INTERNAL AND EXTERNAL AUDITOR COORDINATION FOR CORPORATE GOVERNANCE

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ABSTRACT

Corporate collapses and others damaged the credibility of most companies in the United States, Europe and Malaysia. To help restore confidence, US Congress passed the SARBANES OXLEY ACT 2002 (SOA) and Malaysia introduced the AUDIT COMMITTEE through Malaysian Institute of Corporate Governance (MICG) in March 1998. Both – SOA and MICG, mandate new requirements for the reporting of business results, consequently increasing the scope of work performed by the external auditor. Since, the new responsibilities of the external auditors have grown, internal auditors have the opportunity to add value to their organisation through improved coordination with the external auditors. This paper examines how internal auditors can add value by coordinating through external auditors, the reasons for coordinating with the external auditor, how the coordination may best be achieved, and the steps internal auditors should take to facilitate the coordination effort.

INTRODUCTION

Corporate collapses – frauds and scandals, at ENRON, WORLDCOM, GLOBAL CROSSING, PARMALAT, PERWAJA (just to name a few), and others damaged the credibility of most companies in the United States, Europe and Malaysia. To help restore confidence, US Congress passed the SARBANES OXLEY ACT 2002 (SOA) and Malaysia introduced the AUDIT COMMITTEE through Malaysian Institute of Corporate Governance (MICG) in March 1998. Both – SOA and MICG, mandate new requirements for the reporting of business results, consequently increasing the scope of work performed by the external auditor. Since, the new responsibilities of the external auditors have grown, internal auditors have the opportunity to add value to their organisation through improved coordination with the external auditors.

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Why Coordinate?

Coordination increases **trust**. The recent frauds caused investors to question the truthfulness of management's assertions. The US Congress attempted to restore this trust by passing the SOA – which specified several requirements to increase the accuracy of financial reports. While the requirements in SOA are a step in the right direction, companies should actively pursue ways of improving their perceived trustworthiness. Improving the coordination between the external and internal auditors is one way to do this.

Internal and external auditors have **different strengths** that combine to increase the effectiveness of audits. For example, internal auditors spend most or all of their time working in the same company. As a result, they have a better understanding of the culture and the workings of the company. This allows internal auditors to see things that external auditors would not see during their visits. Because external auditors work for multiple clients, they may be exposed to a wider variety and range of financial issues. External auditors may, therefore, discover and solve issues that internal auditors have not dealt with before.

In addition to improving trust, coordination increases **efficiency**. When the audit is not properly coordinated, external auditors may duplicate work already performed by the internal auditors. This redundancy causes higher audit fees but does not necessarily increase the effectiveness of the audit. Similarly, internal auditors may duplicate external auditors' work, which results in wasted internal time.

The inefficiencies might explain the economic savings reported by Felix, Gramling and Maletta (2001) in a recent research monograph. They found that companies whose external auditors rely on the work performed by internal auditors save an average of $215,961 or 18% of the audit fee. In most cases, these savings are greater than the cost incurred by the internal audit function to perform the work on which the external auditors rely.

Coordination improves both audit effectiveness and efficiency. Coordination improves the underlying reason for the SOA – assuring investors that the information companies release is accurate – while simultaneously improving the efficiency and reducing the costs associated with audits. Combined, the synergies realized through improved coordination add value to a company's shareholders.

What Can an Internal Auditor Do?

Although coordination can add value to an organisation, many internal auditors struggle with improving their coordination efforts. The following **seven (7) steps** will help internal auditing departments to start moving in the right direction. Internal audit department should:

Take the Initiative

The goal of external auditors is to verify that the company they audit complies with accounting standards. While internal auditors are concerned with accounting rule compliance, their scope is much greater.

The Institute of Internal Auditor's (IIA) definition of internal auditing illustrates this difference. 'Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes'.

The objectives of the internal auditor should be the same as the objectives of the company. (This does not mean or imply internal auditors should have the same objectives as the management). Because the internal auditor is concerned with meeting the objectives of the company and not just satisfying accounting standards, the internal auditor should seek to improve the company more than the external auditor does. In the case of coordination, research indicates that internal auditors are not seeking to improve coordination more than external auditors; consequently, internal auditors are missing an additional opportunity to add value to their organisation (Felix 1998).

The internal auditing function needs to reverse this trend and take responsibility for coordinating with external auditor. The audit committee can encourage coordination by appointing a specific person in the internal auditing department to be in charge of coordinating efforts with the external auditor. Assigning responsibility to an individual will help focus the efforts of the company and make sure that the company continues to work to improve its coordination efforts. In addition, the audit committee will be able to easily follow up and monitor the progress made in coordination efforts.

The individual assigned to improve coordination must have authority to examine different ways to coordinate – even if at first glance there are no apparent benefits. In addition, the individual should be given sufficient time and resources to convert ideas into actions. Otherwise, the individual will become frustrated and the entire coordination process will break down. The audit committee may choose to suggest ideas and to request feedback directly from the individual in charge of coordination to make sure the coordination efforts move forward.

If companies want to improve coordination levels, the internal auditing function should take the first step. Internal auditors are vital and major stakeholders in the companies they work for, and as such, they can create value through taking the initiative to improve relationships with the external auditor.

Learn Professional Standards

In order for external auditors to rely on the work performed by internal auditors, the work has to meet standards set by accounting regulators. Statement on Auditing Standards 65 (SAS) explains the evaluation process external auditors must follow before relying on internal auditors work. Specifically, this standard dictates that external auditors must assess the competence and objectivity of the internal auditors.

SAS 65 requires auditors to look at seven factors relating to competence, including:

- educational level and professional experience of internal auditors
- professional certification and continuing education
- audit policies, programs, and procedures
- practices regarding assignment of internal auditors
- supervision and review of internal auditors' activities
- quality of working-paper documentation, reports, and recommendations
- evaluation of internal auditors' performance

When evaluating the objectivity of internal auditors, external auditors are to search for factors under two general headings:

- The organisational status of the internal auditor responsible for the internal audit function;
- Policies to maintain internal auditors' objectivity about the areas audited.

The internal auditors must comply with standards if the external auditor is to rely on the internal auditors' work. The IIA encourages the internal auditors to comply with these standards through The International Standard for the Professional Practice of Internal Auditing, which states: The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

Following this endorsement of coordination, the Standards state that internal auditors should use "a systematic and disciplined approach" to perform all internal auditing work. Then, in similar language to external auditor standards, the internal auditing standards explain what a "systematic and disciplined approach" is. The wording is so similar to what external auditors look for that by complying with the IIA standards, the internal auditors will also be complying with external auditing requirements.

Internal auditors who understand the internal and the external auditing standards will be able to make sure the work they perform meets the necessary regulatory requirements so the external auditors can rely on their work. Understanding the standards will help to lessen duplicated work and thereby increase efficiencies.

Dispel Myths

Corporate myths destroy many coordination efforts before they begin. Two particularly damaging myths are the idea that the internal audit staff does not have the time or the resources to coordinate with the external auditors.

In a survey performed by Felix et al. (1998) the majority of internal auditors surveyed disagreed with the statement:

- Internal audit did not have time available at the end of the year, to provide assistance to the external auditors during the financial statement audit.
- Internal audit did not have resources available to complete work, which could be used by the external auditors as part of the financial statement audit.

Most internal auditors recognize that the additional time and money required to perform tasks in a manner that external auditors can rely on is minimal. Often, all that is required is for the internal auditor to consider how external auditors could use test work and to document properly the test work performed so that the external auditor can rely on the internal audit function's work.

Working with the external auditors may even increase the time available to the internal audit department. Respondents in organisations with exceptionally high coordination efforts indicated that internal auditors extensively relied on work performed by external auditors (Felix 1998). The time savings from relying on work performed by the external auditors can meet or exceed the time spent helping the external auditors perform their duties, resulting in additional time to focus on other areas.

Start from the Top

Once the internal audit function has decided to take responsibility to improve coordination and has dispelled any myths in its organisation, it needs to recruit allies. The most powerful ally – the audit committee – must be on board to advance coordination significantly.

The audit committee can exert a tremendous influence on external auditors; however, they often do not realize the importance of auditor coordination. The internal audit department needs to take the initiative to educate the committee on the benefits of a cooperative working relationship between external and internal auditors. To inform members of the audit committee of the potential benefits to coordination, the internal auditing function should show that coordination increases audit effectiveness for the company and efficiency for the internal auditors.

There are several specific benefits that are likely to cause the committee to act. The audit committee should understand that increased audit coverage through coordination lowers the risk of misstatement and fraud; thus, decreasing the risk of personal and corporate litigation (Section 302 of SOA). In addition, improved coordination can enable internal auditors to follow-up more closely on control deficiencies found by the external auditors and increase the rate at which improvements are implemented. By working together, internal and external auditors can exert greater pressure on management to keep them from using over-aggressive accounting principles than each party can exert independently.

While not as critical as improving audit quality, cost savings result from coordination. The audit committee should understand the potential cost savings and could be encouraged to ask management to funnel these cost savings back into the internal auditors' budget.

Once the audit committee accepts the strategy of coordination, the internal auditors can encourage the audit committee to approach the external auditors with a plan on the potential changes the organisation would like to see. If the auditor does not wish to participate, the organisation can seek to find an auditor who is willing to work together to provide superior audit effectiveness and greater cost savings for both parties.

Select Appropriate Targets

Initiating a coordination effort can be an overwhelming process. Identifying potential areas for coordination is usually not the problem; however, limiting the areas to start on usually is a problem. Internal auditors should first focus on targeting areas that will provide the greatest benefits.

When deciding where to focus, the internal auditors should consider the Public Company Accounting Oversight Board's (PCAOB) proposed audit standard concerning section 404 of SOA. This proposed standard separates testing work performed by third parties, including the internal auditors, into three categories.

The first category includes areas where the external auditor cannot rely on any work performed by a third party. Work in this area includes:

- controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements,
- controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the

financial statements (for example, consolidating adjustments, report combinations, and reclassifications),
- controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend,
- walkthroughs.

The second category in the proposed standard stipulates areas that auditors should only rely on procedures performed by a third party to a limited degree. These areas include:
- controls over significant non-routine and non-systematic transactions (such as accounts involving significant judgments and estimates),
- controls over significant accounts, processes, or disclosures where the auditor has assessed the risk of failure of the controls to operate effectively as high.

The third category includes all other work performed by third parties, and the standard specifies that external auditors can rely on this work without specific limitation.

In order to maximize coordination, the internal audit group should focus their time on the first category of test work stipulated by this proposed standard. External auditors have to perform the work regarding these areas and the internal audit should rely on the work performed by the external auditors. The internal audit department can focus their work on the third category of tests and thereby reduce the fee charged by the external auditor. If time permits, the internal auditor can also work in some areas of the second category – always making sure the external auditor can rely on the work and will not have to duplicate the internal auditors' effort.

As both groups successfully carry out targeted coordination, duplicated work will be eliminated. In addition, internal auditors will develop more skill in the areas they are auditing and will perform audits that are more effective. By understanding accounting standards and choosing a specific area of focus, internal auditors will improve the auditing process in their companies.

Increased Communication

Once the internal and the external auditors have agreed to improve coordination, communication becomes critical. The success of the entire effort hinges on the communication level established. Again, the internal auditing department should be proactive and initiate communication on a regular basis.

Proper communication encompasses more than meetings. Although formal meetings are important, informal meetings, e-mail, phone calls, and other forms of communication are necessary to work together on a continuous basis. Often overlooked, communications during the early part of the year and the financial quarter will result in greater external auditor reliance when they perform the audit. Internal auditors should request to meet with key members of the external auditing team early in the financial year to coordinate a year long effort.

The frequency of communication between internal and external auditors depends upon the size of the organisation and the amount of coordination that is currently taking place. Formal meeting times should be established throughout the year where goals can be set and reviewed. In addition, relatively constant communication throughout the year should ensure both parties stay focused on improving the audit coverage in the organisation.

Instigate Training

Research indicates that internal and external auditors differ significantly on their appraisal of internal auditors' understanding of the external audit (Felix 1998). External auditors do not believe internal auditors understand the work of the external auditor as much as internal auditors believe they understand the work. Whether warranted or not, this perception must be improved before the external auditors will place significant reliance on the internal auditors' work.

In order to change this perception, internal auditors should seek to follow IIA standards by honing their professional skills. Specifically, the International Standards for the Professional Practice of Internal

Auditing states, "Internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development." Internal auditors can focus efforts to improve their competencies in external auditor methods, vocabulary, and procedures.
Training should help educate internal auditors on the vocabulary and the procedures used by external auditors. While many of the procedures are the same, simple differences in vocabulary could account for the external auditors' lower perceived understanding levels of the internal audit function. The perceived competence of the internal auditors will grow if internal auditors communicate using the same language as the external auditors.

Internal auditors might inquire about the possibility of attending training sessions sponsored by their external auditor. Most large CPA firms provide excellent training to their employees and adding a few internal auditors at several meetings would enable them to learn along with the external auditors. Attending external auditor training would improve the competency of the internal audit staff and increase external auditors' confidence in the abilities of the internal auditors.

The best way to improve the external auditors' perception of the internal auditors' competency is by gaining professional certifications. The Certified Internal Auditor (CIA) and Certified Public Accountant (CPA) designations prove that the internal auditor has attained to a high level of professional competency. External auditors will feel more comfortable relying on the work performed by individuals who have demonstrated their professionalism by acquiring professional certifications.

Through a focused training effort, companies will increase both the perceived and the actual competency of their internal auditors. As internal auditors communicate with external auditors on their level, the external auditors will be more likely to rely on work performed by the internal auditors – resulting in improved audit efficiency and effectiveness.

CONCLUSION

Internal auditors stand in a unique position to help improve investors' confidence after the corrupt and dishonest acts of companies like Enron and WorldCom. A step to help quicken the restoration of confidence is for internal auditors to improve audit effectiveness and efficiency by coordinating their efforts with external auditors.

The passing of SOA offers an excellent opportunity for internal auditors to improve coordination efforts. The SOA requires companies to disclose more information and to increase the testing to make sure the disseminated information is accurate. Through coordination, the internal auditors can team with external auditors to improve shareholders trust in the information companies release.

Seven steps (as enumerated above) will help the internal auditing department improve coordination efforts. These steps become a cycle of continuous improvement when an organisation dedicates itself to improving audit quality.

Although individuals will continue to commit fraud, organisation can consistently follow these seven steps to improve coordination between internal and external auditors. A coordinated audit approach will improve stakeholders' trust in the organisation and decrease costs – thus adding long-term value to an organisation.

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