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Theme 1: Basic Approaches and Challenges for  
Ensuring Transparency and Accountability

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**“Strengthening Public Financial Management through Internal Audit Reform”**

**1. Introduction**

Public Financial Management (PFM) incorporates all phases of the budget cycle, from budget planning and execution, internal control, and internal audit to financial reporting and external audit. Good public financial management, therefore, can support fiscal discipline, allocation of resources to priority needs, and efficient and effective delivery of public services.

There have been numerous attempts to modernize financial management systems at various levels of government and organization. Despite all the recent reform efforts to strengthen financial management in both developed and developing countries, the current fiscal crisis reveals that the PFM system has not succeeded with the basics, which include: controlling the growth of expenditures; preventing the waste of public money; or responding to changing environment. The painful lessons from the past economic crises, particularly the Asian financial crisis in the late 1990s, are still meaningful. In essence, we must restore public trust by getting the basics right.

The Supreme Audit Institution (SAI), as the last fortress of public trust for government policies and practices, needs to take leadership in the fundamental areas of PFM, so as to restore public trust and to continuously improve the public financial system. In fact, the development of sound financial management is one of the specific objectives of auditing as stipulated in the Lima Declaration of INTOSAI.

Toward this end, the Board of Audit and Inspection (BAI), as the SAI of Korea, has

initiated and fought for the enactment of the basic law for internal audit units (IAU). Meanwhile, the BAI has played the roles of supervisor, promoter and partner for internal audit units. As a result, the BAI helped the Korean government regain public trust through its efforts to improve PFM by re-establishing the roles and functions of IAUs.

## **2. Road to the enactment of Public Sector Internal Audit Act**

In the past, internal audit functions in Korea tended not to work properly. When the Korean government introduced internal audit in 1962, it did not pay much attention to the control of financial management itself. Under these circumstances, the government has decentralized the internal audit system, since the last 1980s, by allowing the heads of central government agencies and local autonomous bodies to decide on how to implement their internal audit function.

The results were not encouraging at all. Without rigorous legal foundation or sufficient recognition of the values and benefits of a sound internal control and checking system, internal auditing was given much lower priority than necessary. In most cases, in a typical government agency, the internal audit function was carried out by a division of planning or legal affairs. Also, internal auditors were appointed from among generalists within the organization through regular job rotation. After all, the internal audit function turned out to be very weak, lacking independence and professionalism.

This unfavorable development caused some concern over low audit quality. According to a Gallop Poll conducted in 2009, 79.5% of citizens responded that monitoring and control functions of internal audits in public entities are insufficient. The Poll also showed that the public did not have confidence in the performance of internal audits, and, therefore, called for a change.

The discussion on enacting the Public Sector Internal Audit Act, as a way to re-establish internal audit function in the public sector, began in 2003, but it was put on hold until 2007. Public entities opposed to the legislation on the basis that the Act might undermine the autonomy given to the heads of public agencies and might infringe on the management authority for organization and personnel.

In response, the BAI held public hearings and symposia to provide platforms where the concerned members of the National Assembly and other stakeholders could discuss the legislation of law governing public sector internal auditing. At the same time, the BAI organized policy fora with these public entities to promote that autonomy and

professionalism of internal auditing are not to conflict with each other, but instead coexist under the new system. Ultimately, the law was enacted in 2010, after seven long years of tough battles against resistance and lack of interest.

### **3. Key elements of the Public Sector Internal Audit Act**

The Public Sector Internal Audit Act aims to enhance the performance of internal audit operations by enhancing independence and professionalism of internal auditors in the public sector. The significance of the Public Sector Internal Audit Act can be summarized as follows:

#### **3.1. Mandating the establishment of an internal audit unit (IAU)**

The Act stipulates explicitly that an IAU should be established within central government agencies, local autonomous bodies (whose number of citizens exceeds 300,000), and public enterprises. The Act, therefore, provides a firm legal basis for the establishment of IAUs in the public sector.

#### **3.2. Ensuring the independence of internal auditing**

The Act stipulates explicitly that the independence of the IAU in audit activities, organization, personnel, and budget be ensured. To this end, the heads of IAU are recruited internally or externally. Also, they have fixed terms of office.

#### **3.3. Strengthening the professionalism of internal auditors**

The Act stipulates the qualifications of the head of IAU: the Act requires the recruitment process of the head of IAU to be carried out through an open competition process.

The Act also encourages internal auditors to be more independent and professional. Besides, the head of IAU may call on external experts or professional institutions when special skills or experiences are needed in such areas as accounting, health care or environment, for example. The heads of public organizations may also give preferential remuneration and promotion to internal auditors.

#### **3.4. Standardized and transparent audit process**

The Act prescribes that internal auditors should comply with the internal audit standards and the code of conduct as established by the BAI. Meanwhile, the Act ensures internal auditors' right to have access to documents and to ask the parties concerned to appear

and answer. Also, internal auditors may conduct pre-audits. Though not mandatory, the publication release of audit results is encouraged. When an auditee disagrees with audit results, the auditee may request a re-examination.

### **3.5. Cooperation between SAI and internal auditors**

The Act prescribes the establishment of a Joint Coordination Committee, so to speak, in which the BAI and the IAUs discuss improvement and development of a wide range of internal audit from audit plan, audit standards, and code of conduct to the measures to avoid audit overlaps. The BAI, the SAI of Korea, has the responsibility to help internal auditors with audit planning, audit techniques, staff training and personnel.

Also, the Act specifies that the BAI should evaluate the IAUs on management, audit operation, and audit performance. Upon completion of the evaluation, the BAI reports its evaluation to the National Assembly. Depending upon the evaluation result, the BAI may give an exemption of BAI's external audit to those public entities that showed an outstanding performance; or may ask for the replacement of the heads of IAU for poor performance.

## **4. BAI's role in re-establishing the internal audit system**

The Public Sector Internal Audit Act specifies three different roles that the BAI should play to re-establish the internal audit system. According to the Act, the BAI may serve as supervisor, promoter, and/or partner for internal auditors.

First, as a supervisor, the BAI makes a comprehensive assessment of the performance of the IAUs on a regular basis. This is indeed a very effective tool for enhancing the heads of public organizations' recognition of and commitment to the internal audit. In order to secure a continuous cooperation from them, the evaluation measures must be accurate, objective and relevant.

Second, as a promoter or sponsor, the BAI may promulgate audit standards, guidelines, and manuals which are to be adopted by the IAUs. Further, the BAI may organize training workshops and seminars on both basic and advanced audit skills, such as project evaluation and risk assessment methods. In addition, the BAI may establish a database of internal audit information as an audit clearing house for the IAUs.

Third, as a partner of IAUs, the BAI should actively communicate with the heads of

IAU through various channels to build mutual trust. In this regard, the above-mentioned Joint Coordination Committee will be a centerpiece of steering all the cooperation activities between SAI and IAUs. Also, it can be a good platform to implement the single-audit principle<sup>1</sup> in the future.

## **5. Some early outcomes and challenges**

Since the start of its implementation a year ago, the Public Sector Internal Audit Act has brought about several positive changes and achievements in the internal audit system.

First, a growing number of public entities set up within their organization an IAU which is exclusively commissioned to conduct internal audits. As of July 2011, 32 out of 41 central government agencies and 85 out of 258 local autonomous bodies newly established IAUs, some of which are in the form of audit committee, a collegiate decision-making body.

Second, there have been remarkable changes inside the IAUs. More IAU heads were recruited from outside of the organizations. Out of 100 newly recruited IAU heads, 58 were recruited from outside and only 42 were recruited from inside. The influx of these professionals is expected to contribute towards enhancing independence and professionalism of the IAUs. To support the IAUs, the BAI has been providing training programs specifically aimed at the newly recruited personnel of the IAUs.

Third, the cooperative relationship between BAI and IAUs expanded into several new areas. The BAI established internal audit standards which will serve as guidelines for carrying out internal audits and for managing the IAUs. The BAI also worked closely with the IAUs to develop more specific audit guidelines and audit manuals. The Joint Coordination Committee of the BAI and the IAUs has been operational since October 2010. This Committee successfully formulated a long-term development plan for public sector internal auditing in May 2011. In July 2011, the BAI completed the first comprehensive assessment of IAU performances in accordance with the Act. Also, in order to better support internal auditors, the BAI set up within the BAI the Internal Audit Support Group, consisting of two divisions and twenty staff members.

Fourth, internal auditing has gained more attention from the public. News media

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<sup>1</sup> Under the newly established internal audit system, the SAI and IAUs coordinate each other for audit selection to avoid overlapping of audits.

coverage on the topic of internal auditing has more than doubled after the promulgation of the Act. Following the elevated public interest, the efforts of the public sector to reform internal auditing spilled over to the private sector. Private corporations, such as Samsung, disclosed their internal audit findings, emphasizing their willingness to eradicate internal fraud and corruption practices and to strengthen their internal audit and inspection units.

Though a series of great achievements were observed throughout the inaugurating year, many challenges do lie ahead of us. Firstly, disclosure of internal audit results is still insufficient. According to a recent survey of 156 public agencies, only 55 percent of internal audit results were released to the public. Furthermore, among the disclosed audit results, only a fraction of them was released in a full report.

Secondly, expanding the mandates of internal auditing has been much slower than expected in many public organizations. For instance, adding pre-audit to the mandates of internal auditing often has been faced with internal resistance and debates within an organization.

Lastly, a number of heads of public organizations still have a concern that the establishment of independent IAU would undermine the autonomy of the organization. Therefore, some of them were inclined to intentionally mislead the issue of re-establishing the internal audit function into the SAI's seeking excessive control and power over the IAUs.

The Public Sector Internal Audit Act is a culmination of the efforts of the BAI, with the public support, to reform the internal audit system. However, improving the legal framework is merely the first step taken in a long and bumpy road toward realizing independent and capable internal auditing. In fact, there are several challenges that lie ahead for achieving stable operation of internal audit units and for building cooperative ties between SAI and IAUs. Further leadership from the SAI is again called for here.

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