health Fund	1. Budgetary state units 2. State academies 3. Independent health care institutions established by local government units 4. Executive agencies 5. State target funds 9. Others

Source: the grounds of Article 274 of the Act of 27 August 2009 on Public Finances.

Independently from the indicated groups of units that are obliged to submit to an audit, the regulations of Article 274 of parts 4 and 5 determine one more group of such units. In this case, carrying out an internal audit requires a decision from the head of the unit of the public finance sector – Article 274 of part 4, or the minister responsible for the government administration division – Article 274 of part 5. Such an audit is therefore relative, meaning that until the decision is issued the audit has a facultative character, and only becomes obligatory once the decision has been made. These groups of units can include, for example, some central offices, customs offices, treasury offices, state entities, common prosecutor’s organisational units and the organisational units of the penitentiary system. Implementing such a solution, the legislator was aiming at “(...) *establishing internal audit as an effective and efficient tool for evaluating managerial control functioning in the government administration section, as well as the attainment of targets and tasks specified by the minister.*”⁷ This decision was made by the Minister of Finance, among others, implementing the obligation of carrying out an internal audit in the treasury control offices. Moreover, these regulations are applied relatively to the units subjected to the Prime Minister or those administered by him, as well as to the units operating the organs subjected to the Prime Minister, or those supervised by him.⁸

As mentioned, in the majority of units of the public finances sector, the audit becomes obligatory, which in turn affects the scope of responsibility of the head of the unit for a violation of public finances discipline. Changes regarding the circle of subjects obliged to carry out an audit have their source in organisational changes of the whole public finances sector, in three ways (Bury, 2010, p. 100):

1. liquidating some of the existing forms of public finance sector units;
2. changing the scope of activity of some of them, by expanding or limiting their competencies and range of their activity;

⁷ *Uzasadnienie do projektu ustawy o finansach publicznych*, parliamentary paper No 1181 available on the website www.sejm.gov.pl.

⁸ Disposition No 52 of the Minister of Finance of the 22nd of December 2010 regarding the indication of the units obliged to carry out an internal audit (Journal of Laws MF of 2010 no 14, pos. 59).

3. creating new organisational forms – the institution of financial economy as well as executive agencies.

It is worth noting that, in spite of the attempts to standardise the public finances sector in the countries of the European Union, there are still significant differences between member countries. In the subjective scope, these discrepancies mainly come down to the criteria of classifying a particular unit – in the Polish system, the decisive factor is the organisational form (legal form), while in other countries it is the nature of the tasks performed (Malinowska-Misiąg, Misiąg, 2006, p. 34).

Beyond the major current of considerations of this article, there is also the question of the legislator's inconsistency on the application of terminology when indicating the subjects obliged to carry out the internal audit. First of all, the act does not include a definition of a public finances sector unit, and only indicates in what legal organisational forms these units can occur. Admittedly, in light of the remaining regulations of the Act on Public Finances, it may be assumed that Article 9 includes a catalogue of public finances sector units, but this regulation does not have a directive character, merely an instructive one. It can therefore be concluded while interpreting Article 9 (Nowacki, Tobor, 2007, p. 222–245). The first argument in favour of this thesis is based on a grammar interpretation – in Article 9 of the Act on Public Finances of 2009, the legislator did not use the expression “public finances sector unit”, but only introduces the expression “public finances sector includes (...)” This operation appears to have been done on purpose, as confirmed by the fact that in Article 4 of the Act on Public Finances of 2005 the legislator also used the expression “public finances sector includes (...)” and in spite of its abatement, the same expression is still used.

3. INTERNAL AUDIT IN THE SYSTEM OF CONTROL

The next crucial element when analysing the legal character of the internal audit is to specify its position in the system of control, in particular its correlation with internal control. To place an audit in this structure in the proper way, it is necessary to explain the meaning of the notion “control”. This is a complex task because the term, in spite of its frequent occurrence in legal acts, has never been defined by the legislator. In the doctrine of administrative law, it is necessary to pay attention to the standpoint of H. Fayol, who formulated what is known as the classic function of management. According to him, control is a crucial element of the entire management process, because it is responsible for all the undertaken activities being in accordance with the specified regulations and the issued orders (H. Fayol, 1926, p. 15). Though subsequent conceptions of management have been based on the Fayol attitude, the development of the surrounding has led to crucial changes in this respect. Control became an essential link in the process of managing an institution. At present, control is identified with screening, specifying or detecting the factual state, comparing reality with intent, and then signalling the relevant subjects about the results of such observations without deciding, however, about the change in direction of the activity of the controlled unit (Starościk, 1975, p. 356).

Referring to the notion of “internal control”, it is necessary to indicate that, of all the various definitions of the notion, the most appropriate should be considered the one specified by M. Klimas, according to whom an internal control should constitute a ver-

satellite linked system comprising all employees of firms who, considering the posts they occupy, perform supervisory functions, employees whose duty is to control particular issues, as well as those persons whose duties within the scope of control follow from appropriate regulations or temporary orders of their superiors (Klimas, 1985, p. 9).

The unquestionable advantage of this definition is underlining the position of internal control in management. Moreover, although internal control is an activity that is to some extent secondary in relation to other undertaken activities in the unit, it is necessary to agree with the postulate of B.R. Kuc that internal control should be something more than a process. It should constitute a system (Kuc, 2007, p. 83).

Here, attention should also be paid to the opinion of J. Jagielski, who uses the notion of internal control in a strict sense. According to him, we speak about control in a strict sense with reference to control that is organised, and acts within (inside) a particular organisational unit that take the form of an institutional or functional control (sometimes it takes both forms) (Jagielski, 2003, p. 3). In this state of things, there might appear to be a significant similarity between J. Jagielski's definition of an internal control and an internal audit. This is based primarily on the placement of those two institutions inside the unit. However, the essential difference between those two notions comes down to the scope of their performance. H. Szymańska rightly remarks that the internal control is used to detect errors and irregularities in particular situations, as well as to specify responsibility in order to protect the property of the unit and to strengthen the managing processes (H. Szymańska, 2009, p. 36).

The internal audit reaches a bit further. In the opinion of the authors, an audit is not limited only to the function of detection, but also enriches the internal control system through the screening mechanism and has an advisory function. It is focused upon the drawbacks "of the system as well as correcting them," and it also allows an evaluation of the processes that take place in the unit, including an evaluation of the internal control functioning and all the connected activities. Control can become one of the targets of the audit and contribute to its improvement.

4. CONCLUSIONS

Taking into consideration the findings regarding the institution of internal audit, it can be seen that for the 10 years in which audit has been functioning in Poland, a dynamic development has been observed, though based on the patterns of Western European countries (Przybylska, 2010, p. 44). The changes have involved nearly all aspects of the audit, but the most crucial one is the separation of audit from the notion of internal control. Other positive aspects include the attempts to widen the scope of audit – from financial into newer and newer areas of unit operations. While the challenge was to adjust Polish legal regulations to the demands of the European Union, the changes occurring after 2004 have certainly been heading in the right direction. The manifestation of this can be seen in the new standards and ways of approach of the legislator himself, who has changed the theoretical character as well as the methodological dimension of the audit. The extension of the internal audit contents comes down to the fact that it is used in the management process to an ever greater extent, through evaluations and in the manner of managing and controlling units while also formulating recommendations aimed at making the work of the unit more efficient (Banaszkiewicz,

2003 , p. 16). In the Authors' opinion, the regulations regarding the internal audit should be excluded from the Act on Public Finances, and the question of audit should be regulated in a separate legal act, especially if the position of internal audit is strengthened. Finally, in spite of several changes in the law, while the question of audit is regulated in the Act on Public Finances, there will always be an equals sign between the internal audit and internal control. The Authors believe that the next changes affecting the internal audit should tackle this problem, and believe that such changes are indispensable.

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