

Audit in Small Local Government Units: The Case of Estonia

Raivo Linnas

Abstract

The author of this paper considers the issue of audit, particularly internal audit, in small local government units. The author argues that an internal audit functioning in a small local government unit without optimal integration into a coherent integral system of audit, control and supervision does not have the relevant possibilities of fulfilling all of its expected responsibilities and helping local political decision makers and managers to achieve their set goals, objectives and targets in a timely manner as well as meeting the expectations of its citizens. The author argues that there is little to no place at all for internal audit in tiny local government units because of the limited nature of their resources. The additional drain on the limited financial and human resources of a region will decrease the administrative capacity of its local government units and by this means operates as a negative, not a positive factor in serving local inhabitants. This is not only the case of Estonia and states in transformation, but more generic phenomenon. Academic literature does confirm that situation of LGU-s does not depend only on the political order, degree of democracy, liberalism, welfare and socio-cultural environment of a country.

Key words: Audit, Internal Audit, Governance, Local Government, Estonia.

Aim and Content of the Article

The author of this paper considers the issue of audit, particularly internal audit, in small local government units. This is an interesting and complex object of research because the audit profession has been challenged as never before during the past few years. Accounting standards are biased, financial reporting is too complex and financial reporting is evolving to another level not only in the USA and European Union but throughout the world. In addition, general management, particularly core business-line management fields, are more and more supported by services 'in the rear' or 'secondary' functions like internal audit, quality assurance, compliance assurance, risk management, and/or prevention of conflict of interest functions that can cause confusion in management, a lack of clarity, and duplication in areas of responsibility as

well as an increase in management and administrative costs. Furthermore, the fields of responsibility of CEO-s, CFO-s, risk managers, auditors, quality assessors and compliance officers are changing and getting more complex, and the self-governments of municipalities and societies where local government units exist are in the process of permanent change.

The aim of this article is to present analytical overview of the state of the local government sector and audit of local government sector in Estonia, discuss and present some options for the future development of external and internal audit in small LGUs like Estonia is and discuss strengths and weaknesses of options offered by the author. The author does hope that this article will help politicians, public servants and researchers find optimal solutions for improvement of audit effectiveness in local government sector.



This article consists of chapters: Method, Options for the Future Development of External and Internal Audit in Small LGUs, the State of the Local Government Sector in Estonia, Audit and Local Government in Estonia, What Are the Strengths and Weaknesses of the Abovementioned Options for Estonia and Conclusions.

Method

Audit in local government unit is to be treated as interdisciplinary object of research and due that ideas those of the author are based on different theories. Mainly on Systems Theory, Organizational Theory, Theory of Complex Self-organizing Systems, Self-government Theory, Functionalist theories and Theory of the State. The author performed research based on the qualitative approach to methodology and used qualitative methods of collecting, processing and interpreting data. The author performed a structural search of the relevant theoretical publications and other sources of information and data (such as laws and other legal norms, standards, official documents, verbatim reports of constitutional institutions, academic dissertations, websites of international organizations, public journals and newspapers), and validated, analysed and synthesised the information collected. The sources of information the author used were qualitatively analyzed for semantics and content.

Options for the Future Development of External and Internal Audit in Small LGUs

The Audit Commission defines corporate governance as *"the framework of accountability to users, stakeholders and the wider community, within which organisations take decisions, and lead and control their functions, to achieve their objectives."* (AC 2003, 4) Thus, external audit and internal audit are core components of governance. *"Good govern-*

ance can be seen in the quality of decisions and that effective decision making is based on 'hard' information from robust systems and processes that are used effectively by leaders in a culture that supports challenge and scrutiny." (AC 2003, 33) Thus, external audit and internal audit are significant success factors of good governance.¹ According to Gonzalez de Asis and Acuña-Alfaro (2002, 1) *"when local governments lack sufficient capacities, the participation of local civil society can promote good local governance. In fact, for good governance to be sustainable, it requires partnerships between government and civil society."* Civic participation mechanisms at the local level can be participatory workshops, information and citizens complaints offices, sectoral working groups, public hearings for accountability, public hearings for budgeting, citizen oversight committees, radio audiences, tripartite control committees, e-citizens and ombudsneighbor (Gonzalez de Asis and Jairo Acuña-Alfaro 2002, 7). Civil society organizations and inhabitants of local communities can take a part in conduction of internal audit and external audit of LGU as well.

Audit, the avoidance of corruption, control, supervision, quality assurance, compliance, the prevention of conflicts of interest, and risk management activities as an end in themselves and as abstract research objects are rather clear and easily determinable objects to observe, analyse and treat. Taking into account that *"audit is not an end itself"* (INTOSAI 1998) and taking a wider view in the new paradigm, this subject will be more complex and complicated to treat. According to Linnas, the Audit, Control and Supervision System (hereinafter ACSS) of an LGU is a

¹ According to Gonzalez de Asis and Acuña-Alfaro (2002, 4) local governance is the processes and institutions by which authority in a local municipality is exercised for the common good. This exercise of authority includes three points: the process by which those in authority are selected, monitored, and replaced; the capacity of the local government to manage its resources effectively, and to implement sound policies; and the respect of citizens and the local government for the institutions that govern economic and social interactions between them.



complex and complicated system consisting of many elements and subsystems (internal audit, external audit, supervision, ICS, etc.) that are simultaneously a subject and an object of the system (Linnas 2007, 288). Furthermore, Linnas states that *"internal audit is a subsystem of the ACSS and an element of internal control system, but also an influencer of the internal control system and subject for the external and internal supervision as well."* As a result, this subject is more confusing indeed, because one has to take into account the connections between its elements and subsystems, as well as the connections between an ACSS and a particular environment. Let us imagine that an internal audit unit or internal auditor is a well-experienced, skilled and high-qualified professional in governance, management, risk management, audit, quality assurance and the other relevant fields of expertise of a modern internal auditor. Thus, obviously one very important element or sub-system of an ICS is reliable and effective, benefiting the entire organization. Nevertheless, this does not mean that the other elements or sub-systems of an ICS are relevant and functioning. Furthermore, external supervision activities may be less extensive if there is a strong internal audit unit or an excellent internal auditor who is independent and an objective equal partner in management. The lack of such a strong internal audit unit or an excellent internal auditor means that the ICS lacks one significant element or sub-system. However, this does not mean that an ICS is weak and irrelevant itself. In such cases, supervision over LGUs should be more focused and extensive. Thus, it is inevitable that internal audit, control and supervision be treated as a system which is uniform, cohesive and whole (a holistic approach), and where its elements and subsystems are in constant interaction (Linnas 2007, 288). This cohesive whole may serve as an excellent system, even if an element or sub-system is not present at all. If there is a lack of some sub-systems of an LGU's ACSS, then other elements or sub-systems have to compensate for this missing part in sufficient degree. Any proposed solution should be very carefully analysed, evalu-

ated and assessed taking into account all the relevant aspects of the environment's characteristics for that particular society.

What are the possible scenarios and options for solving the problems (low qualifications, a lack of available professionals, independence, and financial and human resources, etc.) of trying to run an internal audit activity in a small LGU? One can find a few incremental, moderate or radical changes as alternative options as follows: 1) The merger of small LGUs (a radical change). 2) Starting wide-range co-operation between LGUs in the field of an internal audit's activities (the creation of joint audit units at the county associations of LGUs or joint outsourcing of internal audit activities; a medium change). 3) The creation of audit units at county governors' offices and the enlargement of the audit capacity, mandate and scope of the county governors' offices (A radical change that will move the focus from an internal audit unit of an LGU to the external audit unit of a county governor's office). 4) Strengthening the audit capacity of the State Audit Office (strengthening an external audit, a medium change). 5) Widening outsourced audit activities, including internal audit activity, but under a principally changed keystone (An LGU as an auditee should not be able to decide who will be its auditor, whether or not to accept or refuse audit results, or make or refuse to make payment for an audit or audit report; a radical change). 6) A change in the principles and procedures of appointing the members of audit committees of LGU councils (a radical change). 7) A change from an appointment-based approach to an election-based approach in staffing ACLGUCs and the post of internal auditor in LGUs (a radical change). 8) A combination of the abovementioned options. It is possible to implement each option on this list, but there is a different likelihood of each coming into actuality during the next decade. These options are not very specific for Estonia and countries in transition, but they have more generic sphere of application. Local government sectors differ from each other all over the world, but some trends are common: a mismatch between the responsibilities and



sources of finance, life under permanent change, reform and merger processes, and the increasing share of networking and co-operation between LGUs. Academic literature does confirm that situation of LGU-s does not depend only on the political order, degree of democracy, liberalism, welfare and socio-cultural environment of a country. At present, there is one more common characteristic – internal audit activity does not operate very well in many different countries.

The author will treat issue of Integrated Model of Audit, Control and Supervision of Local Government Units more deeply in his next article.

The State of the Local Government Sector in Estonia

According to Mäeltsemees, the most acknowledged expert on local government sector issues in Estonia:

“The position of local self-government in the society varies from country to country and understanding it requires knowledge of relevant legislation, especially the constitution. Local self-government is thoroughly and well regulated by the Constitution of the Republic of Estonia compared to constitutions of other countries; foreign experts have also remarked about it. Local self-government is mentioned in about 25 articles of the Constitution; yet, chapter 14 and articles 154–160 specifically regulate the institution.” (Mäeltsemees, 2006a).

In addition, Mäeltsemees also states the following:

“the difference between the terms administrative-territorial division and administrative-territorial organisation needs to be explained since they are often used incorrectly or even as synonyms. According to the Territory of Estonia Administrative Division Act adopted in 1995:

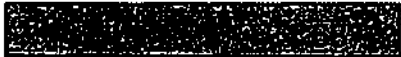
1) The administrative division of the territory is the division of the territory of Estonia into counties, rural municipalities and cities;

2) Administrative-territorial organisation is the division of the territory of Estonia into administrative units that are units based on administrative division, the status, name and boundaries of which are determined by law and other legislation, and in the territory of which state administration or self-governmental administration is carried out.” (Mäeltsemees, 2006b)

Estonia is divided into 15 counties. There is no regional-level government (MI, 2005, 20), but there were 227 LGUs (33 towns and 194 rural municipalities) as of January 1st, 2007 (MI, 2007). All LGUs – towns and rural municipalities – are equal in their legal status (MI 2005, 2). The size of LGUs in Estonia is quite varied, but all of them are small or very small.² 32 LGUs have a population of under 1000 inhabitants, only 3 have a population over 50 000 (MI, 2005, 3) and half have less than 2000 inhabitants (MI). Nevertheless, Estonia is not a very rare case. According to Oulasvirta (2003, 340), most (57%) LGUs in Finland are small as well (2000–10000 inhabitants). The average surface area of local governments is 180 km² (Suur, 2006). According to Söder (2006) in 2005, “The volume of local governments’ consolidated assets amounted to 42 billion kroons, liabilities to 8 billion kroons, and net assets to 34 billion kroons as at the end of the year. The total consolidated net gain constituted 1 billion kroons.”³ Oviir (2006), argues “that 90% of LGU-s in Estonia are extremely small and due that, it is difficult for them to find and maintain well-qualified accountants, information technologists, lawyers, and other specialists. There just are no such people, and there is no point in giving

² It is very difficult to determine what qualifies an LGU as a small one, because this cannot be determined by only one or two quantitative characteristics. However, according to the US EPA (2004, 5), a small local government is a local government that provides municipal services to 3,300 or fewer permanent residents.

³ 1 EUR =15.6 kroons (EEK).



the local governments a thrashing for not having them, because it is likely they will not have them in the future, either."⁴ Since Estonia regained independence in 1991, its LGUs have had more and more tasks and functions heaped upon them, but in most cases there has never been enough money to fulfil them all (Mäeltseemes, 1994; Pelisaar, 2004). According to Ryyänen (2003, 255, 256), Haveri (2003, 319) and other academicians, the situation is similar in Finland as well. This long lasting situation along with the initiative of the Riigikogu and the Government of Estonia (RTI, 15.07.2004, 56, 399) to promote the merger of LGUs is 'pushing' LGUs more and more towards merging in order to solve these problems as well as others.

Taking into account all the relevant factors, one can conclude that small LGUs do not have sufficient capacity and the resources needed to establish internal audit units within their jurisdictions that can conduct audits in accordance with internationally recognized standards. Thus, one can deduce that internal audit activities without support of external audit, control and supervision activities cannot serve as proper and effective tools supporting good governance in small LGUs. According to USAID (1995) *"to be successful, democratic local governance must develop on two discrete levels. First, the national government must create laws and policies that empower local communities to conduct their own public affairs. Second, local actors – government officials, NGO leaders, and entrepreneurs – must acquire the skills, institutions, and material resources that will allow them to practice self-governance. The first level refers to the 'enabling environment,' the second level refers to 'capacity building.'*" Thus, state government and local government

⁴ Oviir (2006): *"As long as our country is dotted with thimble-sized communes, the state should offer them support so that they would be able to fulfil certain basic functions. ... I would like to stress it once again: there are approximately 220 local governments in Estonia and 30 of them do not have any problems. Tallinn has no problems, Tartu has no problems, maybe Pärnu has none, and so on, but 190 local governments are facing serious predicaments."*

have to act in tight co-operation with civil society to increase capacity of audit, control and supervision in LGUs.

Audit and Local Government in Estonia

According to Nicolaisen (2006), the audit profession has been challenged as never before during the past few years because accounting standards are biased, financial reporting is too complex, financial reporting is evolving to another level and *"it's tough in this complicated world for smaller businesses, whether they're private or public, to get all the right information at the right time, so that they can prepare their financial statements accurately and so that auditors can audit them with confidence."* Auditing is under permanent change (Caplain, 2005; E&YA, 2005, 6; E&YF, 2007, 6; Fogarty, Graham, and Schubert, 2006; McConnell and Banks, 2003; Ramos, 2003). Auditing as an issue of academic research and day-to-day function in businesses and local government units⁵ (hereinafter LGU) is a rather more complicated issue than one can expect on the basis of a theoretical approach. Internal auditors' work is in a state of change (D'Arcy, 2007, 36) and their area of responsibility in day-to-day life has been unclear up until today (Banham, 2004; Caplain, 2005). One can hardly find an argument against Caplain's statement that *"Everyone has his or her own view of internal audit. ... There are many misconceptions and unrealistic expectations about the role of internal audit."*

According to INTOSAI's⁶ Lima Declaration (1998), *"The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust."* Audit as an object of research and audit activity as an inherent part of an organization's life is well defined all over the world, but there are still some mate-

⁵ Hereinafter, a local government unit (LGU) means a rural municipality or town.

⁶ INTOSAI – International Organization of Supreme Audit Institutions.



rial differences^{7, 8, 9, 10} in its definitions and treatment (Nieuwlands, 2006) by academicians, politicians, public administrators and audit professionals of different states and regions across the globe.¹¹ Estonia's legislative body, the *Riigikogu*, defines an internal audit as an 'activity' focused on the 'assessment' and 'analysis' of the existence and efficiency of an internal control system (hereinafter ICS). The scope of the Estonian definition of an internal audit is very narrow in comparison with that determined by the IIA and the IIA UK&I and is actually out of touch with the modern approaches to an internal audit. According to Clause 54³ (1) of the Statute of the City of Tallinn, the scope of activities of the internal audit service of the City of Tallinn is also narrowly focused on an ICS. In contrast, §46 of the Statute of the City of Tartu sets the scope of activities of Tartu's internal audit service on almost the same scope as that defined by the IIA and the IIA UK&I. According

to Clause II (5) of the Bylaw of the Internal Audit Service of the City of Pärnu, the scope of activities of Pärnu's internal audit service is wider there than in Tallinn, but nevertheless, it is not in complete accordance with the international standards mentioned earlier.¹² Thus, the legal definition of an internal audit in Estonia should be reviewed and revised.

There is no legal obligation to establish an internal audit unit or appoint an internal auditor in LGUs in Estonia.¹³ According to Clause 92² (3) of the Government of the Republic Act, the Government of Estonia is responsible for establishing the general rules for the conduct of internal audits, including provisions for reporting, but only for government agencies and state agencies administered by government agencies (RT I 2007, 66, 408). Nevertheless, one can find some clauses in the Local Government Organization Act (hereinafter LGOA) that enact issues concerning internal [Clause 22 (1) 1)] and external auditing [Clause 22 (1) 18; Clause 39¹(2); Clause 48 (1)-(7)].¹⁴ More clauses regulating internal audit activity in other laws of Estonia can be found; for example, Clause 26 (3) 3) of the Rural Municipality and City Budgets Act and

⁷ According to The Institute of Internal Auditors (hereinafter IIA), an Internal Audit Activity means "A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

⁸ The IIA UK&I has defined internal audit as follows: "Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

⁹ According to Clause 92¹ (1) of the Government of the Republic Act, "internal audits are activities involving assessment and analysis of the existence of an internal control system in an agency of executive power, the efficiency of the system and its compliance with the requirements established by legislation." (RT I 2006, 14, 111)

¹⁰ According to The Institute of Internal Auditors (IIA), "Assurance services involve the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system, or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor."

¹¹ According to The Institute of Internal Auditors (IIA), "Consulting services are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client."

¹² Here, it is noteworthy that these services are actually 'called' 'internal audit services' only in the translation from Estonian into English. In their original languages these units are called *stsekontrolli teenistus* (Internal Control Service) or *teenistusliku järelevalve teenistus* (Supervisory Control Service).

¹³ This argument concerns an internal audit unit as stated by the IIA, not the internal audit commissions of LGU councils (*Revisjonikomisjon*) pursuant to the laws of Estonia.

¹⁴ Pursuant to Clause 48 (3) the audit committee shall monitor: 1) the conformity of the activities of the rural municipality or city government with the regulations and resolutions of the council; 2) the accuracy of accounting of rural municipality or city administrative agencies and agencies under the administration of a rural municipality or city administrative agencies, and the purposeful use of rural municipality or city funds; 3) the timely collection and registration of revenue and the conformity of expenditure with the rural municipality or city budget; 4) the performance of contracts entered into by the rural municipality or city; 5) the lawfulness and purposefulness of the activities of the rural municipality or city government and the administrative agencies thereof. Pursuant to Clause 48 (4) the audit committee shall monitor the agencies specified in subsection (3) of Clause 48 pursuant to the procedure provided by the statutes of the rural municipality or city and on the basis of its work schedule, or as required by the council.



Clause 14 (3) of the Accounting Act. Concerning the legal basis of internal and external audit issues in the LGUs of Estonia, one has to keep in mind three particularities. First, according to Clause 14 (3) of the Accounting Act,

"In addition to the other cases provided by law, the annual report of an accounting entity shall be audited if on the balance sheet date of the accounting year the accounting entity exceeds the limits of at least two of the three following criteria: sales revenue (net turnover), in the case of a company, or income, in the case of other accounting entities: 10 million kroons; balance sheet total: 5 million kroons; number of employees: 10. An accounting entity which is a consolidating entity pursuant to Subsection 27 (1) of this Act shall determine whether an audit is compulsory on the basis of the consolidated indicators."

Thus, not all public and private entities, including some LGUs, in Estonia have a compulsory responsibility to contract an internal or external audit of annual accounts and reports.¹⁵ Second, an internal audit activity, defined in the LGOA as an activity conducted by the internal audit commission of an LGU's council¹⁶ [called a *Revisjonikomisjon (Revision Commission)*], does not match the exact meaning of an internal audit in many aspects as defined and principles of action stipulated by the IIA or by the IIA UK&I. Nevertheless, it is enacted in the statutes of towns where an internal audit unit exists, or in the statutes of the internal audit services themselves, that they shall act according to the standards of the INTOSAI and IIA. Third, independent internal audit units¹⁷ in LGU administrations exist in only a few of the biggest towns of Estonia [in the City of Tallinn and its city districts (§ 54³ of the Statute of the City of Tallinn), in the City of Tartu (§ 46 of the Statute of the

City of Tartu), in the City of Pärnu (Statute of the Internal Audit Service) etc.]. Thus, the political, legal, cultural and historical aspects of the environment are those which do not support an internal audit activity in the majority of LGUs in Estonia.

There is no official or unofficial body which is responsible for the methodological and professional assistance of LGUs in internal audit issues in Estonia. According to Clause 65 (1) of the Government of the Republic Act, the area of governance of the Ministry of Finance shall include co-ordination of the implementation of the ICS of the Government and the organisation of internal audits of the central government. The ICS and internal audit of the local government sector are out of its scope. According to § 9 of the State Audit Office Act, the SAO shall co-operate with local government units and the Government of the Republic in order to improve internal control and internal audit, but the scope of this law is only 'co-operation' (RT I 2007, 16, 77). In addition, there is no official or unofficial body which is responsible for the education and training of public sector auditors, both internal and external, in Estonia. Thus, there is no methodological and other professional support for the internal auditors of LGUs and no official body responsible for issuing professional certificates for public internal auditors in Estonia. This means that there is no 'seedbed' for the internal auditors of the public sector. The Parliament of Estonia, the *Riigikogu*, has to decide which body, whether the State Audit Office, the Ministry of Finance or Estonian Chapter of the IIA, will be responsible for internal audit issues over the public, central government and local government sectors.

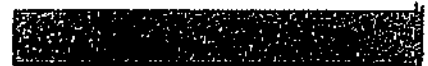
According to attribute standard 1100 of the *International Standards for the Professional Practice of Internal Auditing (hereinafter ISPPIA) of the IIA*, an internal audit activity should be independent¹⁸ and internal

¹⁵ This is a very reasonable circumstance that avoids the loss of value of an audit and an audit into a useless formal bureaucratic procedure.

¹⁶ Hereinafter, a council means a council of a rural municipality or a town.

¹⁷ Not internal audit commissions in council of LGUs.

¹⁸ Independence – The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels. (IIA)



auditors should be objective¹⁹ in performing their work. According to the State Audit Office of Estonia, "in several cases, the internal audit committee had failed to perform the objectives provided by law and its role was mainly formal" (SAO 2006, 46). According to Linnas (2007, 286), "an internal audit service, even if any does exist, of LOG (Local Government – Author) is in both objective and subjective situation of a conflict of interests, as their activities are directly steered by the will of the political powers in office via a local council or government." Thus, the majority of audit commissions of LGU councils (hereinafter ACLGUC) in Estonia do not fully meet the meaning of independence as stated above and cannot be expected to conduct audits as objectively as one might expect. The situation of internal audit units in city administrations is slightly better, because the staffs of these services consist of officials who are not acting politicians, but civil servants instead. The head of the internal audit service of the City of Tallinn is under the direct management of the city secretary, who used to be the non-political head of the administration. Thus, in the City of Tallinn, at least in a formal legal manner, internal audit activities are in accordance with the ISPPIA1110.²⁰ This situation is not as clear in the City of Tallinn's district administrations. In the City of Pärnu, the head of the internal audit service is accountable directly to the Mayor. The issue of positioning the head of the internal audit unit in the local government's administrative organization is not very clear. It is the utmost challenge to determine whether it is better that an internal audit unit of a town or rural municipality is under the

direct management of and accountable to the municipality government (political management), to the mayor (politician) or to the head of administration (administrative non-political manager). That is dependent on a complex set of characteristics, including political, ethical, economic, cultural and historical factors. It is more important to have a situation where the ACLGUC is headed by politicians in opposition and staffed in the majority with opposition politicians, so experienced audit practitioners and internal audit units in town and rural municipality administrations can conduct audits in accordance with the principal hard and soft norms of the ISPPIA.

It is very hard if not impossible to conduct internal audits in small LGUs in accordance with the attribute standards ISPPIA1200,²¹ ISPPIA1210,²² and ISPPIA1220.²³ Why is this so? First, because internal auditors have to play a number of roles such as an auditor, adviser, advocate, coach, educator, assessor, communicator, etc. The field of internal and external audit is going to be much more complex because of relatively new and unclear issues of reporting on Enterprise Risk Management (ERM) (Banham, 2004), the Sarbanes-Oxley Act of 2002 (SOX) (McConnell and Banks, 2003; Vorhies, 2005; Lebovits, 2006), Good Governance (Rosario and Holl, 2005) and Good Corporate Governance, Social Responsibility or Corporate Social Responsibility (Nieuwlands, 2007), Sustainable Growth and Corporate Sustainability Reporting²⁴ (Ballou, Heitger, and Landes, 2006); as well as issues of ethics (Lebovits), combined

¹⁹ Objectivity – An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others. (IIA)

²⁰ According to ISPPIA1110, the chief audit executive should report to a level within the organization that allows the internal audit activity to fulfil its responsibilities. According to ISPPIA1110.A1, an internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

²¹ According to ISPPIA1200, engagements should be performed with proficiency and due professional care.

²² According to ISPPIA1210, internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

²³ According to ISPPIA1220, internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

²⁴ Corporate sustainability reporting (CSR) involves reporting financial and non-financial information to key stakeholders on the company's operational, social and environmental activities and its ability to deal with related risks (Ballou, Heitger, Landes, 2006).



assurance (Lukeman, 2007, 36), etc. According to Ballou et al., "CPAs within organizations will play a key role by providing and measuring the social and environmental information, using their skills to improve its quality and facilitate its use to make sound business decisions in areas such as investment appraisal, budgeting and strategic planning." Second, the work of auditors will be more and more under pressure and the expectations of managers and stakeholders will increase (Rosario and Holl, 2005; Ballou, Heitger, and Landes, 2006; Green, 2006; Vorhies, 2006). Therefore, the level of knowledge, competences and skills of auditors has to rise (Winters, 2004) and change as well. According to Linnas, "Audit (including internal audit), control (including internal control) and supervision (internal and external supervision) are interconnected in a complex, non-linear manner... (Linnas, 2007, 228) The audit, control and supervision of LOG (Local Government – Author) units (organs, constituents) form a uniform cohesive whole (holistic approach) and are in constant interaction, which is why it is impossible to refer to a permanent equilibrium when speaking about the ACSS (Audit, Control and Supervision System – Author), although the balance of the organism (ACSS) as a whole and fixed proportions of its organs-constituents (audit, control, supervision) may be the desired result." (Linnas 2007, 290) Third, not only are accounting- and auditing-related issues changing endlessly, but local governments (Aarrevaara, 2003, 298; Helander, 2003, 290; Pihlajaniemi, 2003, 264, 268; Ryyänen, 2003, 256; Woolas, 2005; Dexia 2006, 7) and societies (Ketunen, 2003, 277, 287; Walker, 2005, 81) where LGUs exist are in the process of permanent change as well. Both LGUs and internal audits in LGUs are an integral part of society where the key factor is the people themselves. This means that an internal audit in an LGU should be treated as a social system (Linnas 2007, 290), its development/change processes should be treated as a social process, and its key factor should be the people of the LGU in question (Linnas 2007, 290). Social systems and processes are very

complex (Wallerstein, 1998, 5; Näpinen, 2002, 130, 131), they operate under the influence of self-organizing processes (Heyligen, 2002, 23; Näpinen, 1994, 164) and work in open systems (Prigogine 2000, 895), sometimes called a world-system (Wallerstein, 1974, 347; Straussfogel, 1997, 123) or eco-social system (Lemke 1995, 16). In social systems, individual information (such as individual values, norms, conclusions, rules, opinions, ideas and beliefs) changes dynamically because of the new experiences of individuals (Fuchs and Hofkirchner, 1999, 4). Forth, because small LGUs do not have a sufficient amount of financial (Haveri 2003, 321; Pihlajaniemi 2003, 268; Oviir 2006; SAO 2006, 8; Linnas 2007, 284) and human resources (Haveri; Pihlajaniemi; Oviir) to hire, educate, train and keep in office experienced, skilled and well-qualified persons. According to PCAOB (2007, 34), "smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting." The smallest LGU in Estonia has only 101 inhabitants in its administrative territory. It is obvious that it is nearly impossible to find a head of the municipal administration, much less a person suitable for internal audit activities. Gonzalez de Asis and Acuña-Alfaro (2002, 10) argue that the smaller size of the local level is an advantage for creating a systemic strategy of cooperation between civil society and government, that will make the latter more responsive to the needs and demands of individuals or groups in the community. The author of this article is rather critical on this argument.

It is very challenging to conduct internal audits in small LGUs in accordance with the performance standard *ISPPIA2000* as well.^{25, 26}

²⁵ According to Performance Standard *ISPPIA2000*, a chief audit executive should effectively manage an internal audit activity to ensure it adds value to the organization.

²⁶ *ISPPIA2130* states that an internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives: promoting appropriate ethics and values within the organization; ensuring effective organizational performance management and accountabil-



Why? The author will use supportive arguments of the Public Company Accounting Oversight Board (hereinafter PCAOB)²⁷ to bolster his point. According to the PCAOB, in smaller less complex companies senior management is often involved in many day-to-day business activities and performs duties that are important for effective internal control (PCAOB 2007, 7). The extensive involvement of senior management such daily activities and the fewer levels of management that exist in smaller companies can provide additional opportunities for management to override controls or intentionally misstate financial statements (PCAOB). The PCAOB further states that smaller companies, by their nature, have fewer employees, which limits the opportunity to segregate incompatible duties (PCAOB). The risk of a management override of controls exists in all organizations, but the extensive involvement of senior management in day-to-day activities and the fewer levels of management in smaller companies can provide additional opportunities for management to override their controls (PCAOB). Internal audit committees (*Revisjonikomisjon*) of LGU in Estonia are usually appointed by the political powers in office (Metsalu 2006, 2) and it is not a rare situation when a council, and thus its internal audit committee as well, may consist of only members of one political party (Kettunen 2003, 275; Linnas 2007, 286) or members of the sitting coalition. The audit committees (*Revisjonikomisjon*) of LGU councils in Estonia are put together in an undemocratic manner of governance (SAO 2006). According to Allar Jõks, former Chancellor of Justice of Estonia, in Estonia party affiliation is taking terrifying dimensions,

ity; effectively communicating risk and control information to appropriate areas of the organization; effectively coordinating the activities of and communicating information between the board, external and internal auditors and management.

²⁷ The arguments of the PCAOB are very useful, because they concern the problems of small listed companies. Listed companies should always be, as they were in the past, the flagships of corporate governance, accounting, auditing, risk management and internal control. Thus, if small listed companies have problems in these particular issues, then small local governments are at even greater risk and trouble.

preference of private interests against public interests is rather a rule and clan economy needs to be handled. In situations like this it is too much to expect that the ACLGUC or internal auditor of an LGU's administration to improve the governance process, promote appropriate ethics and values within the organization, and ensure effective organizational performance management and accountability if the pragmatic interests of the local politicians in power are not in line with the objectives of the ACLGUC. Nevertheless, such a situation is in complete accordance with Estonian law because according to Clause 48 (1) of the LGOA, a council shall form an audit committee of not less than three members for the duration of its term of office. In addition, according to Clause 48 (2) of the LGOA, the chairman and members of an audit committee shall be elected from among the council's members. Thus, the legal, political, economic and demographic environment in Estonia does not support the prudent, independent, objective and effective operation of internal audit activities.

The external evaluation of LGUs by the state is not efficient in Estonia (Linnas 2007, 286–287). Nevertheless, this is not only the case in Estonia, but it also exists in Finland (Oulasvirta 2003, 346), Israel (Friedberg 1999, 11), the United Kingdom (Woolas 2005), and in others as well. Thus, external audit capacity should be improved, but there are always financial limits. External audit activity also does not help very much, because outsourced external audits almost always depend only on the customer of the services (auditee) as regards the expected result (Linnas 2007, 286) and this can affect their temporal and content-related scope as well as the main issues treated. Consequently, there is an inherent conflict of interest, because an external auditor cannot be truly independent and objective in his or her audit work if the payment for his or her job depends solely on the expectations and will of the auditee.

Taking into account all the arguments described in this and the previous two chapters together, one can be confident in the opinion that an internal audit functioning solely with-



out optimal integration in a coherent integral system of audit, control and supervision in a small LGU does not have the possibility of fulfilling all its expected responsibilities and helping the LGU's political decision makers and managers achieve their set goals, objectives and targets in a timely manner as well as meeting the expectations of its citizens. Even more, there is no space at all in tiny LGUs for internal audit because having an internal auditor or internal audit team in the organization of an LGU with insufficient or limited resources is an additional, potentially unbearable, burden on its resources. The diverting of extra financial and human resources will decrease the administrative capacity of the local government unit and by this means operates as a negative factor in the serving of its citizens.

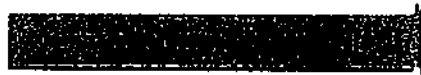
What Are the Strengths and Weaknesses of the Abovementioned Options for Estonia?

The merger of small LGUs is the most radical change. It creates a significant source for developing the capability and performance of internal audit activities in LGUs in Estonia. Whereas these LGUs are small by their population, area, personnel, budget and the fact that internal migration is redistributing the population to the detriment of the smaller ones, the merging of these smaller LGUs is an imminent necessity. The author is of the opinion that the administrative territory of an LGU in Estonia should match the administrative territory of a county in size.²⁸ There is space in Estonia for about 15 LGUs under this scheme. These 15 LGUs will in turn have the relevant resources to cope with the responsibilities and demands of modern society. The Estonian Parliament and Government of the Republic are 'pushing' this idea, but with no significant success. One reason for the lack of progress is the resistance of local politicians and civil servants. A second reason is the fear

of restricting the constitutional rights of citizens to self-governance. A third reason is the fear of citizens of losing access to local public services in their locale. This scenario has more strengths than weaknesses.

Starting wide-range co-operation between LGUs in the field of internal audit through the creation of joint audit units at the county associations of LGUs or the joint outsourcing of internal audit activities is a medium change scenario. This might turn out to be the favourite scenario for many reasons as there are a number of supportive legal, political, financial, cultural and historical factors in Estonia. According to §12 of the LGOA and to §2 of the LGAA, LGUs in a county may form a county association of LGUs to foster the balanced and sustainable development of the county, to preserve and promote the cultural traditions of the county, to represent the county and the members of the association, to protect the common interests of its members, to promote co-operation between the local governments in the county and to create possibilities for improved performance of the functions of its members as prescribed by law. There is a regional association in each county that unites almost all the LGUs within them (MI 2005, 20). There are two national associations of LGUs in Estonia: the Association of Estonian Cities and the Association of Municipalities of Estonia (MI). These two cooperative bodies established a joint body, the Co-operation Assembly of Associations of Local Authorities, to conduct negotiations with the central government of Estonia (MI). Many small LGUs in Estonia buy public services from neighbouring LGUs on a contractual basis (MI). The co-operation and networking of LGUs is a regular occurrence in Finland (Aarveaara 2003, 302; Haveri 2003, 316; Heuru, 2003, 258; Niemi-lilahti 2003, 284; Helander 2003, 295; Rynnänen 2003, 256), a country, which is a paragon of good governance for the politicians and civil servants of Estonia. According to Aimo Rynnänen (2003, 256), "*economic difficulties have compelled the municipalities, as a rule, to arrange their functions more and more sub-regionally.*" Oulasvirta (2003, 340) stated that municipalities "*with*

²⁸ Thus, LGUs will serve as bodies of local self-governance and counties as representative bodies of the central government on the spot.



between 2000–10000 inhabitants, they have established so-called joint local authorities to handle tasks that need a wider population base to function efficiently.”

The creation of audit units at county governors' offices and enlarging the audit capacity, mandate and scope of county governors' offices is a radical change that will shift the focus from the internal audit units of LGUs to the external audit units of county governors' offices. This scenario is realistic enough because the Prime Minister of Estonia, Andrus Ansip, and former Minister for Regional Affairs, Vallo Reimaa, intended to change the areas of responsibility of county governors' offices in Estonia. County governors' offices will have to serve more as representative and supervisory bodies of the central government in the future. Currently, there is an internal audit unit or an internal auditor in 12 of 15 county governors' offices. Thus, there is a reasonable possibility of placing an external audit activity under the county governors' offices area of responsibility. This will decrease the need for an internal audit activity within LGUs. However, this scenario has one significant threat. In Estonia today, it is not uncommon that county governors are politically biased as their posts are allocated according to political affiliation or other political reasons and one's competence is of secondary importance (Linnas 2007, 286). Due to this circumstance, county governors may not be independent in their duties. Increasing the power of county governors over LGUs is not an idea that is favoured by some national-level politicians, local politicians and civil servants.

Strengthening the audit capacity of the State Audit Office is a medium change that will strengthen its external audit capacity over LGUs' performance. It is a medium change because the SAO of Estonia has had limited authority to audit LGUs since 01.01.2006 (RT I 2005, 32, 235). Nothing but the SAO's scope of audit has to be made broader. This scenario will decrease the need for internal audit activities within LGUs. However, widening the SAO's scope of audit over LGUs is not a well-liked idea for some national-level politi-

cians, local politicians and civil servants.

Widening outsourced audit activities, including internal audits, under a principally changed keystone is a radical material change. The main idea of this option is to change the situation in a manner allowing for the elimination of conflict of interests as a source of a lack of independence in contracted audits.²⁹ An LGUs' council, government and administration, as representatives of an auditee, should not have the right to decide who will be their auditor, whether or not to accept or refuse audit results, or make or refuse to make a payment for an audit or audit report. New situation will make the auditor independent from the will of the auditee, creating a clear non-conflict of interest objective situation.³⁰ This scenario is more unrealistic, because it has to receive the wide support of politicians, civil servants, chartered accountants, businessmen and civil servants since such a change has to be state-wide and not only applied to the local government sector. This scenario does have one significant risk as well. Small LGUs do not have sufficient amount of resources for contracting high-level-quality internal audit experts to conduct internal audits. While the *Riigikogu* will enforce an act that will make internal audits as compulsory obligation for all LGUs, this will cause situation, where LGUs will pay to outsourced internal auditors money for 'stamping', but will not gain any actual value of that. High-level-quality internal audit experts will not follow 'petty cash'.

Changing the principles and procedures of the appointment of the members of the ACLGUC is a radical change. The essence of this option is that the chairman and a majority of members of the audit committee of an LGU council will be persons from the opposition. The legal situation in Estonia allows for this scenario; nevertheless, the chairman of the ACLGUC has to be a member of council. Thus, if the council consists of only coalition party members, this scenario will not work.

²⁹ Look at the Enron and the WorldCom cases.

³⁰ However, this does not mean that an auditor will be objective in her or his work.



Consequently, there is a need for change in the LGOA. Implementation of this scenario needs the good political will of the politicians and citizens of a particular LGU. This option will increase the independence of an ACLGUC and makes the role of an ACLGUC more trustworthy and effective.

Changing the appointment-based approach to an election-based approach in staffing ACLGUCs and the internal auditor of LGUs is a very radical change. This scenario means that an auditor of a town or rural municipality and members of ACLGUCs should be elected by the citizens of a rural municipality or town like the members of council.³¹ This scenario is more like unrealistic, because it requires a couple of laws be repealed or even a new law to be implemented (Law of Election of ACLGUC and the Internal Auditor of a Rural Municipality or Town) and because of that it needs to gain the wide support of members of parliament, local politicians and civil servants. This is a huge challenge for Estonia's society at the moment, but common situation in USA. However, this particular scenario does match very much with modern theories of civil society and good governance.

Conclusions

Local government sectors differ from each other all over the world, but some trends are common: a mismatch between the responsibilities and sources of finance, life under permanent change, reform and merger processes, and the increasing share of networking and co-operation between LGUs. Academic literature does confirm that situation of LGU-s does not depend only on the political order, degree of democracy, liberalism, welfare and socio-cultural environment of a country. At present, there is one more common character-

istic – internal audit activity does not operate very well in many different countries. According to Friedberg (1999), *“for the last three decades public and internal audit in local government in Israel has continued to be impotent. They do not currently fulfil their function.”* The case of Israel is telling, but not rare. Because of before mentioned trends some options offered by the author as possible solutions to overcome this shortage are suitable not only for Estonia. The author offers some more or less radical options to improve audit situation in LGUs. These options are: 1) The merger of small LGUs. 2) Starting wide-range co-operation between LGUs in the field of an internal audit's activities. 3) The creation of audit units at county governors' offices and the enlargement of the audit capacity, mandate and scope of the county governors' offices. 4) Strengthening the audit capacity of the State Audit Office. 5) Widening outsourced audit activities, including internal audit activity, but under a principally changed keystone. 6) A change in the principles and procedures of appointing the members of audit committees of LGU councils. 7) A change from an appointment-based approach to an election-based approach in staffing ACLGUCs and the post of internal auditor in LGUs. 8) A combination of the abovementioned options. The author of this article is confident of the opinion that it is inevitable that internal audit, control and supervision will be treated as a system which is uniform, cohesive and whole (the holistic approach); where elements and subsystems are in constant interaction (Linnas 2007, 290). This cohesive whole may serve as an excellent system, even if one element or sub-system is lacking, such as an internal audit unit/internal auditor, or some other elements of an ICS or supervision system. If there is a lack of some element or sub-system of an ACSS of an LGU, then other elements or sub-systems have to compensate for this particular lack in sufficient degree. However, different models of ACSSs in LGUs apply to different political, legal, historical, cultural and economic environments and to different sizes of municipalities (Linnas 2007, 289).

³¹ This is similar to the USA, where a City Controller is elected by the citizens of a city. In the USA, a City Controller is independent of the Mayor and City Council, whose operations the City Controller audits. The term of office of the City Controller is four years, and is not subject to term limitation. Office of the Controller – City of Philadelphia. Available at [WWW]http://www.philadelphiacontroller.org/aboutdet.asp?ID=9, 03.01.2008.



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