

**CORRECT RELATIONSHIPS BETWEEN AUDIT AND
MANAGEMENT PROVIDE ECONOMIC EFFECTIVENESS AND
ADDED VALUE TO THE ORGANIZATION**
(Keynote paper)

Pregledni članak

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Abstract: The purpose of this article is:

- to address the right relationships between actors and to ensure success in the Organization,
- to explain the relationship between the senior management level and the audit management level,
- to explain the ways of *understanding and cooperation between auditors and managers*,
- to address the expectations and difficulties that exist between the head of the organization, managers and auditors,
- to explain the responsibilities of the functioning internal control in an organization,
- to define the role of internal and external actors for the functioning of internal control in an organization,
- to illustrate the *cooperation between "Internal" and "External Audit", and to explain that while the responsibilities and objectives of them may vary, they have common interests*,
- to illustrate the cases when external auditors can use the work of internal auditors

Keywords: Managers, Internal Audit, External Audit, Auditing, Internal Auditors, External Auditors, Relationships, Actors, Independence, Communicating, Organization, Expectations, The responsibilities, common interests, Internal control.

Introduction

The main purpose of this article is to provide an overview of the opportunities that exist for building and improving the correct relationship between managers and employees of internal and external audit on the one hand, and the different managerial levels of organizations in the public and private sector on the other hand. In summary, in this article we have addressed some of the basic concepts related to the internal control system, as well as the actors that play a important role in the establishment and operation of this system.

The implemented methodology refers to the theoretical-practical model, which tries to explain the importance of communication between internal and external actors, in public and private organizations, and the results of which affect the improvement of the environment of the Public Financial Internal Control (PFIC) system as a whole.

The concept of "internal control" conveys a difficult and complex process. Different countries have different interpretations of the internal control system, and in accordance with their tradition use different methods, techniques and philosophies for its implementation. With regards to standards, internal control is not a detached action that come from a person or a group of people performed within a short time. It is a complex of actions, measures, organizational procedures, which are performed by all employees throughout the duration of their activity to achieve certain objectives. The head of the organization (Board of Directors) is responsible for the establishment and operation of the organization's internal control system. Based on the content of the Internal Control system and the treatment of this concept according to international standards, and mainly according to the model of the European Union, it results that the two main pillars that make up this system are:

1. Financial Management and Control (FMC)
2. Internal Audit (IA)

If the board establish a system, which ensures the functioning of these two pillars, then the guarantee for the correct implementation of laws, bylaws, instructions, orders, regulations and manuals, etc., is increased, and the basic purpose of this system is likely to be achieved. Otherwise, when the activities that are planned to be carried out are associated with flaws, abuses and even corrupt phenomena, they negatively affect not only the management unit within the organization, but the whole system of Public Internal Financial Control as a whole. The leader of the organization (CEO) must foster the belief that the Internal Control system, for which he is responsible, functions properly and helps to achieve the objectives of the organization in a cost effective manner.

To earn this trust, the director must ensure correct communication relations with the Internal Audit and External Audit structures. Currently, the overall control environment in countries aspiring to join the EU is still far from being able to implement international standards in the field of auditing. The actors that make up the general environment of internal control, play an important role in raising the level and awareness for the implementation of activities that ensure the establishment and operation of both pillars of the internal control system.

Unless the top management in any public or private organization understands that the audit activity helps them move forward, the overall environment of control remains powerless to play the right role for overall development. To avoid wrong decisions, the governance of private and mainly public organizations must rely on accurate and objective information. Audit services play an important role for this matter. It is precisely this reason that has prompted us through this article to shed light on the path that public and private organizations should follow to build the right, fair and real relationship between auditing and management. If these relationships are correct, and the audit reports are accurate, then we can say that we have provided effectiveness and added value through audit suggestions and recommendations.

The relationship and communication of internal audit results is defined in Standard 2400, published by the American Institute of Internal Auditors⁴⁴, which states that: *"Internal auditors must communicate the results of the engagement."*

Meanwhile, the sub-standards of this standard define: Criteria for communication, quality of communications, engagement disclosure of noncompliance with the standards and disseminating result.

⁴⁴ The professional Practises Framework-January 2004, fq.21

1. Creating the right relationships between actors, ensures success in the Organization

To ensure success and effectiveness in the audit activity, communication and relations between the actors of the organization being audited are of special importance.

The relationship and cooperation between them is one of the most important elements or to be more accurate the key that ensures the achievement of success in a public or private organization. The relationship between senior management and other managers (heads of departments, directorates or other management units in the organization) should be based on a multifaceted understanding and confidence. Auditors in their activity should:

- ✓ conduct research;
- ✓ perform tests and controls;
- ✓ draft reports based on professional standards and practices; and
- ✓ follow the implementation of the recommendations issued in cooperation with the auditees.

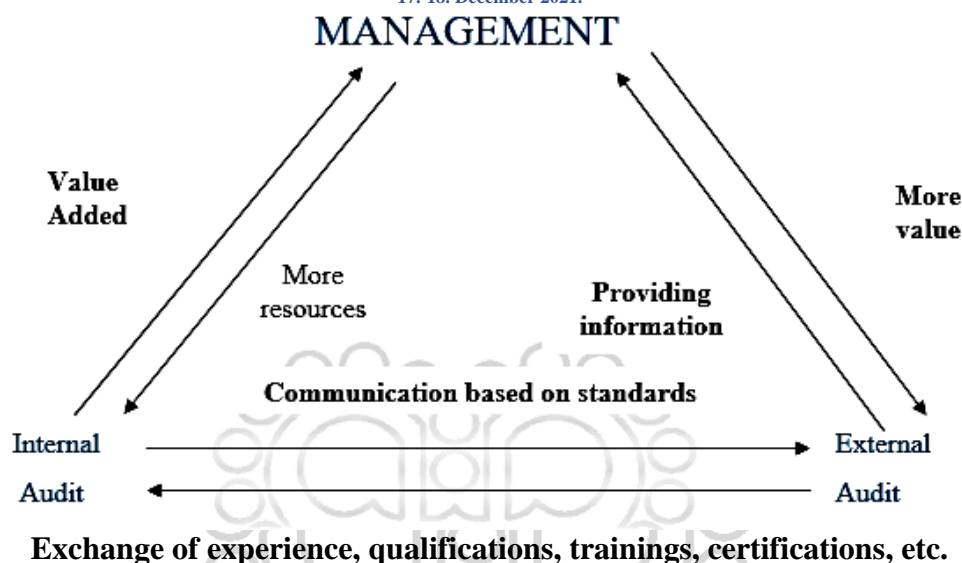
Management on all levels must have full confidence in the integrity and independence of the audit process. This should be reflected and strengthen the link between Internal Audit, External Audit and management by meeting the following expectations:

- understanding of feedback on different levels of management to the work and activity of the audit structure.
- synchronization of different management planning styles with the methods and techniques used by the audit.
- whether management tasks are fully explained to management.
- whether the performance of audit tasks (missions and commitments) is done in an open, friendly and respectful manner.
- ongoing progress in improvement of relationships and communication.

Every opportunity should be used to improve communication and develop good relations between management on the one hand and auditors on the other. Auditors, too, need to appreciate and understand that they need to have a privileged relationship between themselves and managers at all levels in the organization, and keep it confidential at all times.

Communication between auditors and managers should be a three-way process. Such a system is known as the "Audit Management" strategy/method. Figuratively, this move creates the audit management triangle.

The following diagram illustrates the basic features and benefits of this strategy or method.



2. The relationship between the levels of management and the levels of audit management

2.1. What is meant by managing audit activity?

The criteria for communicating audit results are set out in Standard 2410, published by the American Institute of Internal Auditors⁴⁵, which states that: *"Communications should include the engagement's objectives and scope as well as applicable conclusions, recommendations and action plans"*.

Audit management is the service that results from the application of professional principles and standards of auditing in the conditions when for the audit team there are:

- ✓ Clean financial systems
- ✓ Effective control systems
- ✓ Reliable accounting processes
- ✓ Well-organized internal audit system/structure.

Maintaining independence, internal and external auditors perform their function by interacting constructively with management in order to eliminate any unnecessary duplication or audit effort.

2.2. How should the management level understand the Audit Activity?

Audit is an independent activity that guarantees and ensures the high level of management (head / board) and other managers regarding:

- ✓ Effectiveness of control operations;
- ✓ Economical and efficient use of resources;
- ✓ Compliance with policies, procedures, laws, regulations;
- ✓ Safeguarding assets against losses of any kind, including those resulting from fraud, irregularity, or corruption;

⁴⁵ The professional Practises Framework-January 2004, fq.21

✓ Reliability of information, accounts and data.

In order to carry out these activities effectively and to assist the structures being audited, auditors need to demonstrate high quality, based on communication standards in this area. The quality of communications is defined in standard 2420, published by the American Institute of Internal Auditors⁴⁶, which states that: *"Communications should be accurate, objective, clear, concise, constructive, complete and timely."*

External audit is a process, which is performed by the structure and professionals independent of the entity being audited. Through this process the auditor performs the independent review and evaluation of the control, accounting and management systems of the economic-financial activity. Regarding the functioning of control systems, the auditors aim to assess the manner of extension and compliance with policies, procedures, laws and regulations, in order to provide the necessary assurance for the level of management that the approved policies have been carried out economically, efficiently and effectively. The external audit activity assists on the functioning of the accounting system, as it is precisely this activity that certifies this system, which provides evidence of economic and financial operations as well as data and evidence for the top level of management in the organization. External audit also plays a very important role in improving the procedures related to risk management, control processes and governance in the organization.

2.3. Understanding and cooperation between auditors and Managers.

When an auditor understands management structure and its processes, at all levels including those of governance, it is easy to work collaboratively. The participatory method brings auditors closer to a modern, constructive and consultative role with management needs. Many audit departments have moved towards this course and explanatory models suggest that further movement can be designed towards continuity in direct participation. It is acknowledged that if more participation is promoted, then we will also have a satisfactory level of independence. It is increasingly required for the internal audit to be positioned by moving from a traditional audit model and style to a modern one, which relates to management needs without affecting the independence and objectivity of the audit activity, in order to assist senior management in achieving objectives. Some of the factors related to the requirements of this model are:

Factor	Traditional style	Modern style
Role	Policeman	Adviser
Authority	Formal	Informal
Source of authority	Office	Personal attributes
Sanctions	Force, coercion	Suggestions, comments, recommendations

In the table above are treated two extremes where, on the one hand we have the role of audit as a function defined by management to observe the whole organization as a police officer, and on the other hand we have the audit service as an advisory function that goes in line with management needs and with the standards governing this activity. Clearly, today modern audit has shifted towards a partnership relation with management. As long as it does report to the managers, it must enter into the core of the needs for change and improvement and there can be no reason to orient auditing work and activity towards mysterious and vague goals. On the other hand, the solutions for the management needs can not be realized without their consultation and participation in future decision-making. Auditors need to be aware of the culture that exists in

⁴⁶ The professional Practises Framework-January 2004, fq.22

the areas where they audit and ensure that recommendations are made to assist and meet management needs (recommendations serve to ensure improved performance in the work of managers for all levels of management). Modern auditing means working with management levels rather than auditing them. This is in line with the view that controls belong more to management and that management should be encouraged to maintain and improve control activities in the service of achieving objectives within their economics, efficiency and effectiveness.

3. Expectations and difficulties that exist between the head of the organization, managers and auditors

In general, the expectation of the head or the board about the traditional audit service is as follows:

1. Inspect documents to ensure that they comply with procedures.
2. Investigate fraud required by management. In this case, the Head requests the audit to express itself on the implementation of procedures for criminal prosecution of responsible persons.
3. Investigation of employees who have caused management problems in the context of breaking provisions, rules and procedures. In this case, the head requests the audit team to comment on the level of disciplinary measures or the implementation of procedures for criminal prosecution of responsible persons.
4. An ongoing program of inspections of financial system data to ensure that they are correct.
5. Immediate advice on decisions proposed by management if they are in line with procedures and best practices.
6. Additional resources for computer systems and project developments

To ensure successful audit engagements and to avoid the non-compliance of a specific commitment with the standards, auditors must comply with the requirements of Standard 2430, published by the American Institute of Internal Auditors⁴⁷, which states that: “*When non-compliance affects standards, a specific commitment, communication of results should reveal:*

- *Standards with which full compliance has not been achieved,*
- *Reasons for discrepancies, and*
- *The impact of non-compliance on engagement”.*

The implementation of this standard requires that the employees who engage in auditing activities, be certified and equipped with full knowledge on the functioning of the internal control system and mainly on the functioning of the financial management and control system. Regarding the function of audit and any other function aswell, the basic necessity is the ability to perform tasks efficiently and effectively. The standard also refers to this argument where it provides an orientation for the professional competencies of the audit function as a complex activity, and also of its operators in particular.

In addition to the ability of analysis and judgement, the auditor must also possess significant human qualities: An important feature is the ability to examine and evaluate items and people besides numbers. The following table presents some characteristics that the auditor must possess in order to be able to perform his duties better.

⁴⁷ The professional Practises Framework-January 2004, fq.22

Types of Features		
Personal characteristics	Qualitative characteristics	Complementary characteristics
The behavior	Suitability	Practicality
Humanity	Rationale	Curiosity
Care	Determination	Constructiveness
Imagination	Independence	Cooperation
Tact	Credibility	Business sense
Honesty	Objectivity	
Reservation	Accountability	

In the first group: Personal characteristics include those that a person should have, regardless of preparation. Such are: behavior that has to do with external reflection; humanity with the inner motivation of a person; attention to detail refer to the auditor's ability to discipline behavior, understand interlocutors, use diplomacy; imagination consists in predicting the consequences of the auditor on procedures and activities, etc.

In the second group: Qualitative characteristics are those that, when are present in human character, can be developed through a programmed and appropriate preparation through training, addressing each of the characteristics listed in the table.

In the third group: Complementary characteristics, belong those characteristics and qualities that are not innate, but that are acquired mainly through the performance of the audit activity. Practicality and curiosity consist in the application of practical sense, in the search for concrete solutions that are really necessary; constructiveness and cooperation means that the audit function is not critical, but advisory in order to improve management, efficiency and effectiveness; business sense requires orientation towards the profitability of the organization.

Rules to be applied in situation management can be set as follows:

1. Partitioning of two areas for the Head of the organization (through the establishment of the Audit Committee) which will be the body where the internal audit will approve the programs and will report, while the managers will receive security and consulting services additionally from the audit activity.
2. Ensure that the Head or Audit Committee understands the concept of the planned audit work and that a resource base is required for this task.
3. Providing consultancy as additional services which are clearly distinct from the audit work as a security service. Ensure that management understands that auditors are responsible for compliance with the organization's provisions, guidelines and regulations, information system, theft investigations and value for money.
4. Publication of Audit work through appropriate brochures, correspondence and representation on the website.
5. Encourage managers to rely on long-term distinctive control systems, thus avoiding many problems stemming from weaknesses.

In the aspect of cooperation between audit and management, there are important matters to be considered by both parties, managers and auditors, which consist of the following:

- ❖ **Timing:** Top managers barely find time to talk and agree with auditors. The same trend is observed by middle and lower level managers. This is helped by the negotiating skills to convince the management level that the audit service is not an activity that hinders them, but an activity that helps them to achieve the objectives within the framework of the role and mission of the organization.
- ❖ **Terms of reference:** The terms of reference in the beginning are always difficult, so the obligations of the parties are not left out. There is always a suspicious element from the

client, as he puts himself in a situation of change that may occur to management. Internal auditors need to recognize and consider two client concerns:

- That auditors can make recommendations that can lead to results and changes in management.
 - That auditors can, in fact, audit the operational management itself.
- ❖ **Audit method:** The audit method and the behavior of the auditor, in general, can have an impact on the outcome of the negotiations. In general, it is expected that negotiations will be about compromise and ensuring benefits for all parties to the dispute in the event of loss or gain.
- ❖ **Final Result:** Considerations on audit opinion is viewed as an improvement on the previous position of the subject. This does not mean that every recommendation given by internal auditors will be implemented immediately by management. But, this is based more on the fact that management will be advised and where deemed essential the recommendations will be taken into account through open negotiations. It is imperative that internal auditors negotiate recommendations with management and differentiate between recommendations that are essential, very useful and important, and those recommendations that are less important, referring to the costs of implementing them. By applying this method, progress will be achieved in other areas of the organization and will go towards the joint drafting of recommendations, enabling their timely implementation because they are accepted at the stage of development of the audit process.

4. Responsibilities for the functioning of internal control in an organization

There are generally several major groupings on the issue of defining internal control, which come from: IFAC, IIA, GAO, INTOSAI, the COSO model and the EU model and best practices. Basically these definitions do not represent radical changes. Since the countries of Western Europe, where both our countries belong, aspire to join the EU, we are quoting the definition of internal control according to the model and practices of the EU, which is as follows:

Internal Control (IA) is an integral process of the Financial Management and Control (FMC) system, as well as Internal Audit (IA), set by the head of the public organization, within its governing objectives, to assist in the performance of activities of the public entity with economy, effectiveness and efficiency.

Mr. Robert de Koning in his book "Public Internal Financial Control-PIFC" has made an in-depth analysis regarding the functioning of this system and the path and difficulties that have been identified by EU member states, in order for countries aspiring to EU membership to take measures to understand and implement the elements of this system. On page 33, he writes:

“The variety of internal control system in EU Members states; the Commission’s analysis of existing public control systems in applicant countries; the lack of a common concept relating to internal control, internal as well as external audit; developing a strategy for supporting applicant countries in accordance with guidelines developed by SIGMA, the IIA, COSO model and INTOSAI.”⁴⁸

The organization's integrated risk management network has recently reviewed previously published components under the "COSO Cube" from five to eight components as follows:

1. Control environment
2. Setting objectives

⁴⁸ Public Internal Financial Control-PIFC, Robert de Koning, January 2007.

3. Identification of events
4. Risk assessment
5. Risk response
6. Control activities
7. Information and communication
8. Monitoring

As seen above, the normal functioning of the IC system, which should be set up in each organization, requires the implementation of eight elements and in this context, in any public or private institution, each employee has several responsibilities related to internal control.

4.1. The first large group of internal control actors are: Head of the Institution, managers, staff members in the organization and internal auditors

Executive Director of the Organization-CEO: It is directly responsible for all activities of a public or private organization, including: establishing, maintaining and documenting a complete internal control system. The responsibilities of the holders vary depending on the function they have in the organization and the way of organization and management of the organization (board of directors, financial independence, audit committee, etc.), as well as the characteristics of the organization (institution).

Leaders (managers - second and third level, etc., leaders in the organization): Managers are directly responsible for all activities and control activities covered by their management unit, including: programming of the unit activity, internal organization, segregation of duties, hiring of staff, quality control of work, recording of products, storage and documentation of assets, etc. Their responsibilities vary depending on the function they have in the organization (institution) as well as the specific features and requirements set out in laws, bylaws and regulations related to the organic structure and functions of the units according to the organization.

Staff members in the organization: Staff members in the organization are directly responsible for all control activities which they cover in accordance with their job descriptions, thus playing an irreplaceable role in the development and implementation of the internal control system in the organization as a whole. Internal control is a whole system, implied with parts of duties and responsibilities by each employee. If an employee does not fulfill his responsibilities in this chain, "Internal Control" is disrupted which means that it does not function regularly. All staff members play their part in the functioning of an effective system and should feel (and be) responsible for the products they produce, the activity they carry out and the reporting they should do according to the hierarchical scale in the governing bodies of the organization in order to avoid problems or actions that lead to non-compliance with the established code of conduct or violations of the organization's policy.

Internal Auditors : Internal auditors are directly responsible for evaluating the activity of the financial management and control system (FMC), reporting directly to the head of the organization and making recommendations for improvements. Auditors have no responsibility regarding the establishment of the internal control system, this responsibility belongs only to the head. Auditors assessment of the financial management and control system means : Determining the significance and vulnerability of the risk for which the controls have been assessed. Assessing a predisposition to misuse resources, failure to achieve ethical, economic, efficiency and effectiveness objectives, or to meet obligations of responsibility or compliance with laws.

4.2. The second largest group of internal control actors are:

External "parties" such as : external auditors, legislators, regulatory bodies and other stakeholder parties. These can contribute to the achievement of objectives or can provide the right information regarding internal control. However, they are not responsible for the establishment and operation of the internal control system in the organization.

External Auditors : Audit certain state and private institutions. They and their professional bodies should provide advice and recommendations on the internal control systems.

Legislators and regulatory bodies : establish rules and directives related to internal control. They should contribute to an overall understanding of the internal control.

Other Parties : interact with organizations and provide information about the achievement of its objectives. Internal control is primarily influenced by internal “actors”, including managers, internal auditors and other staff. However, the actions of external "actors" also have their own impact on the internal control system.

5. Cooperation between Internal and External Audit

While the responsibilities and objectives of external and internal auditors may vary, they have common interests, but often their work overlaps. Common interests of the two types of Auditees:

- Effective accounting and control systems;
- Effective operation of these systems on an ongoing basis;
- Effective movement of financial and operational information;
- Non-financial controls to safeguard assets;
- Actions in accordance with laws, rules and other additional requirements.

Examples of overlap aspects are:

- Examination of control systems in the organization;
- Examination of accounting records, books, accounts and receipts payable;
- Verification of assets and liabilities.

Some of the ways that can be used to encourage collaboration between two types of auditing include, but are not limited to, are:

A common audit methodology: Close cooperation may result from the adoption of a similar audit methodology;

Joint training programs: Fully integrated training programs, it would be quite good to do, but can not be applied due to the different nature of audit functions. However, a common training policy can be implemented, but this is mainly limited to general audit techniques;

Joint planning of audit work: They are useful in relation to the coordination of activities between internal and external audit, which presents the main stages in which the audit activity is planned as follows:

- **Phase One:** Exchanging copies of plans after they have been completed;
- **Second phase:** A joint meeting where plans are discussed and harmonized;
- **Phase Three:** Regular meetings where integrated plans are eventually published in a single document.

Passing from one stage to the other increases the cooperation between the two types of auditing. However, in special cases it may result in a single planning prepared for the organization, especially for small organizations which are not able to perform the internal audit service and consequently outsource this service. In such cases they can simultaneously contract the internal and external audit service if the service provider undertakes to carry out both types of Audites.

Direct assistance in each other's projects: An exchange of resources between them creates even closer cooperation.

Exchange of reports: This is a simple method to keep both parties informed, however this is more important for the public sector. However, this process can be distorted by political maneuvers where each party applies special rules for confidential reports or for reports that have not reached the final reporting status. The practical guide according to the 2050-1 standard of IIA, covers the coordination of internal and external audit activities, where its key points are:

- Internal and external audit work should be coordinated to ensure adequate audit coverage and to avoid duplicate audits (overlap audits);
- Reviewing the work of external auditors, including coordination with the internal audit activity is usually the responsibility of the board;
- The chief audit executive may agree to work on the external audit in respect of the annual control they exercise over the financial statements;
- The chief audit executive must make regular assessments of the coordination of work between internal and external audit;
- In exercising its review role, the Board may ask the CEO to evaluate the performance of internal auditors in coordination with internal audit and other issues such as: professional knowledge and experience, knowledge of the industry (field), independence, special services, liability, employment relations, contractual obligations and exchange of values;
- The internal auditor can report to the Board various issues such as: independence, significant weaknesses in the system, errors and irregularities, illegal acts, accounting estimates, adjustments in the audit work, disagreements with management, and difficulties with the audit;
- Coordination, audit coverage, access to work programs and materials, exchange of audit reports, and management letters, understanding of audit techniques, methods and terminology;
- More effective for internal and external audit may be the use of related techniques, methods and common terminology, to effectively coordinate their work and to rely on each other.

6. Cases when external auditors can use the work of internal auditors

During the planning process of an engagement, the external auditors should make a preliminary assessment of the internal audit system, if it is possible for part of the internal auditor's work to be used by the external audit. A favorable assessment may allow external auditors to modify the nature, timing and extent of external audit procedures. Details on the criteria used to decide whether an external auditor can rely on internal audit work are set out in International Standard on External Audit 610 - “Consideration of Internal Audit Work”. External auditors will generally consider the following elements as part of their review:

- ❖ **Organizational Status:** The special status of Internal Audit and the possibility for its activity to be objective. Internal Audit reports to the highest levels of management and has no accountability over the operational work activities for the organization. Any conditions or restrictions imposed on Internal Audit by management should be carefully considered by the External Audit. In particular, the internal auditor should be free to communicate on all aspects with the external auditor.

- ❖ **Areas of Functioning:** The external auditor should consider whether management (middle management level) acts on the basis of Internal Audit recommendations and how this is evidenced by the governing structures in the organization.
- ❖ **Professional Competence:** If the Internal Audit is performed by persons who have the training and possess the appropriate professional skills as internal auditors. The external auditor may, for example, review policies for the employment and training of audit staff, their experience and professional qualifications.
- ❖ **Professional Care:** If the Internal Audit is properly planned, supervised, reviewed and documented. The existence of appropriate audit manuals, work programs and working papers should be considered.

But it is important to keep in mind that:

- Any work done as part of the Internal Audit function by anyone who is assigned to do it, (which may also include the external auditor) is part of the organization's activity.
- The internal auditor can never achieve the same degree of independence as required for the External Audit, regardless of the degree of autonomy and objectivity that the internal auditor may have.

While the external auditor can use the work performed by the Internal Audit:

- External auditors only have the responsibility to express an audit opinion
- This responsibility is not limited by the use of Internal Audit work
- All judgments related to the audit of financial statements are those presented by external auditors

External auditors do not have the opportunity to obtain adequate and sufficient audit evidence to support their conclusions on materiality problems based solely on the work of Internal Audit. The person responsible for the management of internal audit should always keep in mind that the work report for his unit will be subject to review by the External Audit. For this reason, Internal Audit work reports should be up to that standard to meet the requirements of External Audit and allow them to be based on the work of Internal Audit. Internal Audit reports, like all work reports, should be understandable by any other experienced auditor.

The Internal Audit Manager and his staff, therefore, should prepare work reports in order to be self-explanatory in case they are to be reviewed by the External Audit. In this context, it is normal practice for Internal Audit to provide a copy to external auditors after finalizing their reports. The provision of the Internal Audit reports to the external auditors is an additional source of information towards the internal auditors. This, in particular, works in cases where the external auditor is looking if the management line takes appropriate action in response to internal audit recommendations. This strengthens the status of Internal Audit if they underline the fact that these reports have been taken into account in the relevant line of management. If the external auditors are not satisfied with the attention that the management line pays to the results of the Internal Audit then this will be reflected in the external auditors' reports addressed to the highest levels of management.

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