

ORGANIZATION OF THE AUDIT PROCESS IN MUNICIPAL INSTITUTIONS: CASE STUDY ALBANIA

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Abstract: Accountability and transparency are the basic principles of the efficient functioning of public finances at local level, and especially of a modern welfare state. The development of external and internal audit commitments is necessary to ensure an economical and cost-effective use of local government financial resources. This study has focused on how to organize internal and external audit activities at secondary level of government in Albania, in other words the local government. But which are the units responsible for the functioning of audit process in local self-government entities? This study's findings show that, although the legal framework for internal and external audit has been developed, the quality of internal audit units is not at the expected levels. Particularly in the organization of the audit activity, in the context of Albania's specific conditions, the government must take into account the creation of a favorable and motivating environment for the employment of auditors. The City Council and the Mayor should increase and strengthen the importance of the audit profession and audit capacities at local level.

JEL classification: M42, H83

Key words: local government; internal audit, external audit

1. INTRODUCTION

Municipal government is important in terms of the public sector's strategic planning and represents an important research framework (Johnsen, 2018). Society evolves and advances over time, thus this phenomenon leads to the growth and diversification of people's needs. Organization of internal and external audit activities is

crucial for the implementation of efficient management and internal control systems, as well as for improving the performance of local institutions by maximizing the value offered by audit.

The main purpose of this study is to present the importance of audit activities in local self-government institutions in order for local units in Albania to meet the objectives set in a responsible, transparent and ethical manner and use the funds efficiently and economically.

Year 2014 marked the beginning of a series of reforms in the administrative-territorial organization of Albania, which are associated with the amendment of legal acts in order to improve the quality of local public services by increasing their capacity and citizens' access to high quality local public services. The evaluation of Albanian local administration (IDRA, UNPD Albania and Chatterjee in collaboration with the STAR2 project, 2016) shows that there is no municipality with “excellent” performance in Albania, but, on the other hand, there are no municipalities with extremely low ratings. Most of them revolve around average results, with a higher performance in terms of effectiveness, efficiency and accountability, but lower in terms of transparency, the rule of law, and civic participation and commitment. Even the study conducted in 2020 points out there is no municipality that can represent a model for other municipalities and, on the other hand, none of the municipalities was assessed as "poor" for its activity. Compared to 2016, the evaluation indicates an increase in terms of effectiveness, efficiency, transparency and the rule of law, while accountability and civic participation and commitment have not changed.

Albania has faced many changes regarding the role and importance of auditing, the objective being to consider it a significant help for the proper functioning of public sector. Currently, economic developments have highlighted the need to focus on managing the risks of good governance, since they are increasingly facing issues such as e-commerce, privacy, technological developments, security and health issues, money laundering, etc.

2. OBJECTIVES

The objectives of this study are to examine the current situation of auditing in local self-government units in Albania and to identify the key institutions that perform the audit of local self-government funds (counties, municipalities, communes). This study was conducted with the belief that the role and value of audit in Albania will benefit from the findings.

3. METHODOLOGY

The research questions of this study are:

- Is there a legal framework that defines the institutions performing audits at the level of local self-government units?
- Do local self-government units have an adequate audit capacity?

To answer these questions, we will rely on studies conducted and analyzed in both the national and international scientific literature, Annual Reports on the operation of the internal public financial control system in public administration units prepared by the Ministry of Finance and Economy, Annual Reports on the performance of the Supreme Institution of Audit, as well as on the legal framework of both external and internal audit and local finances.

4. LITERATURE REVIEW

The audit function had been studied regularly and had been the subject of numerous studies and analyzes, due to the added value it offers (Nedelcu, 2015). The concept of audit transparency, which has recently appeared in the scientific literature, can be seen as an effect and a precondition of auditing (Licht, 2019). The existence of a modern legal framework, established in accordance with internationally accepted standards and the best practices in the European Union, would be the fundamental guarantee that public audit is a real agent of change in public institutions (Radu, 2018).

Linnas (2011) concluded that the control, audit and supervision activities of local government units taken into account separately or only as a “control or audit pyramid” have so many flaws that they are no longer considered reliable instruments of modern good governance. Results of the study carried out by Ribeiro et al. (2018) indicated that, on the one hand, internal audit activity generally adds value to local authorities, but there is dissatisfaction with the quality of internal audit services on the other hand.

For the operation of local government units, an internal audit unit and an audit committee are essential in terms of financial performance and controls (Maclean, 2014). Hay & Cordery (2018) mentioned in their study that according to the authors Matkin (2010) and Fitzgerald & Giroux (2014) the use of audit committees in the US local government sector is on the rise. Audit committees assist local government officials in overseeing and monitoring the accounting and financial audit process, promoting improved standards and procedures for financial accountability (West & Berman, 2003). The presence of an effective audit committee can also be one of the mechanisms able to monitor the public sector's and senior management's risks, especially when "self interest" is not in compliance with community's law, rules and expectations (Thomas & Purcell, 2018). Regarding the relationship between audit committees and quality of internal control, Rich & Zhang (2014) revealed that the presence of audit committees in local government plays an important role in the financial supervision of municipalities. In the study by Crawford et al. (2008), audit committees obtained good ratings for internal audit monitoring, but were seen as less effective than hiring independent external auditors and managing the risks.

Audit of local authorities, specifically the audit's timing (the number of days from the end of fiscal year to the date when the opinion on the financial statements is expressed by auditors), should be similar in all countries, as regulations and incentives are assumed to be the same (Jones & Giroux, 2002). In different countries, external audits of local government can be performed by Supreme Audit Institutions, private auditors or other bodies, as shown in the table below:

Table no. 1 External Audit

Country	SAI	Private auditors	Other auditors
Albania	Yes	Legal auditors	
Croatia	Yes	No	
Estonia	Yes	Yes	
Georgia	Yes	Yes	
Italy	Yes	No	
Montenegro	Yes	Yes	

Country	SAI	Private auditors	Other auditors
Romania	Yes	No	
Serbia	Yes	Yes	
Denmark	Yes ¹	Yes	
Portugal	Yes	Yes	State General Inspector
Turkey	Yes	No	
Latvia	Yes	Yes	
Ukraine	Yes		State Audit Service of Ukraine
North Macedonia	Yes	Yes ²	
Bosnia and Herzegovina	Yes	Yes (partly)	
Austria	Yes ³	In particular cases	8 Provinces' courts of audit; 8 Provinces' supervisory authorities; The audit institution of Vienna
Hungary	Yes	Non-mandatory option	Government's (territorial) offices; Hungarian State Treasury
Lithuania	Yes	Yes	60 Municipal control and audit services
Slovakia	Yes	Yes	Office for Governmental Audit; Audit departments of ministries
Spain	Yes	In some situation	12 regional audit institutions
Poland	Yes	Yes, but is not required by the Polish law	16 Regional Accounting Offices; Governors of provinces; Prime Minister.
Greece	Yes	Yes	General Directorate of Fiscal Audits – Ministry of Finance; Observatory for Financial Autonomy of the Local Government Organizations; Inspectors-Controllers Body for Public Administration; General Inspector of Public Administration; Ministry of Internal Affairs.
Slovenia	Yes	Yes	The Budget Supervision Office (Administrative Body within the Ministry of Finance)
Finland	No	Yes	Local authority audit committees

Source: Authors' projection based on TFMA data, 2018.

Due to the large number of entities to be audited, SAI cannot perform the audit of all local units annually. In accordance with the legal acts issued by those states, local government units are subject to mandatory annual financial audit by private auditors or private sector audit firms. Their audit may also include assessments of the compliance or the performance of specific areas required by the top management. At the same time, there are local units where the annual private audit is either not required by law or is performed for specific purposes in the opinion of local units, as shown in the table above. Local units select private auditors through the procurement procedure.

¹ only in terms of state funds.

² only on the public enterprises.

³ if municipalities have at least 10,000 inhabitants.

To avoid overlap between audits, SAI cooperates with private auditors or other audit bodies through legal acts and agreements, such as it happens in Austria, Estonia, Georgia, Latvia, Lithuania, Portugal, Slovakia, Slovenia, Ukraine, Italy and Serbia (with internal audit). There are also states that have not formalized this type of relationship, such as in Bosnia and Herzegovina, Denmark, Greece, Hungary, and Slovenia, where cooperative activity does not exist and the chances of overlapping in audit activity are possible.

Among the states considered, it is noted that only the Finnish SAI does not have a mandate to audit local authorities, but each of those must have an audit committee.

In Norway, internal audits in local public administration can be performed from the internal audit structure or in partnership with other local units (Johnsen et al., 2001). The internal audit must cover two main types of activities, the financial audit and the performance audit. The financial audit represents the audit of the budgetary and financial systems through compliance tests and substantiation tests of transactions, which is performed according to an annual plan. In addition to financial auditing, the effectiveness of accounting systems, IT system and reporting facilities can also be assessed. The performance audit analyzes the extent to which the objectives set have been met or implemented and whether they have been achieved at a low cost, with minimal use of resources. The internal audit must also perform an analysis of the staff, determining whether it is in agreement with the organization's objectives and it has properly performed the tasks received (Allen and Tommasi, 2001). Results of the study carried out by Bowerman and Hawksworth (1999) suggest that internal audit is not fully convinced of the usefulness of their external audit counterparts' results and a major positive impact due to the extensive role of external audit is not expected to be observed. Similar activities performed by external audit and internal audit provide opportunities for coordination and cooperation and should be considered as an added opportunity to improve the effectiveness of audits performed (Xhani & Iliescu, 2018). The specialized literature has also emphasized the importance of internal audit department size and the available human, technological and financial resources for the efficiency and effectiveness of the internal audit (Silvia et al., 2019). Facilitating internal audit activities depends on the availability of resources, including funds, office space, human resources and a friendly environment (Roselyne & Wamitu, 2019).

Rosa et al. (2020) highlighted in their study on the level of harmonization in local government auditing in 18 member states of the European Union that harmonization in auditing is far from being achieved in Europe. The differences between them mean that the European Commission cannot obtain comparable high-quality data, but some countries need to update and standardize their accounting systems at local and regional level. Performance audit is seen as a key means for improving performance in Spanish local government, but this approach is not developed as well as in many other countries (Rosa et al., 2014).

Halili (2016) concluded that internal audit in local government units in Albania operates in violation of legal acts (or contrary to legal acts), does not have adequate management support and the independence of internal audit is not ensured. Budgetary users at local level are obliged to regulate the functioning of internal audit to ensure a satisfactory system of risk management and internal control (Bello and Karapici, 2012). The professionalism and the audit quality are relatively low, so further development of

the professional capacity of internal auditors is necessary. Xhani et al (2019) stressed the importance of reviewing the legal framework for internal audit in Albania. For institutions that do not comply with the legal provisions regarding the organization of internal audit activity in the public sector, the authors proposed the imposition of "restrictive" or "blocking" mechanisms, such as:

- reducing budget allocations;
- limiting the expenses of the respective public institutions up to the maximum ceiling of 30%.

5. ORGANIZATION OF THE AUDIT ACTIVITY

Municipalities hold a significant part of the state budget. According to Law no. 115/2014 “On the administrative-territorial division of local government units in the Republic of Albania”, the Republic of Albania has 12 counties and 61 municipalities.

Local self-government units are subject to both internal audit and external audit:

1. “On local autonomy”, art. 49 of Law no. 68/2017 "On the finances of local self-government" and by Law no. 114/2015 "On internal audit in the public sector". The internal audit units are almost established and operate in the local administration. The Directorate for Harmonization of Internal Audit in the Ministry of Finance and Economy monitors and evaluates the internal audit activity in the local units. By Decision no. 160 of March 2, 2016, of the Council of Ministers, were determined the mode of operation, powers and structure of the Audit Committee.
2. The external audit is organized accordingly:
 - Art. 43 (1) of Law 139/2015 “On local autonomy” and by article 10 of Law no. 154/2014 “On the organization and functioning of ALSAI”, among others, describes the powers of SAI for the audit of budget execution by public administration units, including the annual budget accounts and the audit of annual financial statements for general public government units, and expresses an opinion on them, as well as for the audit of public sector internal audit systems. Part of the ALSAI structure is the Audit Department of Local Administration Units.
 - Art. 50 of Law no. 68/2017 "On the finances of local self-government", point 2, we quote that: "The financial activity and execution of the annual budget of local self-government units are subject to an external audit each year, which is performed by the Supreme Audit Institution or other statutory (certified - private) auditors".
Legal audit, according to Law no. 10091 of 5.3.2009 "On legal auditing, the profession of statutory auditor and certified accountant", as amended, is an independent audit of the annual financial statements, either individual and / or consolidated ... ,, Article 41 of this law defines the entities that are required to perform the statutory audit of their annual financial statements, prior to their publication, by means of statutory auditors or audit firms.
3. According to Article 43 (4) of Law 139/2015, the executive bodies of local self-government units may be subject to audit performed by companies specialized in the field of audit, by special decision of the Municipal Council or the Regional Council.

Table no. 2 describes the establishment of the internal audit structures in local self-government units.

Table no. 2 Progress of the internal audit structures' establishment in local self-government units

Year	Audit Structures	Planned / actual number of auditors	With audit certificate	Without audit certificate	In process of certification
2012	41	75/75	51	24	-
2013	35	79/74	52	22	-
2014	31	70/68	51	17	9
2015	25	60/58	47	11	-
2016	43	125/114	56	38	20
2017	47	140/131	76	34	21
2018	50	160/145	94	36	15
2019	51	160/140	96	44	-

Source: Authors' projection based on Reports on the functioning of the public internal financial control system in public administration units 2012-2018.

From Table no. 2 it is observed that local self-government units have set up internal audit units (50 municipalities) and a general directorate of local taxes for the municipality of Tirana. Meanwhile, six local self-government units perform the audit service in agreement with the internal audit units of other public units based on the specifications of the law on internal audit in the public sector, while another 5 units do not perform the internal audit service through means defined by law.

The number of audit units decreased by 16 units in the period 2012-2015, while in the period 2016-2018 we notice an increase in the number of audit structures set up. With the exception of 2012, the organizational structure of internal audit units was not 100% complete due to the significant lack of human resources. Based on approved and published documents, the number of planned audit staff in local government organizations decreased between 2012-2015, while the period 2016-2018 was accompanied by a significant increase in the number of planned auditors in the structures of local government audit units. However, it is worth noting that there are still vacancies and units that have not established internal audit structures.

One of the legal specifications for hiring internal auditors is to support an "Internal Auditor in the Public Sector" certificate. Auditors, who do not hold this certificate but have 3 years of professional experience, are allowed to be employed in the internal audit unit, provided that they follow the certification procedure within a period of two years. The number of non-certified employees in the analyzed period is high, the responsibility belonging to the institution's managers for appointing inexperienced employees in important units such as internal audit (Halili et al, 2017). According to the law on internal audit, Article 11, internal auditors, in addition to the general conditions of civil servant, must also meet specific conditions, such as: university degree in economics, law or other fields depending on the needs of the audited sector, and the head of internal audit structure and internal auditors must hold a certificate of "internal auditor" and 5 years of experience in the profession or as an

internal or external auditor.. The auditor who does not have the certificate of "internal auditor", but has 3 years of experience in the profession, is employed in the internal audit unit and works in the first 2 years under the supervision of the direct superior and during this period this employee is compelled to submit the certification procedure as "internal auditor".

The annual functioning reports of the system of public financial control government units (Ministry of Finance and Economy, 2012-2019) highlights the unsatisfactory performance of audit structures in fulfilling their duties, particularly in developing audit plans that are not based on the units real sources and achievement of the audit activity, as well as the frequent change of auditors and low professional level. This shows that the responsibility, awareness and knowledge of Mayors regarding the role, importance and benefits of internal audit are quite low and require special attention for future strategies. In the 2019 Report, the establishment of audit committees in local self-governing units is considered a necessity for the functioning of the audit in accordance with standards and best practices.

The supreme audit institution, for the period 2012-2018, performed audits in the units of local administrations and in other units at local level, according to Table no.3. The SAI found out in the audits carried out in local self-government units the lack of effective internal control systems and the non-compliance with the requirements of financial management and control. The audit structures in some of the units are inefficient, unqualified and have been set up illegally and in violation of the principle of independence. Internal audit structures did not perform audits in priority risk areas, such as public procurement, leases, assets, etc. The findings and recommendations are mainly of an organizational nature and the recovery measures are insignificant. The fault of internal audit structures leads to the failure of internal audit mission and vision in the units of local administrations and does not guarantee a complete and efficient internal audit function.

Table no. 3 Audits in local government institutions and other local units

Year	Number of audits
2019	31
2018	45
2017	42
2016	45
2015	44
2014	52
2013	39
2012	64

Source: Annual Performance Report 2018, 2019, ALSAI

ALSAI found that the local self-government units did not periodically report to the city council on the implementation of the audit report recommendations.

6. CONCLUSIONS

Recently, a number of fundamental reforms have been undertaken in Albania to strengthen autonomy and increase the efficiency of local government. These reforms were accompanied by amendments to legal acts, which also affected the functioning of

internal and external audit in local government units. The entry into force of Law 115/2014 was followed by the merger of 14 audit units from Prefectures and Subprefectures.

In order to answer the questions raised in this study, we conclude that, based on the legislation in force, the audit in the local self-government units is performed as follows:

- The external audit is carried out by the ALSAI representatives and the statutory auditors,

- The internal audit is performed by the internal audit structure.

In reality, audits are conducted only by ALSA and internal auditors. Based on Law no. 68/2017, art. 3, the Ministry of Finance and Economy and ALSAI determine by common agreement, the cases in which the audit is performed by other legal auditors, as well as the procedures, deadlines and standards of the external audit performed by these auditors. According to article 50 of the Law no. 68/2017, the financial activity and the execution of the annual budget of the local autonomous units are subject to external audit every year. According to the international standards of internal and external audit, the audit of public institutions' financial activity is planned through the annual audit plan.

The financial activity of public institutions is subject to control, through continuous supervision by senior management and, based on risk, through internal audit of local units and ALSAI. Annual budget implementation audit of local self-government units is a legal competence of ALSAI, in accordance with its function, which must express an opinion inclusively on the annual budget accounts and the annual financial statements. Audit of financial activity, annual budget implementation audit of local self-government units and audit of financial statements are different objectives of the audit activity. Law no. 68/2017 equated a constitutional institution with statutory auditors who carry out, based on contract, for a fee, mainly the certification of financial statements. If the statutory auditor's opinion is required, Article 43 of Law 139/2015 provides that the executive bodies of local self-government units may be subject to audit by companies specialized in the field of audit by decision of the municipal council or regional council. Therefore, we consider it necessary to revise Law no. 68/2017, and we propose to eliminate the obligation to audit financial activity annually, as internal and external audits are performed on a risk basis, and it would be inadequate, uneconomic and contrary to internationally accepted standards, given that the obligation to subject to audit local self-government units each year does not apply to central government units.

To fulfill the primary mission, the audit must have stable structures with a high level of efficiency and professionalism. The role of the auditor must be recognized and this activity must be supported by mayors and municipal councils in order to avoid abuse and corruption at the local level. To support top management and for the successful management and proper use of financial resources, the functioning of audit committees in local units is a major necessity. The audit committee should be seen as a bridge between elected officials and auditors. The added value of internal audit units as well as the efficiency of internal audit committee activity would encourage local authorities to achieve their objectives by increasing performance.

In order to achieve a low level of risk of dysfunctional audit units and a performance of the entities in which these audit units operate, qualified and motivated

human resources must be ensured. Motivation can be achieved by increasing wages of auditors, in a specific and differentiated manner, because the current level of wages does not promote professional development, passion and desire to become part of the internal audit unit. Auditors (for example in the Ministry of Finance and Economy) are paid a lower salary than other employees. Judging by the importance and expectations that the audit has in relation to the organization, review of wage policies, motivation and reward would be necessary in order to comply with the general principles of the internal audit functioning and the Code of Ethics.

The findings of this study highlights that the harmonization of audit process in accordance with international and national regulations in this field is still a long way off. In order to maximize the use of public resources and to minimize risks in the future, the audit structures within local government units must be of high quality, sustainable, professional and collaborative. In the future, we intend to conduct a study on the impact of audit institutions (ALSAI) activity and the evaluation of internal audit structures at the local level.

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