Factors supporting an adequate sizing of internal audit departments in the public sector

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Abstract

This article addresses the issue of determining the appropriate size for the internal audit compartments in the public sector. Public internal control in Romania is undergoing a broad transformation: moving from a standardized management and control (usually through regulations) to an objectives-based management and to a dual control, based on self-management (managerial control), as well as on separate evaluations by independent bodies (public external audit and public internal audit).

Within the article default factors are identified for sizing the audit structures: the risks of the organization and the expectations regarding the manner in which the activity can bring value, which is the basis for the allocation of resources. The dimensioning of the internal audit compartment is analysed in terms of seven critical factors, and a comparative analysis of the proposed models (determinants, strengths/weaknesses, applicability criteria) is presented. For the improvement of the internal audit in the public sector, the Model of the Internal Audit Capacity in the Public Sector is proposed, advanced by The Institute of Internal Auditors. According to it the evolution of the internal audit activity is structured around a number of levels to be attained in succession.

By identifying the factors considered critical for the sizing of the internal audit departments, which have no equivalent (counterpart) in the factors provided for in the current normative framework in Romania, the article contributes to the clarification of issues related to sizing models and procedures in the field.

Keywords: Internal audit; sizing of audit departments; critical factors in dimensioning; models for sizing the audit departments in the public sector.

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Introduction

Internal public control in Romania is undergoing an ample transformation process, which marks the transition from standardised management and control (generally, through normative acts), to an objective-based management and a dual control, based on management self-control (managerial control), as well as on separate assessments made by independent bodies (external public audit and internal public audit).

The new type of management entails, ex-ante, undertaking clear and feasible objectives on setting the direction to follow in order to fulfill the needs of a society or of a target group, the allocation of resources (financial, human, material) to fulfill these objectives, decision-making autonomy in resources use, as well as the implementation of a managerial accountability mechanism for the results obtained.

The managerial accountability concept is not used just to "make managers accountable for their financial decisions, but also to obtain the assurance that these decisions are adequate and implemented in the public interest" (de Koning, 2007). Therefore, de Konig (2007) considers that "managers need to be monitored in keeping with well-known rules and with quality norms able to foresee waste, fraud and irregularities".

Consequently, managerial accountability is in fact the final act of a management cycle, through which the head of a public entity is accountable for the decisions made, and for the results obtained by the entity, during a certain period, following the use of available resources, respectively.

Internal public audit plays a special part in ensuring the functionality of the managerial accountability mechanism. In keeping with law, the general objective of internal public audit is to enhance the quality of public entities' management, through an independent assessment of control processes, risk management and governance (Law no. 672/2002). In this respect, Law no. 672/2002 provides that internal public audit needs to be conducted in relation to all activities within a public entity and there is a legal requirement that over ten activities, domains or systems, such as activities having a financial impact, payments, patrimony management, accounting systems, management systems and information systems etc. be audited at least once every three years, but it is not limited to that (Law no. 672/2002, Art. 15).

The mandatory requirements on the periodical conduct of internal audit entail an adequate sizing of the internal public audit department, to ensure the resources necessary to this activity.

1. Literature review

Referring to the organization of a public entity internal audit, de Koning (2007) considers that the responsibility to set up the internal audit department lays with its manager. This responsibility also includes the adequate sizing of the internal audit structure, for it to have the capacity to cover the sum of the public entity activities.

Furthermore, an adequate sizing involves identifying the answer to the following question: What percent of the organization’s resources should be allotted to the internal audit function? (Anderson et al., 2010a).

In keeping with the study on the internal audit activity conducted by Ernst & Young at global level, in 2013, over 30% of respondents (internal audit executive managers) mentioned an increase of the audit function the previous year, while 37% expected an increase in the subsequent 24 months (Ernst & Young, 2013).

In keeping with the Report on internal audit activity in the public sector for 2013, issued by the Ministry of Public Finance (Ministerul Finanțelor Publice – MFP), one of the problems of internal public audit is the undersizing of internal audit departments, as well as the lack of independence, the inefficiency of the staff recruiting and training systems and a reduced implementation degree of the internal audit function on the local plan.

As to the sizing of the organizations' own internal public audit departments, the above mentioned report (MFP, 2013) shows:

- Approximately 73% of internal audit departments have only one internal auditor position, which is against the provisions of art. 2 letter f) of law no. 672/2002 on internal public audit, where there is provided the obligation to hire at least two full-time internal auditors;
- On sizing internal public audit departments, consideration was given exclusively to the legal obligation to ensure the internal audit function, the number of positions exceeding two persons in only 14% of the public entities;
In the central public administration, in nine public entities whose managers have the capacity as main authorising officers, the size of internal audit departments does not ensure the observance of the periodicity in auditing or the coverage of the auditable scope;

In the local public administration, no internal audit structure sizing was performed, so that 72 departments each have two internal auditor positions, while 580 departments each have just one internal auditor position.

Consequently, one problem of internal audit in the public sector is the absence of proper internal audit departments sizing, which would ensure the required number of auditors to carry out internal audit in keeping with the legal requirements. That is why, in order to perform an adequate sizing of internal audit departments in the public sector, it is important to study the factors that influence the sizing of the internal audit departments in public entities.

2. Research methodology

The objective of the research is to study the factors that influence the sizing of internal audit capabilities (audit departments) in public entities, to identify adequate solutions concerning the justification of the number of internal auditors.

The research methodology was based on studying the literature on the sizing of compartments for internal audit. Factors considered as determinant were analysed, and models used for sizing the departments of internal audit were studied.

3. Sizing of the internal audit departments. Factors proposed in the specialised literature

The International Standards for the Professional Practice of Internal Audit, issued by the Institute of Internal Auditors (IIA), do not provide specific requirements regarding the necessary number of internal auditors to ensure compliance with these standards (Anderson et al., 2010a).

Nevertheless, Standard 2030 – Resources Administration (IIA, 2013), provides the obligation of the audit executive manager to make sure that the internal audit department has adequate, sufficient and effectively allocated resources to fulfil the approved plan (Anderson et al., 2010a). The phrase “sufficient resources” involves, in fact, the adequate sizing of the internal audit department, an aspect clarified in the Interpretation of the standard, which provides that “The word sufficient refers to the quantity of resources required to fulfil the plan”.

Anderson and Dahle (2009) identify as inherent sizing factors: the organisation’s specific risks, as well as the expectation of the way the activity may add value, which, in their opinion, are at the core of the decision basis (criteria) for the audit resources allotment process.

Referring to the planning process, Anderson and Dahle (2009) consider that it includes developing personnel plans, indicating thus an important factor underlying the sizing of the number of internal auditors: the internal audit plans.

In term of sizing of the internal audit department, the specialised literature identifies three traditional approaches implemented within organisations (Anderson et al., 2010a, b):

- The static approach, which starts from the existing sizing of the internal audit department and involves incremental modifications triggered by the emergence of changes within the organisation. The weakness of this approach is that there is no certainty that the initial sizing was adequate.

- Risk analysis-based approach, which involves that the audit department submits various audit plans to the management or to the audit committee, respectively the variant with existing resources, with a fixed percent increase, or with a fixed percent decrease. The weakness of this approach is the subjectivism or perception of risk by the audit committee or by the management.

- Comparison-based approach, which involves a sizing based on the comparison with the number of auditors in other organisations, using surveys on internal audit conducted at global level or in certain domains. The weakness of this approach is the failure to consider the effectiveness of the internal audit department with which the comparison is made or the country-level differences in legislation, culture etc.
Anderson et al. (2010a) drafted a conceptual model, adopted by the IIA of the U.S.A. to establish the optimal size of an internal audit department, based on seven critical, inter-related factors, respectively:

1. **Specific character of the organisation.** It refers to issues such as: whether the organisation is a public entity or a private company, the activity field, the size of the organisation, the location, the complexity, the financial situation, the risk involved by the field of activity etc.

2. **Particular characteristics of the organisation management structure.** This factor considers the way in which the organisation management is provided, whether there is a management board, audit committee or a risk management function.

3. **Internal audit department mission.** The mentioned issue considers the internal audit missions conducted by the internal audit department within the organization. The wider the scope of the activities conducted by the internal audit department, the higher should be the number of internal auditors.

4. **The value added by the internal audit.** This factor considers the way in which resources are allotted according to types of missions (compliance audit, operational audit, frauds investigation, financial audit, IT security etc.) and it generates an increase in the number of auditors in case the internal audit department adds a high value to the organization.

5. **Alignment between management and internal audit department relating to the role of internal audit.** It aims at an adequate correlation between the way management perceives the role and tasks of internal audit, as well as the internal audit missions conducted, on the one hand, and the way internal audit perceives the same issues, on the other.

6. **Specific character of internal audit.** It refers to the internal auditors’ experience and to the techniques used by auditors in the missions they carry out.

7. **Internal audit services quality.** This factor involves the perception of the audit act quality, which influences both the resources allotted to it and, implicitly, the number of auditors.

The influence of the seven critical factors on the appropriate sizing of the internal audit department in a number of 236 companies, from various fields of activity, was analysed by Anderson et al. (2010a). Their results highlighted, in terms of sizing, an average of 19 internal auditors in internal audit departments, the highest number of internal auditors being recorded in the internal audit departments in the manufacturing field. The data on the average number of auditors, as well as on the number of auditors for each 1,000 employees are shown in Table 1 (Anderson et al., 2010a).

<table>
<thead>
<tr>
<th>Activity field</th>
<th>Health</th>
<th>Manufacturing</th>
<th>Sales</th>
<th>Services</th>
<th>Transports</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average number of auditors</td>
<td>6,68</td>
<td>32,43</td>
<td>10,82</td>
<td>13,58</td>
<td>19,60</td>
<td>11,75</td>
</tr>
<tr>
<td>Number of auditors for each 1,000 employees</td>
<td>0,91</td>
<td>2,24</td>
<td>0,5</td>
<td>1,25</td>
<td>0,73</td>
<td>3,5</td>
</tr>
</tbody>
</table>

Source: Anderson et al., 2010a

Thus, Anderson et al. (2010a) established a series of influences (qualitative effects) of the critical factors on the sizing of the internal audit department, which are shown in Table 2. The established model may be applied to set the direction to follow relating to internal audit departments sizing (increase or decrease), the comparison with the average number of auditors in the field of activity, as well as the establishment of a number of internal auditors by applying the above mentioned factors.
Table 2. Sizing of the internal audit department

<table>
<thead>
<tr>
<th>Variable</th>
<th>Number of auditors</th>
<th>Variable</th>
<th>Number of auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Critical factor 1: Specific character of the organization</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock exchange listing</td>
<td>It increases for the listed ones; it decreases for the unlisted ones</td>
<td>Location</td>
<td>Increases for the ones established in the U.S.A.</td>
</tr>
<tr>
<td>Field of activity</td>
<td>Increases in certain fields</td>
<td>Size of the entity</td>
<td>Increases proportionally to the number of assets</td>
</tr>
<tr>
<td><strong>Critical factor 2: Particularities of the organization management structure</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control structure</td>
<td>The more decentralized the management structure is, the higher the number of auditors</td>
<td>Size of the audit committee</td>
<td>It increases if the number of members of the audit committee increases</td>
</tr>
<tr>
<td>Supervision conducted by the audit committee</td>
<td>It increases in proportion to the increase of the supervision level on the internal audit department</td>
<td>Frequency of meetings with committee members</td>
<td>It increases in proportion to the frequency of meetings</td>
</tr>
<tr>
<td>Structure of the internal audit committee</td>
<td>It increases in proportion to the representation of the company managers in the committee</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Critical factor 3: Internal audit department mission</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Externalizing internal audit activities</td>
<td>It decreases in proportion to the increase of externalized internal audit activities</td>
<td>Operational audit</td>
<td>It increases when operational audit is explicitly included in the sphere of internal audit missions</td>
</tr>
<tr>
<td><strong>Critical factor 4: The value added by internal audit</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Use of data extraction tools</td>
<td>It increases in proportion to the use of data extraction tools</td>
<td>Use of fraud detection instruments</td>
<td>It decreases in proportion to the use of fraud detection tools</td>
</tr>
<tr>
<td><strong>Critical factor 5: Alignment between management and internal audit department on internal audit role</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mission/activities alignment</td>
<td>It increases if there is an alignment between the internal audit activities included in the mission of the internal audit department and the ones actually performed</td>
<td>The agreement between management and audit executive director on the importance of IT audit</td>
<td>It decreases when the management and the audit executive director do not agree on the importance of IT audit</td>
</tr>
<tr>
<td><strong>Critical factor 6: Specific character of the internal audit department</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chartered auditors</td>
<td>It decreases if the percent of chartered auditors by the IIA (Certified Internal Auditors - CIA) increases</td>
<td>Use of other departments to manage association compliance</td>
<td>It decreases when the activities relating to association compliance are conducted by other departments</td>
</tr>
<tr>
<td><strong>Critical factor 7: Internal audit services quality</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Value added by internal audit</td>
<td>It increases if internal audit operates in keeping with the expectations of its beneficiaries</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Anderson et al., 2010a.

The model concerning the internal audit department sizing established by Anderson et al. (2010a) has a series of weaknesses when used to size the internal audit departments in the public sector, for the following reasons:

- It does not generate a number of internal auditors as a basis to size departments, but proposes factors which influence the increase or decrease of the number of internal auditors;
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- Critical factors or their variables apply to a little extent or are not specific at all to public entities. Thus, in the public sector, the value added by internal audit is rarely quantified, the term is not clarified, there is a small number of certified auditors (CIA), audit committees are set up in only a few central public entities etc.;
- The model may generate significant errors in the case of small audit functions. As shown before, the under-sizing of internal audit departments represents one of the internal audit weaknesses in the public sector;
- Difficulties in sizing the audit department when variables do not increase or decrease at the same time etc.;
- The model is highly complex and involves a thorough analysis of critical factors and their variables within a timeframe.

The weaknesses of the model listed above make it unsuitable for public entities in Romania and its implementation might generate errors in sizing of the internal audit departments.

Renard (2004) considers that the most important factor related to the sizing of internal audit departments is the size of the organization. In this sense, Renard (2004) appreciates that small and medium-sized enterprises will have between one and three auditors, while the internal audit department of a large international company will have between 20 and 100 internal auditors.

Renard (2004) also considers that internationalization is another criterion for the sizing of the internal audit department, respectively whether the organisation is a large national company or a large international company. In this instance, yet another criterion influencing the number of internal auditors is the form in which internal audit is organized, centralized or decentralized, respectively.

For medium-sized organizations, Renard (2004) considers that there is “a reference average” to set the number of internal auditors, respectively one auditor for each 1,000 employees, mentioning however that this is “an average covering heterogeneous situations”.

In terms of the sizing, this author lists the following possibilities:
- large audit structures such as “directorate made of offices”, specific to large companies, which adopt a centralized-type of audit or a “central office” type one and branch-level internal audit structures, characteristic to large companies, which adopt a decentralized audit;
- small and medium-sized audit structures, “office” type, specific to small and medium-sized organisations. In the instance of “small offices”, Renard (2004) indicates two possibilities in terms of organizing, with two different sizing: the “elementary structure”, specific to the internal audit function being fulfilled by a single auditor, and the “simple structure”, where the maximum number of auditors is set to a maximum of ten, respectively. In the instance the audit structure is made up of a single auditor, Renard (2004) shows that it is necessary to call on the assistance of external consultants, or to externalize certain internal audit activities, respectively.

Spencer Pickett (2006a, b) considers that it is necessary to set an adequate number of internal auditors in order to ensure the independence of this function and to fulfil the internal audit objectives (Spencer Pickett, 2006a). In this regard, the adequate number of internal auditors depends on the internal audit strategy of the organization, on the approved internal audit plans and on the approach relating to the carrying out of the internal audit activity (Spencer Pickett, 2006a, b).

Bal (2012) is of the opinion that the specific character of the organisation is important for the allotment of internal audit resources. This approach involves the comparison with three or four similar organisations and the consideration of factors such as: number of locations, international locations, centralisation degree, control environment, maturity of processes, audit sphere, changes in the activity and management risk tolerance. Bal (2012) considers risk as a primary key factor for the sizing of internal audit departments.

The General Methodological norms for the organisation and operation of internal audit, based on the provisions of the Government Ordinance no. 119/1999 on internal audit and preventive financial control, approved by Order of the Ministry of Finance no. 332/2000, currently abrogated, were drafted to implement the audit concept in the public sector in Romania.

The norms mentioned under item 5 – Organisation of internal audit structures the fact that main authorising officers were responsible for the organisation of internal
audit structures. Furthermore, the main authorising officers, based on certain criteria (annual volume of funds used, number of subordinated public entities, their territorial spread, number of employees of the central institution, as well as the weight of the ones in subordinated public entities) would decide on the organisation or taking over of internal audit activities of subordinated public entities (including under their authority).

The above-mentioned normative act provided clear criteria to substantiate the staffing plan in the instance of established internal audit structures, respectively the number of positions, recommending a minimal normative coefficient of 40 positions, as well as a maximal normative coefficient, one auditor for each 30 positions.

The national normative framework in force on internal public audit includes requirements on the sizing of internal audit departments in the public sector. Thus, art. 12 paragraph (4) of Law no. 672/2002 on internal public audit provides the sizing of internal audit departments based on the volume of activity and on the size of associated risks, so that it may ensure auditing of activities included in the scope of internal public audit.

As to the sizing, the General norms on the conduct of internal public audit activity, approved by the Government Decision no. 1086/2013, provide that the number of internal auditor positions is established by covering the following stages:

a. Identification of all activities carried out both within the public entity and in the entities subordinated/coordinated/under its authority, in which it directly carries out internal public audit missions;

b. Identification of risks associated to activities;

c. Identification of internal control forms attached to each activity;

d. Setting residual risks following the conduct of control forms;

e. Setting the time required to conduct internal public audit missions, by considering the following factors:
   - budget allotted to the entity;
   - number of activities involved;
   - number of subordinated/coordinated/un its authority;
   - number of employees;
   - specific character of the public entity;

   - complexity and social importance of the activities;
   - observance of periodicity in auditing;
   - activities involving high/medium risks.

Consequently, Law no. 672/2002 on internal public audit provides the size of risks associated to the audited activities and the activity volume as main factors, while in the General norms on the conduct of internal public audit activity, these factors are further detailed in seven “sub-factors”.

The Internal Audit Capability Model for the Public Sector can be used to enhance the internal audit activity in the public sector; the model presents the evolution of the internal audit activity structured according to levels which need to be attained successively (IIA, 2009).

Attaining a certain level of evolution depends on the results obtained relating to six elements which are considered essential for the internal audit activity, respectively: services provided by internal audit and the latter’s role; staff management; professional practices; performance management and accountability; organisational culture and relations; governance structures.

According to the IIA, the evolution of an internal audit department in the public sector covers a number of five levels, presented in an ascending order, respectively: Initial; Structured; Integrated; Managed; Optimised.

The Internal Audit Capability Model for the Public Sector does not set factors relating to the sizing of internal audit department, but it lists elements characteristic to certain evolution levels, which indicate the need for sizing or the relation to sizing. This model provides the fact that level 1 – Initial – is characterized by an “isolated audit”, respectively by an internal audit department which is not clearly structured and executes isolated missions. Furthermore, level 2 – Structured – involves setting basic processes concerning internal audit, as well as the fact that regularity audit is predominant.

In this respect, level 3 – Integrated – provides, as results relating to the essential element “staff management”, the resources for the fulfilment of audit plans, an issue which indicates “the planned activity volume” as a sizing factor. For level 4 – Managed – the mentioned volume provides the following essential activities: identification of the resources required to approach the most important and high risk prone areas of the organisation, as well as the quantification of staffing requirements, which would allow internal audit to fulfil its activities. In the instance of
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level 5 – Optimized – the model provides as an essential activity the analysis and drafting of requirements concerning auditing staff required for the internal audit activity, including in quantitative terms.

A comparison between the factors to be taken into account in sizing the internal audit departments established by the legislation in the field of internal public audit in Romania and the ones mentioned in the specialised literature is listed in the Table 3. It shows a similarity among the seven factors provided by the legislation in the field of internal public audit in Romania for the sizing of internal audit departments and the factors mentioned in the specialized literature. The sizing factor relating to the budget allotted to the entity was not mentioned in the analysed literature.

The specialised literature identifies more than six factors which substantiate the sizing of the internal audit departments and which have no correspondence in the legislation governing the internal public audit field in Romania, respectively: the characteristics of the organization management structure; mission of the internal audit department; value added by internal audit; alignment between the management and the internal audit department on the role of internal audit; specific character of the internal audit department; quality of the internal audit services.

Table 3. Factors for sizing the internal audit department, in the Romanian legislation and the specialized literature. Comparative approach

<table>
<thead>
<tr>
<th>Factors provided in the legislation regulating internal public audit</th>
<th>Factors provided in the specialised literature on internal audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Activity volume</td>
<td>Planned activity volume (Internal Audit Capability Model for Public Sector, 2009)</td>
</tr>
<tr>
<td>Specific character of the public entity</td>
<td>Specific character of the organisation (Anderson et al., 2010a; Bal, 2012)</td>
</tr>
<tr>
<td></td>
<td>Particularities of the organisation management structure (Anderson et al., 2010a)</td>
</tr>
<tr>
<td></td>
<td>Internal audit department mission (Anderson et al., 2010a)</td>
</tr>
<tr>
<td></td>
<td>Value added by internal audit (Anderson et al., 2010a)</td>
</tr>
<tr>
<td></td>
<td>Alignment between management and internal audit department concerning the role of internal audit (Anderson et al., 2010a)</td>
</tr>
<tr>
<td></td>
<td>Specific character of the internal audit department (Anderson et al., 2010a)</td>
</tr>
<tr>
<td></td>
<td>Internal audit services quality (Anderson et al., 2010a)</td>
</tr>
<tr>
<td>High/medium risk activities</td>
<td>Risks specific to the organisation (Anderson and Dahle, 2009; Bal, 2012)</td>
</tr>
<tr>
<td></td>
<td>Management risk tolerance (Bal, 2012)</td>
</tr>
<tr>
<td>Number of employees</td>
<td>Organisation size (Renard, 2004)</td>
</tr>
<tr>
<td></td>
<td>International locations/internationalization (Bal, 2012; Renard, 2004)</td>
</tr>
<tr>
<td>Number of entities subordinated/</td>
<td>Number of locations (Bal, 2012)</td>
</tr>
<tr>
<td>coordinated/under its authority</td>
<td>Degree of centralization (Bal, 2012)</td>
</tr>
<tr>
<td></td>
<td>Control environment (Bal, 2012)</td>
</tr>
<tr>
<td>Compliance with auditing periodicity</td>
<td>Audit scope (Bal, 2012)</td>
</tr>
<tr>
<td>Complexity and social importance of activities</td>
<td>Process maturity (Bal, 2012)</td>
</tr>
<tr>
<td></td>
<td>Degree of change in the activity (Bal, 2012)</td>
</tr>
<tr>
<td>Budget allotted to the entity</td>
<td>Source: Author's processing.</td>
</tr>
</tbody>
</table>

Conclusions

The absence of a sizing of the internal audit department is a problem of internal audit in the public sector. An under-sized internal audit department cannot provide the fulfilment of the objectives stipulated in the legislation, its activity being affected by the scarcity of allotted resources.

Therefore, approaching the issue of internal audit departments sizing in the public sector represents the first step required to enhance internal audit independence.

It is important to identify and study the main determinant factors influencing the sizing of internal audit departments, in order to set the internal auditors number in the public sector.
The specialised literature mentions a series of factors which influence internal audit departments sizing. The analysis conducted showed that most of the factors provided by the legislation in the field of internal public audit are related with the factors listed by the relevant literature.

However, this literature mentioned factors considered critical for internal audit departments sizing and which have no correspondent in the factors provided by the normative framework on internal public audit. These factors are highlighted throughout the article, as a contribution to the improvement of the normative and regulatory framework in the field.

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