## INTRODUCTION TO INTERNAL AUDITING

**INTERNAL AUDIT VS EXTERNAL AUDIT**

Internal auditors and external auditors have different but complementary objectives:

***The external auditor*** The external auditor seeks to test the underlying transactions that form the basis of the financial statements and form an opinion of whether such financial statements represent a true and fair view of the state of affairs of the entity in question. ***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 similarities** between internal and external audit are as follows:

• Both the external and internal auditor carry out testing routines and this may involve examining and analyzing many transactions.

• 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.

• 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.

• Both are based in a professional discipline and operate to professional standards.

• Both seek active co-operation between the two functions.

• Both are intimately tied up with the organization’s systems of internal control.

• Both are concerned with the occurrence and effect of errors and misstatement that affect the final accounts.

• Both produce formal audit reports on their activities.

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

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

• 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.

**INTERNAL AUDIT DEFINED**

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.

**SCOPE AND OBJECTIVES OF THE INTERNAL AUDIT DEPARTMENT**

The internal audit activity should evaluate risk exposures relating to the organization’s governance, operations and information systems regarding the:

* Reliability and integrity of financial and operational information.
* Effectiveness and efficiency of operations.
* Safeguarding of assets.
* Compliance with laws, regulations, and contracts.

***Reliability and integrity of financial and operational information*** Internal auditors review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.

***Effectiveness and efficiency of operations*** Internal auditors should appraise the economy and efficiency with which resources are employed. They should also review operations or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations are being carried out as planned.

***Safeguarding of assets*** Internal auditors should review the means of safeguarding and, as appropriate, verifying the existence of such assets.

***Compliance with laws, regulations and contracts*** Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws, regulations and important contracts that could have a significant impact on operations and reports, and should determine whether the organization is in compliance.

**IMPLICATIONS OF THE WIDE SCOPE**

The scope of internal auditing defined above is wide and this has several implications:

***1. Expertise*** Great expertise is required from auditors to enable them to provide advice on the wide range of key control objectives.

***2. Safeguarding assets*** It is necessary to establish who is responsible for investigating fraud since this is resource-intensive.

***3. The compliance role*** Controls over compliance may include an inspection routine and audit’s role in this should be clearly defined.

***4. Information systems*** The audit of management information systems (MIS) is crucial since this may involve reviewing MIS as part of operational audits, or these systems can be audited separately.

***5. Value for money*** The concept of economy, efficiency and effectiveness (or VFM) is another sensitive issue. Auditors can assist management’s task in securing good arrangements for promoting VFM or alternatively undertake a continual search for waste and other poor VFM.

***6. Management needs*** A wide scope requires a good understanding of the operations being reviewed and it is necessary to include management’s needs in the terms of reference by adopting a more participative style.

***7. Specialists*** The four elements of the key control objectives may require specialists in each of the defined areas and the level of expectation may place great demands on the audit service.

**INTERNAL AUDIT COMPETENCIES**

The first thing that needs to be in place to ensure competent internal auditors is effective human resource policies and practices. Here we are concerned with the attributes of successful internal auditors. Auditors should possess the following competencies:

* Proficiencies in applying internal auditing standards and procedures *. . .*
* Proficiency in accounting principles and techniques *. . .*

• An understanding of management principles *. . .*

• Appreciation of accounting, economics, commercial law, taxation, finance, quantitative methods and IT.

• Skilled at dealing with people and communicating *. . .*

• Skilled in oral and written communications

**TRAINING AND DEVELOPMENT**

Training is an important aspect of developing internal auditors, and has to be carefully planned in line with a career developmental programme. We first distinguish the following terms:

* Training— programs for getting people to learn to do things differently.
* Development—untaught activity to increase/improve performance.
* Education—formal courses to develop knowledge and qualifications.
* Learning—acquiring better skills, knowledge and attitudes.

There are various ways that audit staff may be trained and developed:

1. ***Specialist skills training via internal or external skills workshops*** These can be extremely efficient in terms of auditor development.
2. ***Professional training*** This may be based on passing examinations of a defined professional body such as the Institute of Internal Auditors, CPA or CIA, which is a completely different form of training from skills-based courses.
3. ***The training co-ordinator*** appointing a training co-ordinator is a positive way of promoting various training programmes, particularly where the co-ordinator can undertake some of the actual training.
4. ***Directed reading*** This is one way of encouraging auditors to research aspects of internal audit. The department should subscribe to all relevant journals and publications.

***5. Training through work*** Programmed audits enable audit management to ensure auditors are rotated and exposed to a variety of audits and experiences. It is possible to designate smaller audits as ‘training audits’ where they form part of the auditors’ personal development programme.

***6. The audit review*** The audit review process enables audit managers and team leaders to direct the work of junior staff and also provides experience in staff management.

***7. Professional affiliations*** These can be part of continuing professional development (CPD) and stimulate group discussions.

***8. The audit manual***

This sets out the defined methods and procedures required to discharge duty.

**SHOULD THE EXTERNAL AUDITOR RELY ON THE WORK OF THE INTERNAL AUDITOR IN EXECUTING THEIR FUNCTIONS?**

The major question is whether the external auditor should or should not rely on the work of the internal audit function while conducting external audits. If the external auditor could be able to rely on and use the work of the internal auditor, the result would be substantial savings in the cost and time taken to conduct the audit. Before the external auditor can rely on work done by the internal auditor he should consider the following:

i)  **Organizational status:**

The internal auditor is in most cases an employee of the entity and therefore cannot be independent, however the external auditor should evaluate to what extent he is free in performing his duties and communicate with external auditor and consider any constraints placed upon his work. Ideally, internal auditor should be reporting to the highest level of management and should be free from other operating responsibility.   
ii)  **Scope and Objectives of Internal Audit Function:**

The external auditor should examine the range and aim of the assignments assigned to internal auditors by the management and whether management acts on internal audit recommendations.   
iii)  **Technical Competence and experience:**

The external auditor should ascertain whether staff of the internal audit function has adequate technical training experience and proficiency as auditors.   
iv)  **Due Professional Care:**

The external auditor should consider whether the internal auditor has performed his work with reasonable care and skill i.e. work is properly planned, supervised and reviewed. He should also consider existence of working papers, work programs, audit manuals etc.

**LIAISON AND COORDINATION**

In the conduct of an external audit, the extent of liaison between the external auditor and the internal auditor would normally encompass the following:   
i) initial planning to formulate a joint approach to minimize the tests performed by the two auditors i.e. tests level, sample selection, documentation of work performed, review and reporting procedures.   
ii) Regular meetings between the internal and external auditors during the year.   
iii) Exchange of knowledge between the two auditors i.e. the external auditors should be informed of any significant matter that comes to the knowledge of internal auditor which he believes may affect to work of external auditor. Similarly the external auditor should inform the internal auditor of any significant matters which may affect his work.

**ORGANIZATION OF INTERNAL AUDIT DEPARTMENTS**