

THE IMPORTANCE OF THE INTERNAL AUDIT IN A COMPANY. THE DIFFERENCES BETWEEN INTERNAL AND EXTERNAL AUDITING

Internal audits provide a number of important services to company management. These include detecting and preventing fraud, testing internal control, and monitoring compliance with company policy and government regulation. Establishing an internal audit function provides a vital step in the growth of a business.

Internal Audit is a tool of control to measure and evaluate the effectiveness of the working of an organization primarily with accounting, financial and operational matters. The job of internal audit is to ensure that the work of the company is going on smoothly, efficiently and economically and that all the laws, rules and regulations governing the operations of the organization are adhered to, besides ensuring that an effective internal control system exists to prevent errors, frauds and misappropriations.

Internal auditing activity is primarily directed at evaluating internal control. Under the COSO Framework, internal control is broadly defined as a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following core objectives for which all businesses strive:

- Effectiveness and efficiency of operations.
- Reliability of financial and management reporting.
- Compliance with laws and regulations.
- Safeguarding of Assets.

Management is responsible for internal control, which comprises five critical components: the control environment; risk assessment; risk focused control activities; information and communication; and monitoring activities. Managers establish policies, processes, and practices in these five components of management control to help the organization achieve the four specific objectives listed above. Internal auditors perform audits to evaluate whether the five components of management control are present and operating effectively, and if not, provide recommendations for improvement.

Principles

The principles follow:

Integrity - The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity - Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Confidentiality - Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency - Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

The first tasks of a newly appointed internal auditor are:

- to identify and assess, from a professional point of view, the working environment;
- to make an initial objective assessment of the strengths and weaknesses of the organisation;
- to establish and promote a positive image of himself;
- to explain and communicate;
- to integrate and obtain legitimacy by carrying out the first audit activities focussing on ad-hoc processes.

The basic tasks of an internal auditor are:

- to analyse the activities of the audited organisation on a permanent basis, to monitor the management of these activities, and to recommend adequate measures to improve the auditee's performance;
- to verify the reliability and suitability of the information system;
- to check whether the organisation's development policy, standards, and the instructions of the management are implemented correctly;
- to monitor and revise the performance of financial management on all levels of company management;
- to inform the management of any irregularity or anomaly revealed and to recommend appropriate measures for their elimination;
- to assess the organisation's resources and ensure that all resources (human, material, and financial) are utilised appropriately so that the best possible results are achieved;
- to conduct an audit and/or co-operate in the audit of all subordinated entities;
- to verify whether the recommendations and measures proposed by the internal auditor have been implemented or not;
- to support the realisation of changes and encourage the staff of the audited organisation to adapt to the new system.

Types of internal audit

Financial audit – evaluates whether the data in the auditee's financial statements correspond to the actual amounts of assets and liabilities, the sources of financing, the management of assets, and compliance with the approved budget of the audited organisation. On the basis of tests, it is possible to assess the strong and weak sides of internal control. If too many operational defects are found, it will be necessary to carry out more account inspections and checks on the correctness, legitimacy, and regularity of the records.

Audit of compliance (regularity) – verifies compliance with the generally binding legal regulations in financial management and other activities performed by the auditee, it also evaluates the

efficiency of financial management. It corresponds to basic audit work and is relatively easy from the point of view of conduct. For that reason, audit of this type may be assigned to younger auditors.

Audit of performance – evaluates the degree of economic efficiency and effectiveness in the use of material, financial, and human resources as part of fulfilment of tasks by the audited organisation. With regard to its difficult nature, an audit of this type should be assigned to senior auditors.

System audit – evaluates whether the financial management procedures of the auditee are effective in revealing and eliminating deficiencies. System audit is also used to verify the compliance of financial operations with the provisions of generally binding legal regulations, internal directives, as well as the economic efficiency and effectiveness of these operations.

Audit of information systems – evaluates the safety of information systems used by the audited organisation. Audit of this type is also used to assess the adequacy and integrity of data and information stored in the auditee's information system with regard to the nature and scope of its activities. The safety of an information system is defined as the level of protection against the misuse of information stored in the system, its damage, or destruction.

External audit is an independent body which resides outside of the organisation which it is auditing. They are focused on the financial accounts or risks associated with finance and are appointed by the company shareholders. The main responsibility of external audit is to perform the annual statutory audit of the financial accounts, providing an opinion on whether they are a true and fair reflection of the company's financial position. As part of this, external auditors often examine and evaluate internal controls put in place to manage the risks which could affect the financial accounts, to determine if they are working as intended.

Here is a clearly differences and similarities “Internal Auditor” versus “External Auditor” sorted out:

The Different Objectives

The External Auditor: The external auditor seeks to test the underlying transactions that form the basis of the financial statements.

The internal Auditor: The internal auditor, on the other hand, seeks to advise management on whether its major operations have sound systems of risk management and internal controls.

The Main Differences

There are, however, many key differences between internal and external audit and these are matters of basic principle that should be fully recognized:

1. The external auditor is an external contractor and not an employee of the organization as is the internal auditor. Note: however, that there is an increasing number of contracted-out internal audit functions where the internal audit service is provided by an external body.

2. The external auditor seeks to provide an opinion on whether the accounts show a true and fair view, whereas internal audit forms an opinion on the adequacy and effectiveness of systems of risk management and internal control, many of which fall outside the main accounting systems.

The Main Similarities

The main similarities between internal and external audit are as follows:

1. Both the external and internal auditor carry out testing routines and this may involve examining and analyzing many transactions.
2. Both the internal auditor and the external auditor will be worried if procedures were very poor and/or there was a basic ignorance of the importance of adhering to them.
3. Both tend to be deeply involved in information systems since this is a major element of managerial control as well as being fundamental to the financial reporting process.
4. Both are based in a professional discipline and operate to professional standards.
5. Both seek active co-operation between the two functions.
6. Both are intimately tied up with the organization's systems of internal control.
7. Both are concerned with the occurrence and effect of errors and misstatement that affect the final accounts.
8. Both produce formal audit reports on their activities.

We can understand the importance of an internal auditor by understanding internal auditing. 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 the effectiveness of risk management, control and governance processes.