

Internal and External Auditing

Mgt controls, auditing, and evaluation are processes and mechanisms that are designed to assure that budgeting is linked to the real world of program operations. Without these links, there would be considerable risk that decisions would be based on flawed information, that resources are mismanaged, and that the decisions would be ignored by the operating organization. Thus this chapter focuses on the ways in which govts with the help of these processes and mechanisms

- Assure implementation of budgetary and other policy decisions
- Avoid improper use of funds and detect and correct instances of such improper use
- Assess the efficiency of operations and seek ways of improving that efficiency
- Obtain reliable reporting of financial and other data concerning the execution of budgetary decisions and
- Gather information about program operations and results that can be used to adjust future policy decisions and budgets

The three concepts-mgt control, and internal audit, external audit and evaluation are not self evident and other words are sometimes used to describe them. Let us therefore start by pointing out some important characteristics. Mgt control is used here to describe all the policies and procedures put in place by a govt or by the managers in the various entities of the govt, to ensure the proper and effective functioning of the overall govt or the individual entity, a synonym often used for mgt control is internal control. Internal control, in turn, has the key function of reporting to the senior mgt (minister, board, or head of an agency, etc) on the functioning of the mgt control systems, and recommending ways for improvement

External audit is in most countries entrusted to a separate organization connected to or at the same level as the legislative (the parliament). These organizations, the Supreme audit institutions (SAIs) are independent from the govt and have the mandate to audit or investigate most aspects of the govt's activities and to report their findings to the legislative and often to the general public.

A. Management control:

The term evaluation means a systematic effort to identify and measure the effects of govt policies and programs. It implies the use of scientific methods to increase the reliability of findings by systematically isolating the policy of program effects from other factors and influences that might have caused or contributed to those effects

Objectives of mgt control: mgt controls are the heart of budget and policy implementation. The European Court of auditors in its 1998 publication European Guidelines for the INTSOI Auditing standards (draft) defines mgt controls as all the policies and procedures conceived and put in place by an entity's mgt to ensure:

- The economical, efficient, and effective achievement of the entity's objectives
- Adherence to external rules (laws, regulations) and to mgt policies
- The safeguarding of assets and information
- The prevention and detection of fraud and error, and
- The quality of accounting records and the timely production of reliable financial and mgt information

Mgt controls can include a wide variety of mechanisms designed to assure that budgetary and other policy decisions are executed properly; that resources are used appropriately; that waste fraud, and mismanagement are minimized if not entirely avoided; and that reliable and timely information is obtained, maintained and used for decision making. While certain elements are common to most mgt control systems, no single set of control devices is appropriate for all entities in all circumstances

Mgt controls are essential in managing any organization, whether it is a part of govt or it is privately owned business. In a govt ministry or agency, for example, it does little good to enact laws or regulations, to develop budgets, or to establish administrative policies, if there can be no assurance that they will be properly implemented. For example, the Kingdom of Tonga undertook a systematic assessment of govt mgt controls. It found frequent problems involving incomplete or non-existent documents and records, lack of separation of duties, and inadequate training and supervision of staff.

Internal and external auditing.

The essential features of control systems in the public sector are:

- Identification of risk: Such as FWA, unsatisfactory accounting records, failure to execute budgetary decisions etc
- The development of internal control systems to counter the risks
- The establishment of an internal audit procedure for checking that the systems of internal control are countering the risks

Internal Audit of PEM

The institute of Internal Auditors defines 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 effectiveness of risk mgt, control, and governance process”.

The role of internal auditing in PEM is a very crucial one. Since exp mgt is expected to happen at the operating places, an internal audit system is necessary to examine the way money is spent. Internal audit can minimize waste, fraud, and abuse which usually increase the public expenditure. It can assure authorized payments and avoid all illegal payments. Corruption, which is a serious disease of the public sector and which would make a substantial growth in the public expenditure without any corresponding result, can be reduced to a large extent through an efficient internal audit system. The effectiveness of the performance of the whole expenditure system can be measured by the system.

Mandate of the internal auditor

The internal audit service should cover two main type of activity

- Financial audit: is carried out on the basis of an annual plan
- Performance audit: or value for money audit covers the extent to which established objectives and specific programs have been achieved

Internal audit may also cover a specific analysis of staff resources with a judgment on the extent to which they correspond to the objective of the ministry or agency

Independence of internal auditors

The internal auditor should be responsible to the minister or the head of an agency, giving technical advice on the efficient mgt of resources. In order not to get involved in political biases, the internal auditor has to be independent. The nature of the internal auditor's independence, however, it should not be compared with the independence of the external auditor who reports directly to parliament. The internal auditor is responsible to the head of the agency is part of the staff of the agency. The institute of internal auditors defines independence as follows: ' Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgment essential to the proper conduct of audits. It is achieved through organizational status and objectivity''

Relation of internal audit to internal control and external audit

The internal auditor should not be involved in the internal control process which he is required to assess and judge. It is essential that internal audit keeps its distance so that line mgt recognizes its responsibility for internal control

The relationship between the internal and external auditor can be fraught if the external auditor is seen as the supervisor or assessor of internal audit. It should be possible to establish an intelligent relationship in which each side clearly appreciates the role and responsibilities of the other side. There can be fruitful exchange of views, experience, and information on methodology

External auditing

There is an important distinction between so called external and internal audit. The distinction concerns basically the degree of independence the auditor responsible for the audit has in relation to the audited entity. The external auditor should be fully independent of the auditee and its reports should be addressed to entities that are separate from the bodies being audited.

Effective auditing can contribute in several important ways to the mgt of a govt's finances as well as giving the parliament and citizens on objective description of how public funds have been spent. It can

- detect irregularities involving the misuse of funds
- determine the reliability of reports on budgets execution and other financial data
- identify instances of waste and inefficiency

- provide reliable data about program results

In order to audit the govt, a Supreme audit Institution (SAI) has to be established, the following recommendations have to be considered in the establishment of SAI

1. the SAI must have a solid, stable legal base
2. It should have the functional, organizational, operational, and financial independence
3. it should have the powers and means clearly stated in laws, to audit all public resources
4. it should undertake the full scope of govt external auditing
5. it should be able to report freely without any restrictions
6. it should adapt to suit local conditions and formally adopt and disseminate audit standards
7. it should ensure that its human and financial resources are used in the most efficient way to produce maximum results
8. it should develop its internal organization as a supportive structure for the proper conduct of work
9. it should ensure that its staff are competent, capable, and committed
10. it should develop the technical and professional proficiency of its staff through education and training
11. it should focus on the development of high quality mgt control systems in audited entities

There are three issues related to the effective external auditing of all public sector resources and assets; they are (1) independence, (2) audit coverage, and (3) professional skills

1. **Independence:** supreme audit institutions can fulfill their tasks objectively only if they are independent. Usually, the SAI reports to and is accountable only to the national legislature. Not only must the SAI be independent, the individual auditors must also be independent
2. **Audit coverage:** To meet the objectives of govt auditing, all revenues, expenses, assets and liabilities of the govt must be effectively audited. Enterprises established under private law shall also be subject to audit. Tax revenue, EBFs, subsidies, and grants are also expected to be audited
3. **Professional skills:** auditing is a profession that encompasses a wide range of technical skills. For each individual audit, it is essential that the audit team possesses the knowledge and skills required

Types of audit

Many kinds of work are subsumed under the term auditing. There are five broad categories of audit

1. **Ex ante audit:** In this type of auditing, also called, pre audit, or priori audit, individual transactions are examined for propriety before they are completed. That is , a payment may not be made until the auditor has approved the related voucher after examining the related supporting documents. Centralized ex ante auditing by the SAI is still practiced in a number of countries. In other countries, such audits are seen as an element of the mgt control structure
2. **Ex post audit:** it is the examination of events after they have occurred. The full scope of govt auditing includes regularity and performance audit. Regularity audit embraces:
 - attestation of financial accountability, involving examination of financial records and expression of opinion on financial statements
 - attestation of financial accountability of the govt administration as a whole
 - audit of financial systems and transactions
 - audit of internal controls and internal audit functions
 - reporting of any other matters
3. **Compliance audit:** This form of auditing involves checking individual transactions to ensure that the appropriate authorizations and documentation are present. The focus is on determining the legal propriety of the individual transactions
4. **Attestation audit:** many SAIs are requires to perform annual audits of the national budget or other govt financial reports. The audit report may be required before the legislature can close the accounts on the budget year in question.

In some countries, the SAI's audit report on the national budget is a true attestation audit. In others it is primarily a compliance audit, aimed at detecting irregularities, such as overspending or the diversion of budget resource to activities not authorized by the parliament. The objective of a true attestation audit or to render an opinion as to whether the reader of the statement can be reasonably sure that the information contained in the report is correct.

5. **Performance audit:** a performance audit examines an entire entity, activity or program in order to suggest ways of improving the efficiency of those operations. The auditor searches for areas of waste and mismanagement which, if eliminated would permit the same

policy or program objectives to be achieved at less expense, and for areas where the same resources used differently would produce greater value for the same cost. This type of auditing can make a major contribution to increasing the efficiency of govt. performance audit may also be designed specifically to address the adequacy of mgt controls, as part of broader strategy for strengthening such controls.

Reporting audit results

Requirements for the distribution of audit reports are specified in the laws establishing the SAI. In many countries all audit results are required to be reported to the parliament

The general rule for distributing audit reports should be to provide copies to those organizations and persons with an interest in the topic and especially to those who are responsible for acting on the finding and recommendations contained in the reports concerned. For example, the entity that has been audited should always be informed of the results and the ministry of finance should be routinely informed of reports that have implications for budget allocations or the mgt of budget resources

The auditors should recognize that the general public has a legitimate interest on the results of audits of public entities and the use of public funds. In many countries, all SAI audit reports are made available to the public unless they must be restricted for national security reasons. Auditors should also recognize the role played by the media in informing the public about govt operations and should take steps to ensure that media representatives are aware of audit reports

Acting on Audit results

Some SAIs may be empowered to order corrective actions of certain kinds when irregularities are found during an audit. For example, these SAIs may issue an enforceable order to recover the excess payment

For the most part, auditors are authorized only to report what they have found. Modern auditing concentrates on: (1) the reliability of financial data and reports, (2) the adequacy of mgt controls, and (3) the economy, efficiency, and effectiveness of programs and operations. However, the auditor bears considerable responsibility for encouraging an appropriate

response to audit findings and for facilitate needed corrective actions. There are several things an auditor should do to meet this responsibility

1. **Clear findings:** general observations such as “money was wasted on program X” are not helpful. Auditors must state as clearly as possible the nature of the programs they find and the consequences. Which mgt control was absent or which policy caused the observed inefficiency? The auditor should ensure that the reader of the audit report can easily grasp the nature of the problem and the need for correcting it.
2. **Convincing evidence:** the evidence supporting the findings must be relevant and credible and must be presented in a clear fashion in the audit report
3. **Cost effective recommendations:** If an auditor identifies a problem, it is normally useful if he suggests a reasonable solution for that problem. If there was a failure of controls the audit report should specify the actions needed to prevent a recurrence. It is essential that the recommended corrective actions be legally and administratively feasible and that the costs of implementing them are not disproportionate to the problem
4. **Effective communications strategy:** the best written audit report serves no purpose unless its contents are made known to those who can act on its findings and recommendations. The auditor should think carefully about who needs to read the report. Merely sending the report to someone may not be sufficient. As the parliamentarians and govt officials are busy people, a well written executive summary will be helpful

Accountability and Transparency in public exp

The foundation of PE mgt is accountability and transparency. pE mgt tries to identify people who are responsible for spending public money. At the same time, the govt officials who are held responsible to the people of the country as a whole. They have to inform the people the way each coin of the govt spending is transparent, the common people will start developing mistrust on the govt and will think that the govt is corrupt and is manipulating the public fund

An auditor has a very crucial role in building public confidence in favor of the govt by clarifying the doubts of the people. The auditor has to be impartial and independent. He shouldn't be influenced by anyone. He has to she light on the amount spent by the govt and the objectives achieved by the govt. thus the auditor is accountable to the people of the country. He is

entrusted with the responsibility of furnishing information on the public spending and of making the people aware of the manipulations and misappropriations of public fund, if any.

Internal Auditing Standards of Public bodies in Ethiopia

MoFED has published Audit Procurement Manual. However, it has certain omissions and misstatements. The IIA (Institute of Internal auditors) standards have been adopted.

MoFED manual acknowledges only two types of standards- Attribute stds and performance stds. But, the IIA has three type of stds-Attribute, performance, and implementation stds.

The attribute and performance stds apply to internal auditing services in general. But the implementation stds apply the attributes and performance stds to specific types of engagements (e.g. compliance audit, fraud investigation etc)

Attribute standards

They contain four stds, ten sub stds, which are divided into 13 implementation stds

1. Purpose and responsibility (1000): The internal auditing activity of the public body should be clearly defined in the charter
2. Independence and objectivity (1100): the internal auditor should be independent and the internal auditor should be objective in performing his task

1110- organizational independence: internal audit should be free from interference. Internal auditor should report to the Head of the public body

1120: Individual objectivity: internal auditors should be unbiased and should avoid conflicts and interests

1130- Impairment to independence or objectivity: the impairment if any, should be disclosed to appropriate bodies

The standard requires that internal auditors should not assume operating responsibilities such as accounting etc as such activities would block from drawing unbiased audit conclusions. However, the auditor's objectivity will not be impaired if the auditor recommends stds of control. If the auditor designs, installs, drafts procedures for, or operates such systems his objectivity is considered to be impaired

3. Proficiency and Due professional care(1200)

- Professional proficiency is a must
- Auditors have to comply with a code of ethics

1210- Proficiency

- An IA should have adequate knowledge and skills
- He should have an understanding of mgt principles to evaluate the managerial practice
- He should have minimum knowledge in other related areas such as Economics, Commercial Law, Taxation, Finance etc
- Good communicating skills and knowledge of handling people
- He should have sufficient knowledge to identify fraud (though not an expert)

Fraud comprises of an array of irregularities and illegal acts of intentional deception. It can be committed for the benefit of or to the detriment of the organization

Fraud designed to benefit the organization includes (1) sale of a fictitious asset (2) improper payments such as bribes and illegal political contribution (3) improper transfer pricing (4) Intentional failure to record or disclose significant information (5) engage in prohibited business activities etc

Fraud that are detrimental to the organization are (1) acceptance of bribes (2) embezzlement and falsification of financial records, intentional concealment of data, claims submitted for goods not delivered

There are main phases in considering fraud audit. They are (1) deterrence (2) detection (3) investigation and (4) prosecution

Deterrence consists of those actions taken to discourage the commitment of fraud and limit the exposure if fraud occurs. Control is the most important mechanism for deterring fraud. Internal auditors are responsible for evaluating the adequacy of the internal control system.

Detection of fraud consists of identifying indicators of fraud sufficient to warrant recommending an investigation. These indicators may arise from the controls established, tests conducted by auditors and other sources

Investigation of fraud consists of performing extended procedures necessary to determine whether fraud has occurred. It collects the details of a fraud

1220: Due professional care: Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent internal auditor. Professional care should be appropriate to the complexities of the audit being performed. Internal auditors should be alert to the possibility of intentional wrongdoing, errors and omissions, inefficiencies, waste, and conflicts of interest. They have to be alert to those conditions and activities where irregularities are most likely to occur.

1300- Quality Assurance and Improvement program: The internal audit dept should develop and maintain a quality assurance and improvement program that covers all aspects of the dept

1310-Quality Program assessment: the Head of the internal audit dept should make sure of the quality of the audit program. He has to ensure that the audit unit performs in accordance with the Charter, operates efficiently and adds value to the organization's operations

Both internal assessments (1311) and external assessment (1312) are used for this purpose. Internal assessments include periodic reviews from within the dept. external assessments, such as, quality assurance reviews, may be conducted by an independent reviewer or team. Reviews also be conducted by qualified external auditors.

1320- Reporting on the Quality: the chief of the internal audit dept should communicate the results of the external assessment to the Head of the public body. The internal reviewer will issue a formal report after assessment. The Head of the Audit Dept should prepare a written action plan in response to the significant comments and recommendations of the external reviewers.

Performance standards

2000- Managing the internal audit activity: The internal audit head should effectively manage the internal audit unit

2010-planning: The head should establish risk-based plans to determine the priorities of the internal audit activity consistent with the public body's goals. Planning should be consistent with its Charter and the goals should be capable of being accomplished. An audit schedule should also be prepared

2020- Communication and Approval: The chief should inform the head of the public body a summary of the audit plan, staffing plan, and financing budget

2030- Resource mgt: The chief should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan

2040- Policies and procedures: the chief should establish policies and procedures to guide the internal audit activity

2050-Coordination: Internal and external audit work must be coordinated to ensure adequate audit coverage and to minimize duplication of efforts. The scope of internal audit work encompasses a systematic and disciplined approach to evaluate and improve the effectiveness of the risk mgt, control and governance processes

2060- Reporting to the head of the public body: The chief of IA should report periodically to the head of the public body. Reporting should include risk exposures and control issues, significant audit observations, and activity reports

2100- Nature of work: The IA activity evaluates and contributes to the improvement of risk mgt, control and governance systems. The management's actions in these areas are evaluated by the auditors. All working systems, processes, operations, functions, and activities within the organization are subject to internal auditor's evaluations

2110- Risk Mgt: The IA should assist the organization by identifying and evaluating significant exposure to risk mgt and control systems. IA activity should monitor and evaluate the effectiveness of the organization's risk mgt system

2120- Control: The IA should evaluate the control systems of the organization. It should look into the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. It should also ascertain the goals and objectives that are achieved. Proper criteria should be used to evaluate the control system and the goals achieved

2130- Governance: The IS should contribute to the organization's governance process by evaluating and improving the process through which (1) values and goals are established and communicated, (2) the accomplishments of goals is monitored, (3) accountability is ensured and values are preserved

IA should review operations and programs to ensure consistency with organizational values

2200- Engagement Planning: IA should develop and record a plan for engagement

The scope of the engagement should include consideration of relevant systems, records, personnel, and physical properties

The engagement program should

- document the IA's procedures for collecting and processing information
- State the objectives of the engagement
- State the nature and extent of testing required
- Determine to whom the results have to be submitted

2210- Engagement Objectives: The engagement's objectives should address the risks, controls, and governance processes associated with the activities under review. The engagement objectives should reflect the results of the risk assessment

To perform risk assessment, background information should be obtained about the activities to be reviewed. Such information should cover the policies, plans, procedures and laws, organizational information, budget information etc

The IA should consider the probability of significant errors, irregularities, non compliance, and other exposures when developing the engagement objectives

2220- Engagement Scope: the scope of the engagement should include consideration of relevant systems records, personnel, and physical properties. Make sure that the scope is sufficient to address the agreed upon objectives

2240- Engagement Work program: Work programs should establish the procedures for identifying analyzing, evaluating and recording information during the engagement. IA should develop work programs that achieve engagement objectives

2300- Performing the engagement: IA should identify, analyze, evaluate and record sufficient information to achieve the engagement's objectives

2310- Identifying information: IA should identify sufficient reliable, relevant and useful information to achieve the engagement's objectives

2320- Analysis and evaluation: IA have to employ analytical audit procedures. These procedures will assist them in identifying conditions which may require subsequent engagement procedures

2330- Recording information: Auditors should record relevant information to support their audit conclusions and results. They have to prepare the audit working papers on which the results of the analysis are recorded. They may also include other supporting documents such as planning documents, copies of contracts, results of control evaluations

The chief auditor should develop policies governing the custody and retention of engagement records as well as their release to internal and external parties

2340- Engagement Supervision: engagement should be properly supervised to ensure that objectives are achieved and quality is assured. The chief auditor has to make sure that appropriate audit supervision is provided All audit working papers should be reviewed to ensure that they properly support the audit report and that all necessary audit procedures have been performed.

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