

Effectiveness of Internal Audit

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Abstract: Ever since the last two decades of the 20th century and the beginning of the 21st century, the accounting and auditing profession has faced numerous problems resulting from the collapse of major public shareholding companies in the United States, the United Kingdom, Canada, Australia and other countries, and the loss of billions of dollars, and the failure of external auditors, but some collusion in the disclosure of such abuses, and take appropriate professional action, as well as the decline of the role of internal auditors to play an effective role in the face of the phenomenon of financial corruption attributable to those companies, despite the tremendous professional and technical developments that supported the audit profession both internal and external. The internal audit function is one of the cores of the effectiveness of jobs in various economic projects, the most important means by which rely on modern scientific management in the provision of data and information accurately and orderly and needed to make decisions and assist them in examining systems where the evaluation and safety, in the form that allows to be the goals and targets for all areas under revision. In recent years, business environment-organizations have faced rapid changes in expanded regulatory requirements and technological advances. These changes have given the internal audit function a place in the front seat to assist States in fulfilling their responsibilities. That the effectiveness of the internal audit function has become a major support function for senior management, the Board of Directors and the Audit Committee. The head of the Institute of Internal Auditors (Gerry Cox, 2007) says that today's internal auditor works hard with senior management to find solutions, adding that the internal auditor has become more focused on adding value to the organization from finding a mistake.

Keywords: internal audit, efficiency of internal audit

1. Introduction

Organizations have encountered rapid changes in the business environment, expanded regulatory requirements, and technological advancements in recent years. These changes have given internal audit function the front seat to assist organization's members in fulfilling their responsibilities. This view supported by several researchers such as, Ruud (2003) argues that, the internal audit function has become a major support function for senior management, board of directors and its audit committee. Peter Wilson; the IIA president (1988), confirms that, the cooperation between the external and internal auditors is necessary to ensure the most appropriate coverage of all major systems, and more effective reporting of results. Gerry Cox; IIA chairman (2007), says that, the internal auditor these days works hard with the senior management to find solutions. Cox (2007) adds that they focus much more on adding value than finding fault.

2. Internal Audit

2.1 The nature of the internal audit:

This section provides information about the nature of internal audit without exposure to the date of the internal audit, which is outside the objectives of this study.

2.1.1 The concept of internal audit:

The revised definition expands the prospects for internal audit, expanding the scope of work to include risk management, and control governance processes. (Chapman & Anderson, 2002), explained the main changes in the concept of internal audit, as a result of the reformulation of internal audit defined by the Institute of Internal Auditors IIA (1999) In the following important points:

- 1) An internal audit is an objective activity that can be provided both internally and externally. This revised definition allows organizations to obtain quality services for internal auditing through outsourcing.
- 2) By emphasizing that the scope of internal audit includes ensuring advisory activities, new projects of internal audit as an activity definition, focusing on the key issues involved in monitoring and risk management.
- 3) The internal audit aims to add value to the organization and improve the Organization's operations, said the new definition emphasizes the importance of the contribution of an effective internal audit in any organization.
- 4) The revised definition makes the internal audit wide-ranging in the review of the entire organization, to assist the organization to achieve its overall objectives.
- 5) The revised definition broadens the scope of the internal audit, extending its scope to include risk management and oversight of governance processes.
- 6) The revised definition clarifies that the internal audit profession is based on professional standards and internal audit standards and is presented on the basis of a systematic, documented and disciplined process that emphasizes the quality of internal audit performance.

2.1.2 Scope of internal audit:

The scope of the internal audit is determined as follows:

- 1) Review the reliability and reliability of financial and operational information and the means used to identify, measure and classify such information.
- 2) Review systems based on ensuring compliance with these policies, plans, procedures, laws, and regulations that can have a significant impact on processes and reports and whether the organization is in compliance.
- 3) Review and assess the economic and efficient use of resources.
- 4) Review of operations or programs to ascertain whether the results were consistent with the goals and objectives,

- and if the processes or programs that are implemented as planned.
- 5) Review of specific operations at the request of the Auditor Management Committee, as appropriate.
 - 6) Monitor and evaluate the effectiveness of the risk management system of the Organization.
 - 7) Review of the quality of performance of the external auditors, with a degree of coordination with internal audit.
 - 8) Review the internal audit statement from the senior management regarding the audit opinion and the planning of the audit process.

2.1.3 Internal audit effectiveness and corporate governance:

The effectiveness of corporate governance need coordination and cooperation between the four parties:

- 1) Audit Committee
- 2) Senior management
- 3) External Auditors
- 4) Internal auditors

(Carcello et al., 2005), They pointed out that the internal audit function unique opportunity to work an important role with other parties for the management of companies. (Stewart & Bouckaert, 2006). That the existence of the internal audit function in the organization has a positive relationship with the strengthening of corporate governance.

(Stewart & Bouckaert, 2006) They noted that it was difficult for audit committees to be effective without the support of internal audit. They explained that there is considerable scope for strengthening the relationship between internal auditors and audit committees and external auditors.

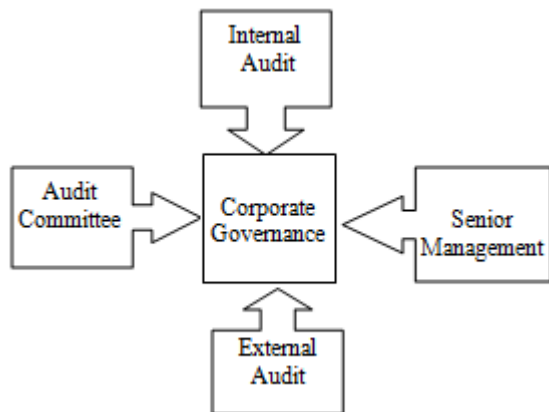


Figure 1: Elements of effective corporate governance
 Source from Staciokas & Rupsys (2005)

Recently (Bostan & Grosu, 2010) noted that the role of the internal audit company is of primary importance to corporate governance in this area. (Gramling et al., 2004), explaining that this depends on the effectiveness of internal audit functions, "assurance of management's advisory and risk management", as quoted from Whitley (2005), providing examples and steps that internal auditors can take to improve corporate governance Like:

- 1) Assist the Board in its self-assessment management.
- 2) Bringing the best ideas and practices on internal controls and risk management processes to the Audit Committee.
- 3) Looking for activities that can reduce long-term costs.

- 4) Review the organization's conduct of ethics and behavior policies.
- 5) Conduct annual audits of follow-up operations and report the results to the Audit Committee.
- 6) Address the objectives of disclosure and transparency in the annual audit plan.

(Bookal, 2002) noted the need and importance of internal audit in corporate governance through WorldCom, for example, where the doubtful debts account was \$ 3.8 billion discovered by internal auditors who presented this to the Chairman of the Audit Committee, Financial action to take corrective action. Based on the above discussion, the role of internal audit effectiveness in corporate governance is clear, internal auditors to help Members fulfill their responsibilities by taking a more holistic view of corporate status, harmonizing internal audit skills for activities, evaluation, and improvement, and reviewing their organizations' corporate governance capacities. Today internal auditors need to understand corporate governance structures, and where the internal audit function can support the organization.

3. The Relationship between Internal Audit and Organization

3.1 Internal Auditor and Senior Management.

The trend to support the relationship must exist between senior management and internal audit in helping each other in fulfilling their responsibilities. An internal audit by the revised IIA definition in 1999 makes the main objective of internal audit, adding value to the organization, improving the organization's operations and achieving a disciplined methodology for evaluating and improving the effectiveness of risk management, control, and governance. The effectiveness of internal audit leads to improvements in both the internal control system and corporate governance, and as a result, the performance of senior management is improving. IIA audit management requires senior management to provide adequate internal audit support.

First: Senior management should be supported by auditors who are involved in the continued objectivity of their business without any interference in determining the scope of the internal audit, or in the performance of work and delivery of results, see paragraph 1110 of the IIA Audit Standards. Appropriate support for internal audit in day-to-day activities See paragraph 1110 of the IIA Standards.

Second: It must be the internal audit on an open and direct with the senior management Connection Manager (see paragraph 1320 of Internal Auditors IIA standards).

Third: the Director of Internal Audit considers senior management input, the internal audit manager must deliver the plan and resource requirements for internal review of senior management for approval of each audit should be through internal audit planning (see paragraph 2010.A1 standards IIA) (see paragraph 2020 standards IIA), and the internal audit manager should communicate the plan and resource requirements for internal audit. (Sarens & Beelde,

2006) presented the relationship between senior management and internal auditing as follows:

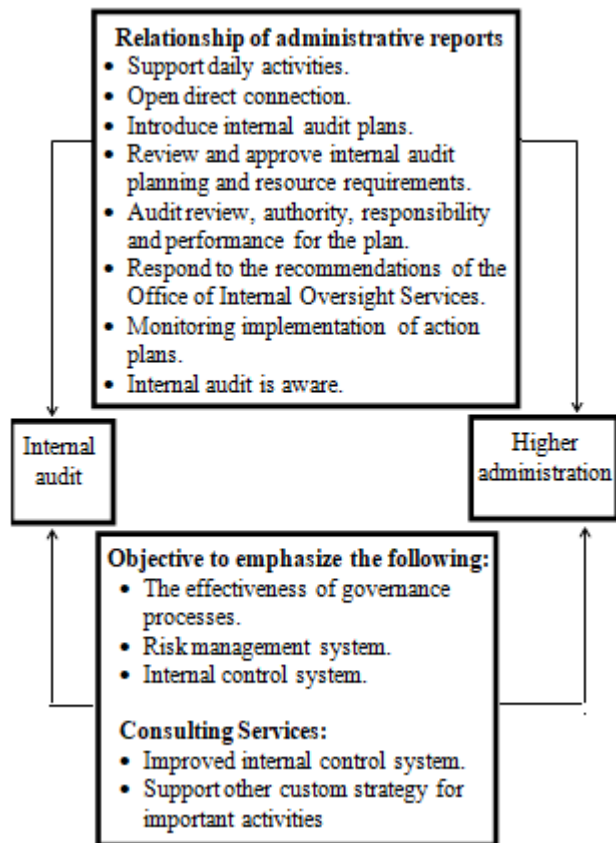


Figure 2: Source from soreness & build (2006)

(Peter, 1994) Explained that the relationship between internal auditors and senior management needed to work closely to ensure a higher level of understanding and to eliminate erroneous assumptions (Peter, 1994). (Sarens&Beelde, 2006), based on five case studies within Belgian companies, found that senior management expectations are significantly affected by an internal audit performance, and internal audit meets most of these expectations.

The results of the study also indicate that senior management expects internal review:

- 1) Compensation for loss of management due to regulatory complexity.
- 2) To be a guarantee of corporate culture through personal contacts with people.
- 3) To be a supportive function in monitoring and improving risk management and internal control system.
- 4) To be a training ground for future managers.
- 5) Collaborate with external auditors to increase overall audit coverage. In terms of internal auditors, senior management is expected to take the first step in formalizing the risk management system as they seek support and general acceptance from senior management.

3.2 Internal Auditor and Audit Committee.

Audit committees and internal auditors have common goals, a strong relationship of support between them and help each other in fulfilling their responsibilities. (Martinov-Bennie, 2009) and (Soh) emphasizes the most important

interdependence between them and the strong relationship between the Audit Committee and the Internal Audit function.

(Sarens et al., 2009), and confirm that regular meetings between the Audit Committee and the Internal Audit function, enhance the knowledge of the Audit Committee on issues related to both accounting and auditing functions.

(Sarens et al., 2009), considers effective internal audit as an important resource for the Audit Committee in discharging its responsibilities (Davies, 2009), emphasizes that it is important for both the Audit Committee and the Internal Audit function to act as a team to be effective.

The internal auditor, in order to obtain an effective relationship between the internal auditor and the audit committee, requires the internal audit manager to provide the following integrated activities: (1) The periodic review of the risks faced by the organization was sent to the audit committee. (2) Assist the Audit Committee with respect to the Charter of the Commission and appropriate activities and processes. (3) Ensure that the Internal Audit Charter, its role, and activities are consistent with the needs of the Audit Committee. (4) Maintain open and effective contacts with the Audit Committee. (5) Provide training to members of the Audit Committee on risk and internal control issues.

By the Audit Committee, for internal audit independence, the Internal Audit Director should report to the Audit Committee in order to obtain appropriate support to achieve operational activities for internal audit (see paragraph 1110 of the Institute of Internal Auditors IIA). Also, the Internal Audit Manager should communicate and interact directly with the Audit Committee (see paragraph 1111 of the Institute of Internal Auditors IIA). When the Audit Committee agrees to appoint and dismiss the Internal Audit Director, independence becomes further support. In order to communicate effectively with the Audit Committee, the Internal Audit Manager should be in open contact with the Audit Committee (see paragraph 1320 of the IIA Criteria). The Internal Audit Director shall also meet in secret with the Audit Committee. These meetings, assist the internal audit manager to present the audit plan, report on the results of the major audits and the main audit findings or other issues. To improve internal audit performance, the internal audit manager should consider the inputs of the audit committee during the preparation of the internal audit planning (see paragraph 2010A1. IIA). The internal audit manager should also communicate internal audit activities, plans and resource requirements, including changes and transfers Task for internal audit personnel and approval by the Audit Committee (see paragraph 2020 of the IIA Criteria), the Audit Committee should approve and periodically review the Internal Audit Charter, the document approved by the Administration that provides for the purpose of internal audit, duty and responsibility.

The Audit Committee shall review annually the objectives of the Internal Audit Department, the audit schedules, the staffing plans and the financial budgets. The Internal Audit Director shall inform the Audit Committee of the results of

the audits and highlight the important audit findings and recommendations.

Through the above-mentioned discussions on the relationship between internal audit, senior management, and the Audit Committee, it is clear that there are competing claims from senior management and the Audit Committee. Senior management wants the internal auditor to provide consultation assurance based on operational skills to address risk and evaluate the efficiency of operations, and stimulate organizational action.

3.3 Coordination and cooperation between internal and external auditors

Coordination and cooperation have become a necessity for both internal and external auditors, and the requirement of professional bodies such as AICPA, SAS No. 9, No. 65 SAS, SOX, Article 404, IFAC, ISA 610 and IIA standards, paragraph 2050. (Al-Twajry et al., 2004). He explained in the study of the level of coordination and cooperation between companies, between managers of internal audit departments and managers of external audit firms. Internal auditors rely on cooperation between internal and external audit, although external auditors are more positive about the extent of cooperation when the internal audit management is of high quality. This subsection discusses the benefits of coordination and cooperation, the system of internal control, coordination and cooperation on external audit fees, and the role of the Audit Committee in such coordination and cooperation.

3.4 The benefits of coordination and cooperation between internal and external auditors:

The main benefit of coordination and cooperation between internal and external auditors is to enhance audit effectiveness, as well as to reduce audit costs. This format includes messages related to asset control and fraud risk. (Schneider, 2009), explained the use of coordination and cooperation with external auditors, focusing on the internal auditors' knowledge of the WMO environment system rather than the external auditors, because internal auditors were more able to detect fraud from external auditors.

(Kpmg's Fraud Survey 2003), the survey to study the fraud, in the case of fraud in the government and industry in the United States study found (Kpmg's Fraud Survey, 2003), that 65% of the fraud was discovered in 2003 by internal auditors, while only 12% were discovered by External Auditors.

(Engle, 1999) points to three important benefits of coordination and cooperation between internal and external auditors, including (1) Useful review, which contributes significantly to the achievement of the objectives of the Organization. (2) That, the external audit is able to rely on the work of the internal auditors, this provision leads to significant reductions in the cost of the external audit. To further utilize this coordination and cooperation of the external auditor in the relationship with senior management in reducing the differences that may ascend from the application of accounting principles, also strengthening this

understanding can lead to further recommendations for external audit (Engle, 1999).

(Lin et al., 2010), based on data collected from 214 US companies, found that the material disclosures and weaknesses reported under Section 404 of Sarbanes-Oxley Act 2002 may be positively correlated with coordination between internal and external auditors.

3.5 Auditors and internal control system:

Several requirements have been requested for the evaluation of the internal control system, such as AICPA (SAS No. 55 and SAS No), SOX (Section 404) and the International Federation of Accountants (ISA, 400).

(Amudo & Inange, 2009) pointed to the lack of an effective internal control system often leads to organizational failure. Both internal and external auditors have a common goal of assessing the internal control system, and they have the responsibility to do so. However, they have different objectives for this evaluation, the external auditor aims to apply the second criterion of fieldwork standards, assess risk control, and determine the sample of the audit. While the objective of the internal auditor is to give some recommendations that help in developing and improving the internal control system. One of the main objectives of the auditors is to assess the internal control system, and coordination and cooperation between internal and external auditors are essential for the achievement of such an assessment. Such coordination and cooperation should also improve the effectiveness of audit activities. This will be the purpose of the discussion at the next point.

Presented a study by (Frank, 1980), this relationship is as follows:

Relationship between auditors and internal control system

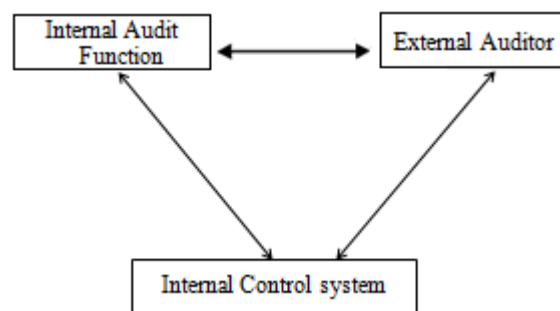


Figure 3: Source from: Frank, (1980)

3.6 The Role of the Audit Committee on Coordination and Cooperation between Internal and External Auditors

The existence of an effective review committee can enhance coordination and cooperation between internal and external auditors. We can recognize that one of the objectives of the Audit Committee is to lend credibility to the provision of financial information, between the internal audit process and the external audit process (Zain, 2005).

The Audit Committee also aims to facilitate communication between senior management and internal and external auditors of the Organization (Zain et al., 2004), as follows:

Relationship between the Audit Committee and internal auditors

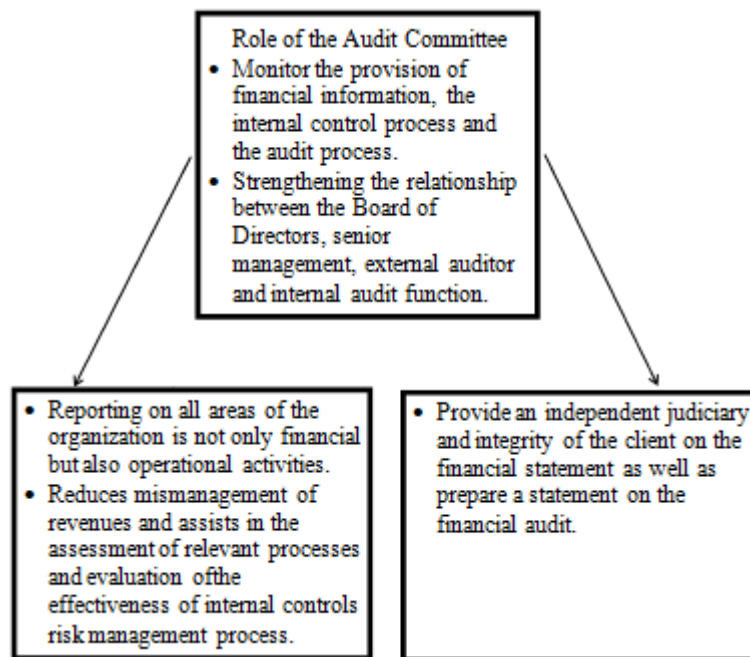


Figure 4: Source: Zain, (2005)

(Zain et al., 2004) Studied the Audit Committee's impact on the characteristics of internal audit and on the contribution of the internal audit function to the financial report and audit was examined, based on survey data from the internal auditors of (76) companies listed on the Malaysian Kuala Lumpur Stock Exchange. The results indicate that the Audit Committee Impact on the relationship between internal audit and external auditors. The foregoing discussions indicated that senior management and the Audit Committee differed in their requests from the internal audit entity.

Senior management wants the internal auditor to provide consultation assurance based on operational skills to address risk and evaluate the efficiency of operations, and stimulate organizational action.

On the other hand, the Audit Committee is more concerned about the controls and regulations of the organization's income. (Hermanson&Rittenberg, 2003). It can be said that it is complementary in roles between the Audit Committee, the Internal Audit function, and external auditors. The audit committee should monitor and coordinate audit activities. Cooperation between internal and external auditors should also be used to assist each other in achieving their objectives in effective ways. Open and direct communication between them has a strong impact on enhancing the effectiveness of audits.

Based on the above in this section, we can conclude that there is a supportive relationship between the internal audit and the members of the organization. Significant support from senior management Management should not interfere with internal audit procedures or weaken the internal audit independence. In addition, the effective audit committee enhances the independence of internal audit and coordinates cooperation between internal and external auditors. This

cooperation helps both internal and external auditors to achieve their objectives in an effective manner. Open and direct contacts between internal auditors and members of the organization have a strong impact on enhancing the effectiveness of audits.

4. Internal Audit Effectiveness

In the previous section, it was to clarify the relationship between internal auditors and members of the organization, in short, support the members of the organization would enhance the effectiveness of the internal audit, internal audit, without this support becomes unable to function to be effective. This aspect discusses the effectiveness of the internal audit function.

4.1 The concept of effectiveness of internal audit function

Efficiency is essential for all control functions, without one of the main reasons for its existence will be lost. The Internal Audit function is one of these purposes, the issue of effectiveness is a key issue for the internal audit function and its auditors to contribute to the achievement of the objectives of their institutions. In general, specific effectiveness must be available to achieve objectives (Dittenhofer, 2001). There is, however, a synergy between efficiency and effectiveness, which simply means that any financial or non-financial process must benefit from the cost. (Mousa, 2005) states that effectiveness is a guarantee to achieve the objectives of the organization, to achieve the pre-defined goals and to increase the production of these inputs, but production should meet predetermined objectives. While (Blackburn, 2003), you should not focus on the lowest cost, but at the lowest cost specific quality. That was Mentioned in (Mousa, 2005) to explain the meanings of the four

efficiencies, effectiveness, economy and justice concepts are as follows

The theory of the four concepts

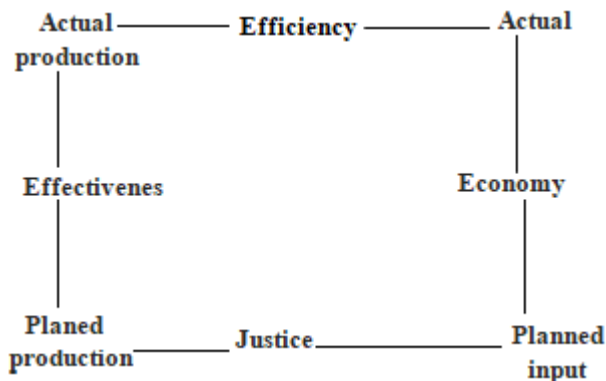


Figure 5: Source from Chambers et al, (1987)

(Chambers et al., 1987), explained these concepts are as follows:

- 1) Effectiveness: Compare actual performance with planned performance.
- 2) Efficiency: Ratio of resource consumption to produce benefits.
- 3) Economy: resources consumed towards planned consumption.
- 4) Justice: The net effect of the institution on society and the environment.

4.2 Measuring the effectiveness of internal audit function:

Even today, there is no agreement on how to measure the effectiveness of internal audit. The distribution of researchers on the effectiveness of internal audit As mentioned (Arena &Azzone, 2009), the three groups in their opinion on this measurement as follows: the first group on the relationship of the effectiveness of internal audit with the quality of internal audit procedures, the second group on internal audit and the relationship of effectiveness of the output of The internal audit activities while the third group related to the results of the audit activities.

(Arena &Azzone, 2009), conducted a study were measured the effectiveness of internal audit in terms of the percentage of recommendations made by internal auditors and implemented by senior management. I found that the internal audit function is most effective in the Malaysian public sector when there is: (1) a legal requirement for the establishment of an internal audit function. (2) A strategy for the development of qualification of internal audit staff. (3) Support from senior management and the presence of the Audit Committee. (4) The Central Internal Audit Policy Unit (a professional body) to develop guidelines, develop community and disseminate best practices. (Van-Gansberghe, 2005) identified six key themes in building an effective internal audit process. Six key themes were identified in the effective building of internal auditing: (1) the concept of ownership. (2) Organization of the governance framework. (3) Law. (4) Improve professional efficiency. (5) Conceptual framework. (6) Resources.

(Gramling et al., 2004) suggested that internal auditing can be considered effective when the quality of internal audit has a positive impact on the quality of corporate governance.

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