Arab Republic of Egypt
Central Auditing Organization (CAO)

Significance of Identifying Internal and External Public Financial Auditing Limitations and Objectives in Improving Public Finance Management

Introduction:

Auditing concept and meaning evolution in recent years with economic entities and units' development has become an urgent need to keep pace with modern management concepts, multi-levels and ownership separation from management... To keep up with this development, there has been an urgent need to strong internal and external auditing systems so as to maintain and protect public finance as a goal for all countries due to effect of their finance and property with regard to their economic position. Therefore, internal and external public financial auditing system adopted within the entity has a clear and effective impact in improving public finance management.

First: Public Financial Auditing Concept:

a- Internal Public Financial Auditing: It consists of developing an auditing system within an entity to assist it in achieving its goals. Such system contains a set of policies and procedures designed to provide management with an appropriate assurance that the targets which are considered essential to the company will be achieved. Such policies and procedures are called auditing elements which form together the organization's internal auditing.
This internal auditing is exercised from within the administrative system on itself through various regulatory tools so as to ensure conformity of work to objectives, detect and correct financial and administrative deviations.

b- External Public Financial Auditing: The auditing entrusted to specialized central institutions independent from economic unit or administrative entity (exercised by institutions external to the Executive thereon). These institutions are financially and administratively independent from the Executive.

Second: Public Financial Auditing Types:

a- Internal Public Financial Auditing Types:

Internal public financial auditing is divided into three main sections, namely:

1- Management Control: It includes hierarchy, procedures and records particular to decisional operations that lead to adoption and approval of operations by management so as to achieve entity's objectives that are indirectly connected to financial and accounting records, i.e., management control seeks to raising maximum productivity by following-up performance and compliance to management policies.

2- Accounting control: It endeavors to provide appropriate accuracy of accounting data and information contained in books and records and to achieve the target by adopting specific accounting systems, e.g., double-entry method, monthly trial balances, constant inventory system with availability of sound documentation and internal audit system.

3- Internal Monitoring: Internal monitoring is a branch of auditing particular to scrutinizing and protecting the entity's assets, resources and property against misappropriation, loss or theft through work division and distribution, competencies and responsibilities identification where each employee automatically reviews another employee's work without duplication of their respective work. It is conducted through proper administrative division, identification of centers for authority and responsibility, relationship coordination between various departments which illustrates rules and regulations governing work progress within each department and designing an integrated accounting system that leads to achieve the objective if this system properly operated.

   We can identify, from the above-mentioned, that internal auditing is not, in aggregate, limited to book-keeping and accounting aspects, but includes the technical and administrative system. For conducting its duty, the institution must be divided into departments where no single department is entrusted with all types of operations. Work should be divided between departments where they monitor, as much as possible, each other's work results without work duplication in order that work progresses in various departments in full harmony towards common interest.

b- External Public Financial Auditing:

External (specialized) auditing institutions performance evolved as they are no longer confined to censorship and inspection, they, rather, extended to all aspects affecting socio-economic and environmental equilibrium and removing obstacles particular to research, study and analysis, and they may conduct the following:

1- Financial auditing in both its accounting and legal aspects.
2- Performance auditing, following-up plan implementation and results evaluation.
3- Legal auditing on decisions particular to financial irregularities.

Third: Internal & External Public Financial Auditing Objectives & Significance:

a- Internal Auditing Objectives:

Internal auditing objective have initially been limited to detection of errors, fraud and manipulation, and as a result of time evolution, internal auditing objectives have developed and are summarized in the following:

- Determine financial and operational information accuracy and reliability.
- Identify institution risks and reduce them to the minimum level.
- Verify adoption of internal procedures and policies and external laws and regulations.
- Satisfy the established criteria.
- Efficient and effective use of resources.
- Help members of the organization to carry out their responsibilities efficiently and effectively.

* Internal Auditing Significance:

internal auditing is significant as an effective control that helps the firm's management and owners to promote business quality and performance evaluation, maintain the firm's property and assets, beside being as the external auditor's visual and auditory systems and the most important institutional control mechanisms. Therefore, it has emerged, evolved and increased in significance as a result of a combination of factors, namely:

1- Magnitude of firms and their operations multiplicity.
2- Necessity for management to delegate authorities and responsibilities to some sub-departments within the firm.
3- The firm's management need to regular and accurate data for policy-making, planning and decision-taking.
4- The firm's management need to protect and safeguard the firm's assets against fraud, theft and errors.

5- Governmental and other agencies' need to accurate data for economic planning, public control, and pricing.
6- Internal auditing procedures evolution from full details to testing based on method of statistical sampling.

b- External Auditing Objectives:
External auditing seeks to achieve several objectives, including:

- Principal objectives:

External auditing main objectives are represented in the following:
1- External auditing process seeks principally to express an impartial professional opinion on financial statements' fair representation for result of operation and financial position, according to the generally-accepted accounting principles.
2- It provides the firm's management with information on internal auditing system and identifies its deficiencies through recommendations presented by the auditor in his report to improve system performance.
3- It provides financial statements users, i.e., investors, creditors, banks, concerned government departments and other entities with reliable financial statements, to help them take appropriate decisions.

- Specific objectives:

The above-mentioned objectives are external auditing principal targets. In order to achieve those goals, the auditor should primarily satisfy sub-goals, which are the six objectives related to financial statement account balances examination. These objectives are used as intermediary targets, form a link between auditing standards and procedures, and are represented as follows:

1- Verification of presence, i.e., assets, liabilities and commitments already exist at a certain date.
2- Verification of completion, i.e., all assets, liabilities, expenses and revenues have perfectly been entered in books and records, and that there is no non-registered operations.
3- Verification of ownership, i.e., all assets and property are owned by the firm at a particular date, liabilities or obligations represent a real commitment to the firm at a particular date.
4- Verification of assessment, i.e., assets and liabilities have been evaluated and recorded at their convenient value.

5- Verification of financial statements true and fair presentation, i.e., all financial statement components have properly been disclosed and presented in accordance with the relevant legal and professional requirements.
6- Verification of financial operations legality and validity, i.e., values of all assets, liabilities, expenses and revenues have accurately been calculated and approved by the legally competent authority in accordance with requirements of valid laws, regulations and systems, and fulfilled the official purposes and works which achieved their goals.

* <u>External Auditing Significance</u>:

External auditing appear as a means to serve many groups who heavily rely on financial statements approved by the independent external auditor, in order to meet their vast heterogeneous information requirements, which vary according to their different interests and objectives. These groups are as follows:

1- Management and Board of Directors' members: The auditor's report focuses principally on obtaining information that will enable them to review performance and evaluate reporting on complex financial operations beside taking decisions that affect the firm's future directions.
2- Shareholders: They seek to obtain information so as to enable them to hold management and staff accountable and to take decisions related to increasing, decreasing or maintaining the current investment ratio.
3- Current and potential bondholders: This category requires information to help them assess the firm's degree of risk and solvency.
4- Employees and labor unions: They require information to enable them to assess profitability, estimate future wages and negotiate on profit sharing agreements.
5- Economists and scientific researchers: They require information to help them assess effects concerning economic policies and public policy decisions, assist in researches and studies. Economists also rely on the audited financial statements in their estimation of national income and economic planning.
6- Customers, suppliers and competitors: This category requires information approved by the external auditor so as to enable them to evaluate the firm's "going concern" as a source of goods and services or as consumer thereof, and assess the firm's competitiveness.
7- Environmental protection advocates and institutions: They require information to help them assess the environmental damage resulting from practicing the firm's activity.

8- Governmental agencies: Some State agencies rely on the firms' data approved by an independent auditor in a variety of purposes, including: monitoring economic activity, formulating the State economic policies or imposing taxes.
9- Judicial system: It requires information to help in evaluating the firm's financial position for the purposes of bankruptcy, assets assessment, and litigation.
10- Consultants, e.g., financial analysts and investment houses: This category requires information to help them assess the firm's financial position in order to express advice and guidance to investors.
11- Creditors and banks: Information approved by the independent external auditor helps this category in determining to what extent the firm can be granted loans, as well as determining the amount of loan and its terms and conditions.
12- Potential investors: They require information to help them take decisions about the firm's investment potential and determine the appropriate investment rate so as to achieve the maximum return.

Fourth: Internal and External Finance Management's Complementary Relationship:

There are cooperation and integration between internal auditor (who represents internal finance management) and external auditor (who represents external finance management) as they take advantage of each other's work, but to varying degrees – i.e., external auditor reliance on internal auditor's work is higher than the vice-versa. This integration is represented in the external auditor's aspects of reliance on internal auditor's work. We should, for being fair and equitable, highlight the integration represented in the external auditor's aspects of reliance on internal auditor's work. These aspects are multiple and can be shown is the following:

1- To achieve auditing maximum effectiveness with regard to broader coverage of the firm's financial activities, the internal auditor coordinates his work with the external auditor's so as to ensure that internal audits of the firm's financial activities complement external auditor's efforts and to eliminate duplication thereof. The internal auditor may also seek behind such coordination to identify audit cost that can be provided.

2- Internal auditor takes advantage of external auditor's expertise as the latter is often more qualified and experienced as a result of the following indicators:
   - Workers with external auditor have a high degree of scientific and practical qualification.
   - External auditor has specialized skills in the area of risk management and systems design.

- He has specialists, in addition to technical expertise, with regard to certain industries auditing.
- He works according to the high-quality international standards.
- He has extensive experience in internal audit.
- He uses sophisticated information systems.
- He has a deep-rooted professional morals inherent within the profession.

Internal auditor can know - through his cooperation with external auditor during external auditing tasks implementation as well as having access to auditing program and reports - the new various methods, ideas, information and procedures adopted by external auditor, and thus takes advantage of them in promoting his efficiency and expertise in the firm's internal auditing.

3- When the external auditor implements audit, his work operations include internal audit function evaluation, to determine its effectiveness and efficiency in carrying out its tasks. He highlights through this evaluation any deficiencies that may appear in its field of work and proposes appropriate treatments. Therefore, such evaluation process gives advantage to internal auditor in continuous development and improvement of his work.

4- External auditor's possession of full independence creates an urgent need for internal auditor's deprivation of full independence. Thus, external auditor shall implement auditing procedures with full independence that enable him to explicitly and obviously express his opinion concerning internal auditing system soundness and adopted policies and procedures' appropriateness. Therefore, it benefits internal auditor in highlighting aspects that he may have overlooked or could not have explicitly and obviously expressed his opinion therein due to his limited independence or to other reasons.

5- He achieves legalization and confidence in the firm's financial statements. Thus, auditing and endorsing the firm's financial statements by its internal auditor is insufficient to achieve legalization and confidence unless they are audited and endorsed by an independent external auditor, particularly if they are intended for third parties, e.g., banks for borrowing or the public for issuance of new shares or bonds .

6- Internal auditor also takes advantage of external auditor in understanding external audit objectives, learning international standards of accounting and auditing and any new versions or modifications thereof, which facilitates the way for him to be more specialized. For example, during internal auditor and external auditor's discussion of the firm's balance sheet, the external auditor may object to the method of presenting the firm's assets in the balance sheet, because it is contrary to what is stipulated in accounting standards in this aspect. Such an objection undoubtedly helps internal auditor to promote his understanding of the international standards of accounting and auditing.

7- The Board of Directors may order internal auditor to evaluate external auditor performance, to achieve the Board of Directors' purpose sought by such evaluation. In this case, the internal auditor will not be able to carry out such evaluation unless he coordinated between his work and the external auditor's operations and find a basis and a method of communication with external auditor. Therefore, internal auditor should adopt a specific method to communicate with external auditor with regard to specific matters that external auditor may have to discuss with the firm's Board of Directors, in order to reach a general understanding of these matters before being discussed with the firm's Board of Directors. These matters include the following:

- Significant weaknesses in internal auditing system.
- Errors and irregularities.
- Significant accounting estimates.
- Significant adjustments resulting from audits.
- Difficulties faced by external auditor in his work.

8- There is occasionally a disagreement between internal auditor and the firm's financial department about soundness of certain accounting procedures application by the firm's financial department. The two parties may not reach an agreement thereof. In such case, the two parties may decide to refer the disagreement to the external auditor for determination. Internal auditor may also rely on external auditor per se to help him in solving any problem during his tasks implementation, particularly if the external auditor is more qualified and experienced in auditing.

Such integration can be achieved through the following:

Aspects of integration and cooperation between internal auditor and external auditor are extensive and available. This integration has undoubtedly been achieved only through a combination of methods. These methods has been addressed by standards of internal auditing professional practice, as they defined them in the following four methods:

1- Periodic meetings between internal auditor and external auditor to discuss matters of common interest.
2- Having access to each other's audit programs and worksheets.
3- Exchange of reports and management letters.

4- Exchange of experiences, techniques and knowledge.

These methods shall be explained in the following paragraphs:

1- <u>Periodic Meetings between Internal Auditor and External Auditor to Discuss Matters of Common Interest</u>:

These meetings discuss, for example, internal auditor's plan of action and external auditor's plan of action to coordinate operations in order to ensure audit coverage for the firm's all activities, prevent work duplication and facilitate exchange of technical information pertinent to activity's efficiency. They inform each other of any information or matters discovered during their tasks implementation that have a significant impact on the other's work.

Those meetings must be scheduleed during auditing to ensure better coordination, efficient and timely completion of audits and to determine whether audit findings and conclusions require adjustments in the scope of planned work

2- <u>Having Access to Each Other's Audit Programs and Worksheets</u>:

It is one of the most significant methods to achieve integration between internal auditor work and external auditor work where each of them can learn the other's techniques, procedures and scope of work and understand the level of experience and skill possessed by the other party. Therefore, both parties coordinate their work, reassure comprehensive auditing coverage and decide to what extent he shall rely on the other's work.

To ensure effective integration through this method, the external auditor should have reasonable conviction and acceptance of the internal auditor's programs and worksheets and the internal auditor should have reasonable conviction and acceptance of the external auditor's programs and worksheets.

3- <u>Exchange of Reports and Management Letters</u>:

Through this method, both internal auditor and external auditor can adjust his scope of work based on the other's report. In addition, internal auditor needs to understand and accept the firm's management letters sent to external auditor, as the matters discussed in management letters help internal auditor in planning areas of internal auditor work's concern in the coming period. After examining management letters and starting any corrective action required by members of management and Board of Directors, the internal auditor must ensure that the corrective action has been done.

4- Exchange of Experiences, Techniques and Knowledge:

Through this method, both internal auditor and external auditor can successfully communicate, coordinate and achieve effective integration between their work, which is reflected on their objectives implementation efficiently and effectively, and thus achieve the firm's best possible outcomes. The most significant of these outcomes are represented in the firm progress and success in achieving its predetermined objectives.

Examples of exchanging experiences, techniques and knowledge between internal auditor and external auditor include the following:

a- Internal audit manager must ensure that external auditor's methods, techniques and terminology are sufficiently understood by internal auditors, to enable him to:

- Evaluate external auditor's work for the purpose of its reliability.
- Ensure that "internal auditors who perform work that achieves external audit objectives" can effectively communicate with external auditor.

b- Internal audit manager must provide sufficient information to enable external auditors to understand internal auditors' tools, techniques and terminology so as to facilitate their reliance on the work performed by internal auditors.

In addition to the above-mentioned methods of achieving integration, there is another method which is considered very significant to promote and increase degree of integration between internal auditor and external auditor, i.e., shared file, where internal auditor and external auditor can more effectively coordinate their work, in addition to increasing their reliability on each other's work.

The shared file shall contain the following:

- System flowcharts.
- Internal auditing policies and procedures.
- Auditing programs and worksheets.
- Reports prepared by internal auditors and external auditors that contain weaknesses and auditing changes.

From the above-mentioned discussion, we conclude that the two types of financial auditing seek mainly to improve and develop financial management performance so as to ensure the optimal and effective use of public finances, effectiveness of decisions taken by the competent authorities, that emphasizes the need for effective accounting system in this regard and providing the necessary information that can be relied upon in preparing financial reports which are useful to decision makers. In addition to the requirements of creating an effective internal auditing system which is reliable to prevent or reduce incidence of errors, manipulation, fraud and treating the situation by taking the appropriate decision. They all realize internal and external public financial management integration, for improving public financial management which is desired in accordance with the international and the Egyptian standards of accounting.

CAO's Deputy-Chairman
Signature: Mona Al-Mallakh
"Accountant: Mona Al-Mallakh Kamal Al-Mallakh"