

The Importance of External Auditing as a Tool to Combat Financial Corruption in Economic Institutions

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Abstract:

This study explores the significance of external auditing as a tool to combat financial corruption in economic institutions. Adopting a descriptive-analytical approach, it defines the concepts of external auditing and financial corruption and evaluates how external auditing contributes to mitigating corruption within these economic institutions. The findings indicate that, despite the presence of external auditing within institutions, which serves as a fundamental pillar in mitigating financial corruption and thereby protecting the national economy and public treasury from embezzlement, there remains a significant weakness in the preventive measures outlined in Law No. 06-01 on the prevention of and combat against corruption. Specifically, this weakness stems from the lack of decisive and strict penalties to deter offenders, combined with the inadequate protection for whistleblowers, which has inevitably led to the spread of this critical phenomenon across most economic institutions.

Keywords: *External auditing, auditors, financial corruption, economic institutions..*

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1. Introduction.

Financial corruption is a persistent and significant issue, deeply rooted in the historical development of our societies, affecting both developing and advanced societies. It manifests across political systems, whether democratic or authoritarian, as well as economic models, such as capitalism and socialism. The widespread nature of financial corruption has amplified the importance of administrative oversight and highlighted the necessity of external auditing. The latter evaluates compliance with institutional policies and procedures, safeguards assets, and ensures the accuracy of financial records. Beyond these functions, the scope of external auditing has expanded to include assessments of operational efficiency, the integrity of employees, and the provision of reliable and credible information for decision-making.

Additionally, external auditors are expected to combat financial corruption by identifying errors, fraud, and illegal activities that undermine an institution's financial stability and operational outcomes. Auditors are also tasked with ensuring the technical adequacy, independence, and impartiality of their reports, preventing the issuance of misleading financial statements.

1.1 Research Problem.

In light of the above, the study raises the following main question:

To what extent does external auditing serve as an effective tool for combating financial corruption in economic institutions?

1.2 Research Questions.

The study seeks to answer the following sub-questions:

1. How does external auditing contribute to mitigating financial corruption within economic institutions?
2. What role does the external auditor play in detecting instances of financial corruption?
3. How does adherence to external auditing standards and professional ethics enhance auditors' effectiveness in combating financial corruption?

1.3 Research Hypotheses.

1. External auditing helps to reduce financial corruption through detection, prevention, and deterrence of corrupt practices in economic institutions.
2. External auditors fulfil their responsibilities by disclosing any findings that raise suspicion of financial corruption within the institution.
3. Adherence to international auditing standards and professional ethics enhances the ability of external auditors to combat financial corruption and its impacts effectively.

1.4 Objectives of the Study.

The primary objective of the study is to evaluate the importance of external auditing as a tool to mitigate financial corruption within economic institutions. Achieving this goal requires addressing the following sub-objectives:

1. Define the concepts of external auditing and financial corruption.
2. Identifying the relationship and impact between external auditing and financial corruption in economic institutions.

1.5 Significance of the Study.

The importance of this study lies in emphasizing the pivotal role of external auditors and their contribution in combating financial corruption by uncovering fraudulent practices and implementing preventive measures. However, any negligence on the part of the auditor can intensify corruption, leading to significant financial and reputational losses for economic institutions.

1.6 Research Methodology.

To address the main research problem and the sub-questions, the study adopts a descriptive-analytical approach. This method involves the gathering of relevant information and data from various sources to provide a comprehensive understanding of the theoretical aspects of the topic.

1.7 Literature Review:

1. Jeppes (2019): This study emphasized the necessity of integrating the concept of financial corruption into the definition of fraud under international auditing standards, applying it to both the public and private sectors. It also called for the implementation of effective detection techniques and procedures, as well as adopting preventive auditing measures, such as the obligation to report the absence of corruption, and to ensure the integrity of financial reports.

2. Guandouz .W Mohammed (2018): This research examined the impact of external auditing on mitigating financial and administrative corruption within economic institutions. This was achieved through a survey distributed to 60 participants actively involved in the field of external auditing. The study identified weaknesses in professional and ethical standards as factors that lead to the exacerbation of corruption, particularly in the absence of strict penalties.

3. Shaimaa Mohammed Sameer Ibrahim (2013): The study examined the growing phenomenon of financial corruption and emphasized the importance of integrating the roles of internal and external auditors to mitigate its impact. It highlighted the research problem, which stems from the lack of coordination between internal and external auditing. This lack of integration and coordination undermines the ability to effectively detect and address violations and irregularities, thereby failing to combat financial corruption.

2. Theoretical Framework of External Auditing.

2.1 Definition of External Auditing.

External auditing has been defined in several ways, the most significant of which are as follows:

1. First Definition:

External auditing is the primary independent and objective tool aimed at examining an institution's financial statements. It is a process designed to ensure the reliability of the information included in the financial statements, which are prepared in accordance with generally accepted accounting principles or other relevant standards. (*Mohamed, 2012*)

2. Second Definition:

External auditing is primarily defined as the verification of financial information or data by an independent and neutral party for any institutional entity, regardless of its purpose, size, or legal status. (*Al-Tamimi, 2004*)

3. Third Definition:

External auditing is also described as a structured, systematic approach for obtaining objective evidence and indications regarding the verification of economic events and activities, assessing the consistency of these assertions with established standards, and communicating the results to relevant stakeholders (Hammad, 2007).

2.2 Types of External Auditing.

In Algeria, external auditing is divided into three main categories: *statutory auditing*, *contractual auditing*, and *judicial expertise*. These categories can be summarized as follows: (Ali, 2016)

- **Statutory Auditing:**

This involves the mandatory review and audit of accounts, as required by law. Every commercial enterprise is legally required to appoint a statutory auditor who conducts compulsory annual monitoring and review.

- **Contractual Auditing:**

This is performed by a professional auditor within a contractual framework at the request of one of the parties dealing with the institution, with the aim of obtaining verified, reliable and accurate financial statements.

- **Judicial Expertise:**

This type of auditing is conducted by an external professional at the request of the court.

2.3 Importance of External Auditing.

External auditing holds significant importance for investors and financial stakeholders who rely on financial statements to make informed and insightful decisions. The primary beneficiaries of external auditing include company managers, business owners, shareholders, creditors, suppliers, investors, governmental agencies, and tax authorities. The importance of external auditing can be summarized as follows: (Mohamed S., 2013)

- External auditing is a systematic and objective process. The external auditor's work is not self-serving; rather, it is aimed at providing an accurate and truthful representation of the institution's management activities and operations.
- The collection and assessing of evidence are the core of the audit process. It forms the foundation upon which external auditors base their opinion on the institution's financial statements. This evidence is used to verify the alignment and the accuracy of economic operations and events that occurred during the reporting period, their impact on the institution's financial results, and their compliance with established standards.
- The external auditor communicates audit findings to relevant stakeholders through the audit report prepared at the end of the process. This report evaluates the financial statements prepared by the institution's management in light of their compliance with generally accepted accounting principles (like: GAAP) and other relevant standards.
- External auditing enhances confidence by ensuring the accuracy, adequacy, and reliability of financial information. This enables stakeholders/ users to make sound, effective decisions while minimizing the risks associated with poor decision-making.

3. Theoretical Framework of Financial Corruption.

3.1 The Concept of Corruption.

- **Linguistic Definition:** In the Arabic *Dictionary 'Al-Waseet'*, Corruption refers to the state of disorder and malfunction. For instance, the term "to corrupt something" refers to its misuse or the act of causing harm.
- **Terminological Definition:** While definitions of corruption vary depending on its type, the World Bank provides the most widely accepted definition, describing financial corruption as the misuse of public authority for private gain (Althamri, 2001).

3.2 Definition of Financial Corruption.

Financial corruption refers to illegal behaviours such as embezzlement of public funds, brokerage in projects, and arms trade. It also includes financial deviations based on violations of established laws, regulations, and institutional rulings, such as tax evasion (Hakima, 2012).

The concept of financial corruption aligns closely with that of administrative corruption but focuses exclusively on the financial aspect, including the depletion of public resources, the exploitation or circumvention of financial laws and regulations, or the deliberate disregard of such laws. Financial corruption is often associated with fraud or financial deception, where both phenomena work hand-in-hand, both aiming to achieve personal benefits by prioritizing individual interests over public welfare.

Some scholars view financial corruption as a set of financial deviations that contravene the established rules and regulations governing administrative and financial operations. (Majid, 2002)

The following table provides a comparative overview of financial and administrative corruption:

Table 01: Similarities and Differences Between Financial Corruption and Administrative Corruption

Aspect of Comparison	Financial Corruption	Administrative Corruption
Differences		
Perpetrators	Employees involved in accounting and financial tasks, including auditors and financial report preparers.	Senior and junior administrative staff.
Focus	Laws, rules, accounting and financial standards, and financial disclosure standards.	Various administrative laws, systems, and rules.
Similarities		
Shared Traits	- Perpetrators possess authority and positions that grant them control over resources and information. - A pursuit of personal interest. - Intentional violation of laws, rules, and regulations governing work. - Both result in harmful consequences.	

Source: Abdul Khaleq Yahya Majid, *Activating Internal Control Systems to Reduce the Phenomenon of Financial and Administrative Corruption in Service Units*, Dar Al-Nashr for Distribution, Jordan, 2002, p. 71

3.3 Manifestations of Corruption in Economic Institutions.

Corruption manifests in various forms within economic institutions, as it does in governmental and non-governmental organizations. These manifestations can be summarized as follows: (Al-Azzawi, 2007)

1. Fraud with the Purpose of Embezzlement:

Deliberate fraudulent acts are committed to achieve personal gain without a rightful justification or entitlement. It is a form of breaching the trust granted by the institution to its employees. Examples of the latter include exploiting contracts and agreements, embezzling cash, goods, or raw materials, and withholding wages.

2. Manipulation of Activity Results and Financial Position for Misleading Purposes:

Deliberate Manipulation often aims to deceive stakeholders or commit fraud by altering activity results or financial positions to present false realities. Examples include:

- Manipulating (Inflating or deflating) inventory valuation at the end of the financial year to increase or decrease profits.
- Misrepresenting reserves and provisions to influence activity outcomes.
- Improper classification of expenses or revenues to alter activity results, positively or negatively.
- Creating secret reserves to either bolster financial positions or cover future losses, which may later be misused for personal gain by management.

3. Bribery:

It involves receiving money or other benefits in exchange for executing tasks.

4. Nepotism and Favouritism:

- **Nepotism:** Granting unjustified benefits or privileges to individuals or entities based on personal connections, even if they are undeserving.
- **Favouritism:** Preferring one party over another in service provision without justification to achieve specific interests.

5. Tax Evasion:

It refers to Business owners/executives bribing corrupt officials to secure unjustified tax exemptions or reductions.

6. Extortion:

Extortion involves demanding money or benefits from others in exchange for performing duties related to the perpetrator's role.

Other Additional manifestations include:

- **Unsecured Favor Loans:** Loans granted without proper guarantees.
- **Commissions and Royalties:** Arising from contracts.
- **Excessive Use of Institutional Funds:** Misuse of organizational resources for personal benefit, among others.

3.4 Causes and Motivations Behind Financial Corruption.

The drives and causes of corruption are numerous and influenced by several factors including economic, social, administrative, and organizational factors. These include the following: (Hawas, 2013)

1. Administrative Factors:

- Ineffectiveness and failure of government systems in addressing administrative corruption and deviations effectively and in enforcing penalties on offenders.
- Structural deficiencies and Organizational shortcomings, such as unclear communication channels, undefined administrative supervision, and overlapping roles and responsibilities, make it difficult to assign accountability.
- Staff Shortages, particularly in financial and accounting roles, when coupled with an increased workload leads to opportunities for corruption and frequent accounting errors due to work pressure and the absence of thorough audits.
- Flaws or inefficiencies in salary and reward systems.

2. Organizational, Legislative, and Judicial Factors:

- Overlapping and contradictory regulations create loopholes that encourage corruption and facilitate accountability evasion.
- Weak internal financial controls and monitoring enables unlawful financial and accounting practices.
- Poorly defined roles and responsibilities within the organizational structure and inadequate job descriptions hinder the clear assignment of duties and required qualifications
- Insufficiency of Financial Systems leads to gaps financial and accounting processes which eventually promote the spread of financial corruption.
- The absence of independent judicial systems fosters corruption, as rigorous legal provisions against corrupt practices are ineffective without proper enforcement. Political pressures or selective application of laws prevent justice from taking its course and deter potential deterrents to corruption.
- Lack of Accountability and Deterrence.

3. Political Factors:

As noted in a United Nations report, political corruption is highly tied to weak governance elements, such as a lack of participation, freedom of expression, and accountability. Additional political motives include:

- Absence of political will to enforce transparency, oversight, and accountability.
- Ineffectiveness of legislative oversight and the absence of a robust media role to expose corruption.
- involving major projects or high-ranking officials and politicians.
- Lack of genuine efforts from governments to address large-scale corruption cases involving major projects or high-ranking officials and politicians.

3.5 International Efforts in Combating Corruption.

Over the years, numerous international organizations have been working to identify the causes of corruption and implement appropriate solutions. Some of these organisations include: (Hawas, 2013)

1. Transparency International.

Transparency International is an international organization that is actively engaged in combating corruption worldwide. It publishes significant and impartial reports that identify corruption hotspots, shed light on the complexities and obstacles that impedes the fighting of corruption, and release an annual global report ranking countries in terms of corruption.

2. The Role of the United Nations.

The United Nations has developed a draft international convention to combat corruption, aiming to mitigate its dangers and negative effects, which include:

- Affecting the stability and security of societies, weakening democracy, moral values, and justice, and endangering the development and the rule of law.
- Establishing connections between corruption and organized crime, including economic crimes such as money laundering.
- The spread of corruption beyond borders and to other nations, necessitating international cooperation.
- Draining state resources and threatening political stability.

The agreement also highlighted various forms of corruption, such as: Corruption in the public sector; Corruption in government offices; Corruption in the private sector; Influence peddling; Abuse of power; Bribery and embezzlement in the private sector; Bribery of public officials; Corruption threatening the judiciary and public prosecution system, obstruction of justice, and corruption through embezzlement or misappropriation of property.

3. The Role of the Organization for Economic Cooperation and Development (OECD).

Since 1989, the OECD has taken a leading role in the international combat against bribery and corruption. In 2003, the organization prepared a paper addressing the role of civil society in tackling and fighting corruption. Some of the key points highlighted in the paper regarding civil society's role include:

- Drafting laws and providing support to establish civil society organizations
- Helping in strengthening the development of independent media to enable thorough, unbiased and fair reviews of government activities.
- Promoting greater transparency in governmental operations and fostering a genuine willingness to collaborate with civil society.

4. The Contribution of External Auditing in Combating Financial Corruption.

As outlined below: (Al-Ayeb, 2022)

4.1 Supporting and Strengthening the Internal Control System.

Evaluating the internal control system and its associated risks is one of the primary and fundamental responsibilities of external auditing. This makes it a pivotal element in preventing and mitigating financial corruption. A strong internal control system with a clear structure, well-defined authorities, transparent mechanisms for risk assessment, monitoring,

reporting processes, and adherence to ethical standards and codes of conduct, helps at reducing incentives and opportunities for fraud and financial corruption. Based on this, the Committee of Sponsoring Organizations (COSO) has emphasized strengthening the internal control systems to combat all forms of corruption by managing four key types of risks: strategic risks, operational risks, compliance risks, and reporting risks. This involves assessing the likelihood and impact of financial corruption, alongside establishing and monitoring internal controls to prevent financial fraud.

Although a robust internal control system contributes significantly to detecting and preventing corruption, lack of transparency and non-compliance with internal and external mechanisms negatively impact its effectiveness. This underscores the importance of integrating and interlinking internal and external mechanisms, chiefly external ones, given their strength and effectiveness in identifying corruption.

Therefore, enhancing internal control systems and reviewing internal control policies aligned with the principle of materiality, along with verifying and ensuring the efficiency and independence of internal auditing functions, can reduce opportunities for financial corruption and deter corrupt financial practices.

Accordingly, the relationship between financial corruption and an effective internal control system is inversely proportional: the more effective the internal control system, the fewer the opportunities for financial corruption.

4.2 Adherence to International Auditing Standards as a Means to Enhance the Role of External Auditing in Reducing Financial Corruption.

The International Auditing and Assurance Standards Board (IAASB) has issued International Standard on Auditing (ISA) 200, which outlines the requirements that define the general responsibilities of auditors. It emphasizes maintaining independence while performing auditors' duties, as well as their responsibility, and ensuring compliance with all relevant legal, regulatory, and professional obligations. Auditors are required to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatements resulting from fraud, deception, errors, or irregularities by relying on sufficient and appropriate evidence to minimize audit risks.

The IAASB also highlights the auditor's responsibility to consider laws and regulations during the auditing of financial statements, issuing the ISA 200, issuing ISA 200, which includes compliance requirements with laws and regulations. It mandates that auditors must pay attention to non-compliance or suspected non-compliance with laws and regulations and take necessary audit actions and procedures to identify cases and issues that may have a material impact on the financial statements. However, this standard excludes other assurance engagements and compliance tests with specific laws or regulations that do not directly and materially affect the financial statements of the organization.

Therefore, the relationship between adherence to international auditing standards and financial corruption is also inversely proportional. The more these standards and their provisions are adhered to, the greater the likelihood of uncovering corrupt practices that materially affect financial statements. Consequently, opportunities for financial corruption diminish, leading to its prevention and reduction.

4.3 Audit Quality as a Means of Strengthening External Auditing to Address Financial Corruption.

Audit quality has been defined by Krishnan and Schauer as the degree to which an audit program and its implementation align with auditing standards. DeAngelo defines audit quality

as the market's estimation of the combined probability that an auditor will detect deviations and breaches in a client's accounting system and disclose and report them. The probability of detecting these deviations depends on the auditor's competence, expertise, audit procedures, and the size and type of audit samples. On the other hand, the likelihood of disclosure and reporting is dependent on the auditor's independence.

Based on this perspective, external audit quality can be divided into two main components:

- **Detection Quality**, which depends on professional and scientific technical competence;
- **Disclosure Quality**, which profoundly relies on the auditor's independence.

Hence, the relationship between external auditing and financial corruption is, likewise, inversely proportional. As the quality of external auditing increases, instances of financial corruption decrease, as it counteracts manipulation by the management of the organization in the financial statements. Conversely, when external audit quality declines, financial corruption thrives due to inaccurate, subjective financial statements, and the management may fail to comply with principles and laws when preparing them to achieve private goals and interests.

Based on the above, we can conclude that the effective contribution of external auditing in preventing and combating financial corruption is fundamentally dependent on the quality of the audit, strict adherence to international auditing standards, and the robust support and activation of the internal control system. These factors enable the identification and prevention of practices involving financial corruption.

5. Conclusion.

This study aims to highlight the importance of external auditing as a mechanism to reduce the phenomenon of financial corruption by ensuring external auditors' commitment to their responsibilities, and thereby contributing to the mitigation of financial corruption.

5.1. Study Results.

The study's findings include the following:

- ✓ The role and responsibility of external auditors in providing early warnings and signs of financial corruption cases and identifying the key procedures required to gain an accurate understanding of the internal control system, ultimately uncovering and reporting the various risks facing the organization.
- ✓ Professional expertise plays a significant role in detecting financial fraud.
- ✓ Weak preventive measures to counter financial corruption, as specified by Law No. 06-01 on the prevention and combat against corruption, where the lack of strict and decisive penalties for perpetrators and inadequate protection for whistleblowers have intensified the widespread occurrence of this severe issue affecting most economic institutions.
- ✓ External auditors' adherence to professional auditing standards, identifying significant errors and violations in financial statements, and disclosing them in audit reports are key indicators of audit quality.

5.2. Recommendations.

- Greater attention must be given to the profession of accountants in Algeria, with regular updates and revisions to the relevant laws.

- The strict and effective implementation of laws and rigorous penalties for those involved in corruption crimes, regardless of their position or the amount gained through corrupt practices, is essential.
- Transparency and disclosure should be prioritized in addressing financial corruption by continuously monitoring its means and methods. Addressing and fighting financial corruption can be enhanced by adhering to international accounting and auditing standards to achieve greater transparency.
- Mandatory rotation/change of external auditors every three years should be enforced, with no allowance for reappointments, to reduce the risk of collusion between auditors and company management, thereby increasing the chances of eradicating financial corruption.

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