

Issue 8

GLOBAL PERSPECTIVES AND INSIGHTS

Internal Audit and External Audit

Distinctive Roles in Organizational Governance

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Contents

| | |
|-------------------------------------|---|
| Executive Summary | 3 |
| Functions..... | 4 |
| Roles..... | 4 |
| Identifying and Managing Risks..... | 6 |
| Closing Thoughts | 7 |

Internal Audit and External Audit

Distinctive Roles in Organizational Governance

Executive Summary

The interests, roles, responsibilities, and activities of internal auditors and external auditors are complementary and sometimes similar; in some cases, they overlap at one point or another. For example, the overlap between an internal auditor and an external auditor may include carrying out an efficient analysis of transactions; becoming intimately familiar with an organization's governance, risk management, and internal control systems; and sharing and developing accurate final reports.

This is not a surprise; each role is based on a professional discipline and operates to that discipline's standards. As such, the external auditor's professional concerns include the inaccuracies and misstatements that affect final

business accounts (financial information). Internal auditors are concerned with the wide range of governance, risk management, and internal controls (nonfinancial information). Keep in mind, internal audit and external audit do not compete and they do not conflict; rather, one complements the other. Both are crucial to good governance, and they should meet at some point and work together.

However, there are distinct differences in the roles, and certainly in the boundaries of the work that they perform. The differences, summarized below, are often under-recognized, and are perhaps even misunderstood and confused by stakeholders.

| Key Differences Between Internal and External Audit | | |
|---|---|---|
| | Internal Audit | External Audit |
| Purpose | Analyze and improve controls and performance | Express an opinion on the financial condition |
| Scope | Organizational operations | Fiscal financial records |
| Skills | Interdisciplinary | Accounting, finance, tax |
| Timing | Present/future, ongoing | Past, point in time |
| Primary Audience | Board, executive management | Investors, public interests |
| Standards | The IIA's <i>International Standards for the Professional Practice of Internal Auditing</i> | Generally Accepted Auditing Principles, Generally Accepted Auditing Standards |
| Focus | Enhance and protect organizational value | Fair representation of financial statements |
| Employment Relationship | An organization's employee | A contracted third party |

Functions

Define and Distinguish

The internal auditor and the external auditor, jointly, are indispensable for good governance, with the internal auditor focusing on all nonfinancial information.”

—John Bendermacher, IIA–Netherlands

Internal Audit

The IIA defines internal auditing as “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.”

- Internal audit professionals have backgrounds in various academic disciplines, and no single discipline is required.
- According to The IIA, an internal audit engagement is “a specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.
- Internal auditors are employed by the organization, but are independent of the activities they audit. Because independence is imperative to be effective, the internal auditor ideally reports directly to the board.
- Internal auditors must conform with The IIA’s *International Standards for the Professional Practice of Internal Auditing*.

External Audit

On the other hand, external auditors are professional accountants.

- According to the International Federation of Accountants (IFAC), an audit engagement is “a reasonable assurance engagement in which a professional accountant in public practice expresses

an opinion whether financial statements are prepared, in all material respects (or gives a true and fair view or are presented fairly, in all material respects), in accordance with an applicable financial reporting framework, such as an engagement conducted in accordance with International Standards on Auditing. This includes a Statutory Audit, which is an audit required by legislation or other regulation.”

- Unlike internal auditors, external auditors are not employees of the organization — they are third parties, and therefore, have no vested interest in the organization.
- Globally, external auditors are guided by the International Auditing and Assurance Standards Board (IAASB) International Standards on Auditing.

Roles

There Really Is a Difference

“A well-resourced and independent internal audit function is uniquely positioned inside organizations to provide objective assurance on the risks that matter most.”

—Carolyn Saint, IIA–North America

In some jurisdictions, an internal auditor is made *mandatory* by corporate governance codes or regulatory rules. This is a recognition of internal audit’s value to an organization. Internal audit saves organizations money, protects reputations, and paves the way to success. At its simplest, internal audit identifies the risks that could keep an organization from achieving its goals, alerts leaders to these risks, and proactively recommends improvements to help reduce the risks. Examples include:

AUDIT FOCUS

IIA Standard 1100: Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

- Detect wasteful spending.
- Identify red flags.
- Verify records and financial statements.
- Assess compliance with rules and regulations.
- Investigate fraud.
- Promote ethics.
- Inform senior management and the board.
- Identify risks and provide assurance over controls.

Internal audit *partners* with management and the board, and focuses on the complete health of the organization, which includes serving the overall needs of the organization, focusing on present and future events of the organization, and ensuring the accomplishment of goals and objectives. The external auditor's primary function — again as a third party — is to provide an opinion on whether the accounts show a true and fair view of the financial statements, and they are incidentally concerned with the prevention and detection of fraud. Beyond those basic functions, an external auditor provides no deeper benefit to the organization.

An organization should never consider using an external auditor to perform the internal audit function. This line of thinking is very dangerous.

External audit firms do not drill down into the organization's governance, risk management, and internal control operations; if for no other reason than, the purpose and the role does not require it. The external audit function is active only annually (at year-end), and is not able to provide immediate and preventative advice and insight into what will add value to an organization — external audit is completely independent of the organization.

"In my experience, I have found that internal auditors communicate why things need to change, and then follow up with mentoring and training of staff across the entire organization."

—Karem Toufic Obeid, IIA–United Arab Emirates

In contrast, internal audit has a constant presence in the organization. Unlike external auditing, internal auditing serves the needs of the organization through its

AUDIT FOCUS

IIA Standard 2070: External Service Provider and Organizational Responsibility for Internal Auditing

When an external service provider serves as the internal audit activity, the provider must make the organization aware that the organization has the responsibility for maintaining an effective internal audit activity.

dedication to all controls *fundamental* to achieving the organizational objectives: governance, risk management, and internal control, and nowadays, more and more, also to covering culture and behavior. Its overall mission concerns providing organizations with assurance on and insight into their business practices, thereby enhancing organizational value.

To this end, internal audit advises management and the board on governance, risk management and control processes, and discusses — on more than an annual basis — the subject of sound internal control systems. To be effective, internal audit suggests improvements to management. As employees of the organization, internal audit has a vested interest in the organization's competencies in these areas.

"Internal audit needs to provide the board with insight into the nature and roles of all assurance providers, including internal and external auditors, and second line of defense functions."

—Hans Nieuwlands, IIA–Netherlands

While internal and external auditing techniques are similar, the intended outcomes vary greatly. For example, voicing concern if there is no understanding about the importance of procedures may be addressed differently by an internal auditor and an external auditor because of differing objectives. According to The IIA, internal audit's mission is "to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight." Internal audit's attention is on whether an organization's

business practices are assisting the business to meet *all* of its objectives, while recognizing and managing its risks — those that are obvious, and those that are not so obvious.

Identifying and Managing Risks

The Three Lines of Defense Model

“Audit committees need operational information, and although external audit’s role is outside of the Three Lines of Defense, it is in a position to ‘watch the perimeter.’ That contribution is vital and complementary.”

—Nur Hayati Baharuddin, IIA-Malaysia

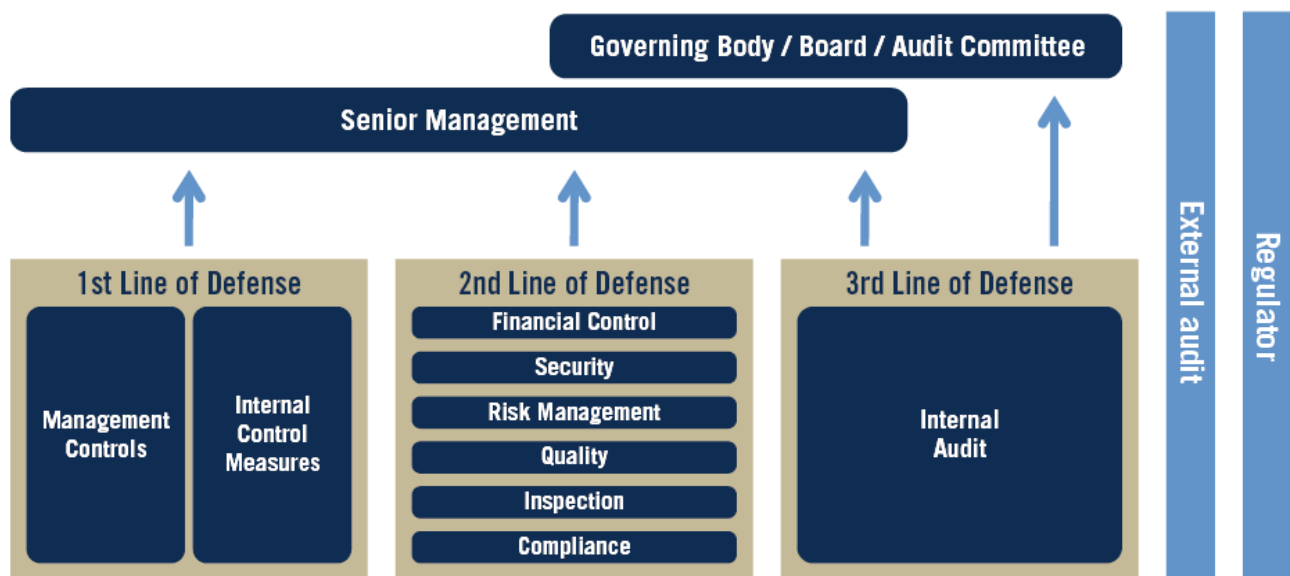
Anything important is worth protecting. Unrecognized risks will negatively affect an organization sooner or later. The IIA Position Paper “The Three Lines of Defense in Effective Risk Management and Control” discusses the fact that “duties related to risk management and control must be coordinated carefully to assure that risk and control processes operate as intended.” Further, the position paper provides direction to clarify important roles and duties to develop those risk management

initiatives. It states, “Establishing a professional internal audit activity should be a governance requirement for all organizations. This is not only important for larger and medium-sized organizations, but also may be equally important for smaller entities, as they may face equally complex environments with a less formal, robust organizational structure to ensure the effectiveness of its governance and risk management processes.”

The Three Lines of Defense model, illustrated below, states, “Without a cohesive, coordinated approach, limited risk and control resources may not be deployed effectively, and significant risks may not be identified or managed appropriately. Clear responsibilities must be defined so that each group of risk and control professionals understands the boundaries of their responsibilities and how their positions fit into the organization’s overall risk and control structure.”

Operational management, the first line of defense in risk management, is responsible for maintaining effective internal controls on a day-to-day basis. The controls are designed and executed under management’s guidance, and performed by their employees (e.g., accounting). *Risk management, compliance, and other functions* — again established by management — comprise the

The Three Lines of Defense Model



Adapted from ECIIA/FERMA *Guidance on the 8th EU Company Law Directive, article 41*

second line of defense, which supports management policies and assists risk owners to define target risk exposure within multiple compliance functions (e.g., safety, supply chain, etc.).

The second line of defense is responsible for disseminating risk-related information throughout the organization. Internal audit is solely the third line of defense, and actively and continuously contributes to effective organizational governance, risk management, and internal controls (e.g., operations, assets, regulations, contracts, etc.). Internal audit provides independent assurance, and assesses the effectiveness of the processes created in the first and second lines of defense. External audit's role is outside of the model, but it is important to have for assurance over financial reporting processes.

Working Together

"Internal audit partners with management and the board, and focuses on the complete health of the organization."

—Ana Cristina Zambrano, IIA-Colombia

The January 2017 *Internal Auditor* magazine article "Mapping Assurance" stated it plainly, "When it comes to providing assurance, internal audit isn't the only player in the game. Boards and executives seek assurance information on the effectiveness of an organization's governance from a variety of internal and external sources, including external auditors."

Identifying risk is one of the most important tasks to perform while conducting an audit. The U.S. Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* suggests that while external auditing's role is outside of the Three Lines of Defense model, risks (e.g., operation, compliance, strategic, and reputation) can be identified by both internal auditors and external auditors. The difference is that external auditors take no action to help eliminate the risk.

Recognizing the difference in roles and duties, internal and external auditors, in many instances, already work together. They work together to not only cover the full area of financial and nonfinancial information, but also to avoid unnecessary overlap in execution of audit

AUDIT FOCUS

IIA Standard 2050: Coordination and Reliance

The chief audit executive should share information, coordinate activities, and consider relying upon the work of other internal and external assurance and consulting service providers to ensure proper coverage and minimize duplication of efforts.

procedures by sharing risk assessments, reports, and other information — formally and informally. Internal and external audit working together increases the effectiveness of the total audit efforts made, and is beneficial to the board and the audit committee.

As stated earlier in this report, the internal auditor's interests and responsibilities and the external auditor's interests and responsibilities complement one another, which is a good practice. The Implementation Guide for Standard 2050 states, "The CAE meets with each of the providers to gather sufficient information so that the organization's assurance and consulting activities may be coordinated."

"Allies in Governance 2.0," published by IIA–Netherlands (2016) states, "The roles of the external auditor and the internal auditor go hand-in-hand. Clear positioning, optimum collaboration, and knowledge sharing are key in this respect."

Closing Thoughts

Internal Audit: Constant and on Behalf of the Organization

"Internal audit reports on the overall health and well-being of the organization, and is indispensable to effective governance, risk management, and control."

—Lesedi Lesetedi, African Federation IIA

In closing, effective organizational governance requires a robust, independent internal audit function — a very necessary part of healthy, successful business practices.

Internal audit's efforts are purposely centered on governance, risk management, and internal control. As employees of the organization, albeit in an independent role, internal auditors are fully vested in the organization's successes, and their concern is to cover *all* organizational operations on a continuous basis. At the conclusion of an audit engagement, internal auditors are careful to deliver thorough "made-to-order" reports to the board and/or audit committee that include specific and detailed conclusions about how risks and objectives are currently known and being managed.

In addition, internal audit's reports include well-thought-out suggestions for continuous improvement, and help the entire organization accomplish goals and objectives to improve internal control and eliminate identified risks. The bottom line? Internal audit is *the key*. To ensure that an organization creates short-, medium-, and long-term value, internal auditing is the undeniable answer, and the internal audit function is best performed by *qualified individuals* working within a well-resourced and independent internal audit function.

For More Information

- International Federation of Accountants (IFAC), "Handbook of the Code of Ethics for Professional Accountants," 2010 (www.ifac.org).
- The IIA "Implementation Guide 1100: Independence and Objectivity," available to members only, January 2017 (www.theiia.org).
- The IIA "Implementation Guide 2070: External Service Provider and Organizational Responsibility for Internal Auditing," available to members only, January 2017.
- The IIA Position Paper "The Three Lines of Defense in Effective Risk Management and Control," 2013 (www.theiia.org).
- The IIA *Internal Auditor* magazine "Mapping Assurance: Internal auditors can facilitate efforts to document the organization's combined assurance activities," Y.S. Al Chen, Loïc Decaux, and Scott Showalter, Dec. 2016 (www.theiia.org).
- The IIA "Implementation Guide 2050: Coordination and Reliance," available to members only, January 2017 (www.theiia.org).
- IIA–Netherlands, "Allies in Governance 2.0: Towards a sustainable relationship between the Audit Committee and the Internal Audit Function," September 2016 (www.iaa.nl).

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 190,000 members from more than 170 countries and territories. The association's global headquarters are in Lake Mary, Fla., USA. For more information, visit www.globaliia.org.

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