

IMPACT AND IMPORTANCE OF INTERNAL AUDIT IN SUCCESSFUL MANAGEMENT OF THE ENTERPRISE

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Abstract

Internal audit is an independent activity to provide objective assurance and advisory activity, designed to add value and improve an organization's operations. Internal audit helps an organization to accomplish its objectives by promoting a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, controls and governance processes. Lack of transparency in companies' financial statements lead to the financial crisis. Continuous monitoring is a process that must be evaluated by the internal auditor, in order to monitor whether management is acting on the basis of business policies, procedures and processes, namely whether it is operating effectively.

Economic growth and globalization of businesses, market pressure to improve the operations, rapidly changing business environment created the need for control in order to ensure that examinations are effective and the risk is detected properly. In order to meet these needs internal auditors are using continuous audits to maximize the efficiency of their work. The auditor maintains independence of internal audit and objectivity in evaluating the effectiveness of controls, risk management, and governance processes.

The internal audit is designed to provide reasonable assurance regarding the achievement of key objectives such as:

- * Effectiveness and efficiency of operations.
- * Reliability of financial reporting and management.
- * Compliance with laws and regulations.
- * Preservation of assets.

The complexity and size of the organization makes it impossible for senior managers to personally monitor whether the organization is carrying its activity effectively. To ensure that the organization is functioning effectively it is relevant for the organization to have the internal audit services.

Keywords: Internal Audit, organization, management, effectiveness, and governance controls.

1. INTRODUCTION

The role of internal audit is very important and related to successful management of both public and private enterprises and is twofold.

- It monitors the overall management policies of the company in order to ensure that there is effective functioning.
- It monitors strategies implemented in order to make sure that the company will continue to function in an effective manner.

An important management policy for companies is to implement internal controls. The internal audit plays a key role in assessing systems and testing control systems. Internal audit can assist in developing systems. Nevertheless, the key role will be in monitoring the overall process and in provision of safeguards for department systems to act in effective manner. The Internal Audit System safeguards its objective.

The Mission of the Internal Audit System is to provide independent, objective, assuring and advisory services designed to add the value and improve operations of the organization. It helps the organization to achieve its objectives by taking systematic and disciplined approach in assessing and improving the effectiveness of risk management, control and governance process.

The scope of work of the Internal Audit Department is to determine whether the network of the organization used for risk management, control and governance processes designed and represented by the management, is adequate and works in a manner which ensures that:

- risks are identified and managed properly;
- interaction with different groups of governance occurs as needed;
- sufficient financial, managerial and operative information are accurate reliable and timely;
- actions of employees are in line with policies, standards, procedures and applicable laws and regulations;
- sources are ensured in an economic manner, are used efficiently and are protected in an adequate manner;
- plans and objectives are accomplished;
- the quality and constant improvement are promoted through organization's control process; and
- important legislative or regulatory issues with an impact in the organization are accepted and addressed properly.

Opportunities for beneficial improvement of management control and organization image can be identified during an audit. They will be communicated in adequate levels of management. (CENTRAL UNIT FOR HARMONISATION OF INTERNAL AUDIT)

1.2 Research questions

- What is the role of internal audit in effective management of the organization
- Is audit a preventive measure against frauds and errors
- What is the role of audit in empowering the responsibilities of management

1.3 Hypothesis

- The functioning of the audit system in organizations will have functioning controls
- The impact of audit in accountability and increase of efficiency in managing finances and performance of the organization

1.4 Contribution of the paper

This paper will contribute in awareness rising of companies about the role and importance of audit in successful management of finances and ensuring effective control in the company and institutions.

2. THE ROLE OF AUDIT IN BUILDING UP A CONTROL SYSTEM IN THE COMPANY

An important field that requires focus is the importance of professional skepticism on the quality of the audit. The Regulators are trying to incite a debate as to whether actions are needed to ensure the right level of skepticism for auditors in practice. We look at the professional skepticism as an event to illustrate how important it is for companies and their shareholders to conduct auditing and other engagements in an effective manner. We will illustrate this further in the following text:

Internal audit is determined as an "independent function of assessment within an organization for reviewing activities as a service for all levels of management. It is a control that measures, assesses the reports on effectiveness of internal financial control and it is a process that contributes to the efficient use of sources within an organization."

The internal control is a process that is projected and conducted by those in charge of governing and managing and other staff in order to ensure reasonable assurance for achievement of objectives of an economic unit in relation to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

In one of its functions, internal control helps the auditor in identifying types of possible errors and factors that influence the risk of material errors, and in the drafting the nature, time and scope of further procedures of auditing. Initially as a tool of internal control, it helps auditors in determining which are relevant issues for auditing. ISA 315 Identifies and assess risks for material anomalies through understanding the entity and its environment which indicates if there is a direct relationship between the objectives of the entity and controls that it implements to provide reasonable assurance for achieving them. Many of these controls will be linked with financial reporting, operations however not all objectives and controls of the economic unit will be important for auditor's risk assessment. By deciding which controls are important, and which are projected in adequate manner in order to help in prevention of material errors in financial statements, the auditor can decide whether it is more efficient to seek for the support in these controls and conduct the control tests in that area, or whether it is more effective to conduct substantial testing over that area. If the controls are designed in adequate manner, the auditor needs to conduct sufficient substantial tests over that area of financial statements in the light of significant lack of risk control.

Identification and assessment of risks and material anomalies is done through understanding the entity and the environment throughout the control area.

Internal Control has five elements:

- Control environment
- The process of risk assessment of economic unit
- Relevant information system and financial reporting activities
- Control
- Monitoring of controls

Thus, the internal audit with its analysis, assessments, recommendations and information related to all reviewed activities helps organizations in effective and efficient use of sources (both financial and non-financial). The internal audit unit is vested with the power of independent controls, in order to assess compliance with rules and regulations determined for the organization.

2.1 Subject of internal audit

1. All financial decisions about revenues, expenditures, administration of assets and debt are subject to internal audit.
2. Internal audit as independent process and activity from the functional point of view assesses the functioning of financial management and internal control system. At the end of auditing process, auditors provide recommendations and propose measures for improvement of functioning and management of audited entities.

The principles of internal audit are as following:

Legality – Every internal audit unit and every internal auditor should conduct audit in full compliance with applicable law, regulations, standards and practices, including but not limited to,

Integrity - Every internal audit unit and every internal auditor should conduct audit in a professional manner and based on all applicable legal requirements. Internal auditors should avoid conflict of interest and should not allow personal issues of any kind influence the internal audit that he/she is conducting;

Objectivity - Every internal audit unit and every internal auditor should act with the highest level of professionalism during collection, assessment and transmission of data on the activity or process that is being audited. They should make balanced assessments of all respective circumstances and should not allow that their activities stand points or conclusions be influenced in any way by their personal interests or interests of another person;

Reliability – Every internal audit unit and every internal auditor should respect the values and ownership of information they receive and should not disclose information to any other person except when that is specifically required;

Competence - Every internal audit unit and every internal auditor should possess and use their knowledge, skills and experience in implementing the internal audit in a professional manner;

Independence - Every internal audit unit and every internal auditor is completely independent from activities that are being audited and persons responsible or involved, directly or indirectly in such activities.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) of the USA recognized and accepted the need for clarification of factors and processes which are combined together in order to form effective internal control systems. In 1992 COSO issued a document on Internal Control – Integrated Framework, which provides for a standard model for establishing internal controls that promote efficiency, minimize risks and help in ensuring reliability of financial statements and are in compliance with the laws and regulations.

COSO chose the approach according to which the objectives of an enterprise are analyzed from the aspect that is focused in risks; they respectively, consider that the management is responsible for identification and assessment of risks which are faced by the organization. (The management should respect and implement internal controls within its functioning systems in order to reduce identified risks).

One of the early conclusions of initial meetings of COSO members was that “internal control”, as expression had a different meaning, not only for different organizations but also for different managers working there. Thus, the need for identification and clarification of different definitions of “internal control” emerged.

As a result, the COSO framework identifies five key components of internal control:

1. Control environment;
2. Risk Assessment;
3. Control activities;
4. Information and communication; and
5. Monitoring.

Risk assessment and management is a responsibility of the Management. The responsibility of Internal Auditing process is to:

(a) review and test procedures and controls established by the management, in relation to risk reduction and
(b) comment on suitability of such controls and procedures and show whether such controls and procedures are functioning properly.

Organization Management is responsible for risk management (its assessment of risks and correctional measures after it receives the report from the Internal Auditor).

Internal Auditors use their risk assessments as the first stage of risk assessment in planning audit activities.

The duty of the internal auditor is to help the manager of the organization in discovering and assessing essential risks and contribute in improvement of financial management and control systems of that organization. In general, "a system" is a combination of interrelated elements which comprise a single and complete process that performs a certain function. Every system can be considered as an element, sub-system or process within another bigger system.

Internal audit should provide deep analyses of financial management systems and control systems for assessing effective functioning of control mechanisms. In other words, the emphasis should be on audit of systems rather than examination of transactions.

When auditing systems, auditors form an opinion in relation to the type of existing control mechanisms, how they operate and what is their impact on the objectives of the organization.

This is done by examining and assessing processes in the organization. This was illustrated in the following scheme: Processes in the organization that is subject to audit, have their specific objectives. Internal auditors should know all the processes and focus their auditing attention to those that are more important or prone to risk. Knowing the intentions, sources, flow and results of processes, auditors are capable of defining objectives and scope of internal audit.

Auditing of systems is a "step by step" process. Nevertheless, steps should not be considered as independent stages, since every one of them should be completed before the next stage of audit can begin. Audit of systems is a complete and integrated process. Elementary knowledge of the auditor over systems that are being audited will gradually expand during the audit. In every stage of audit process, internal auditors will have the possibility of revising their planned approach, based on the improved understanding of the system.

The key to high quality audit is the approach of auditors towards planning and performing of the audit itself. In order to ensure sustainable and high quality audit, internal auditors apply standard approach in every audit. The audit process has permanently four stages: planning, the field work, reporting and monitoring of recommendation implementation (including follow up).

Internal audit is conducted in different legal and cultural environments; within organizations with different sizes, purposes, complexity and structure; and by persons inside or outside of the organization. While differences may influence the internal audit practice in every environment, compliance with international IAB Standards on professional practice of internal audit are essential for complying with responsibility of internal stakeholders and internal audit activity.

If internal auditors or internal audit activity is by law or regulations allowed being in noncompliance with some parts of Standards, the compliance with other parts of standards and declarations is necessary.

If standards are used in conjunction with standards issued by other authoritative bodies, internal audit letters can quote the use of other standards, when necessary. In these cases when there are inconsistencies between other standards, internal auditors and internal audit activity should be in compliance with Standards and can be in compliance with other standards if they are more restrictive.

The purpose of Standards is:

1. To describe basic principles that represents the internal audit practice.
2. Offer a framework for performing and inciting a wide range of internal audit with knowledge from the practice.
3. Establish the basis for assessing and performing internal audit
4. Incite improved organizational processes and operations

Standards are mandatory requirements based on principles consisted of:

- Statements of basic requirements for professional practice of internal audit and assessment of performance effectiveness, which are applied internationally in organizational and individual levels.
- Interpretations which explain terms and concepts within a single statement.

Standards use terms which were given special understanding and are included in the dictionary. More specifically, Standards use the word "mandatory" (must)¹ in order to qualify an unconditioned requirement and the word "should" when consistency is expected and when during the implementation of professional judgment circumstances justify deviation.

The structure of standards is divided into attribution and performance standards. The attribution standards address the traits of organizations and persons who conduct internal audit. Performance standards describe

the nature of internal audit and provide for qualitative criteria through which the performance of these services is measured. Attribution and performance standards are also offered to be implemented in all internal audit services (<http://www.theiia.org/guidance/standards-and-guidance/ippf/standards/full-standards/>)

2.2 Internal audit as prevention for errors and fraud

During the planning process, external auditors should conduct a preliminary assessment of internal audit function, if possible for a part of internal auditor's work to be used by an external auditor. A favorable assessment may allow the auditor to modify the nature, deadlines and the procedures of external audit.

Fields of functioning: the nature, extent and assessment implemented by internal audit. External auditor should also consider whether management is acting based on recommendations issued by the internal auditor and how was that entered into records.

2.3 Effective Control

The Control activities include policies, procedures techniques and mechanisms that assist in guaranteeing implementation of management directives. They assist in ensuring that proper actions are undertaken to address the assessed risks.

Managers are mainly responsible for identification of financial risks and consistency of their operations, they are also responsible for designing, implementation and monitoring of their internal control system. Control activities include:

Approvals, authorizations, verifications, consents, reviews, performance reviews, making sure the equity is positive, division of duties and controls over computer and information systems: approvals, authorizations, verifications (preventive).

The director authorizes employees to conduct some activities and execute some transactions within limited parameters. Furthermore the director specifies the transactions that need approval by the supervisor before being executed.

Control actions are integral part of planning, implementation, review and responsibility of the entity for administration of resources and achievement of effective results. Internal control activities occur at all levels and functions of the state. Such activities comprise of approvals, authorizations, verifications, consents, performance review, security, maintaining of registers and operational and functional documents or information systems, computerized systems manual systems.

Some examples of internal control activities as following:

1. Review of current performance by senior managers
2. Review by the functional level management and activity level
3. Human resources management
4. Control over Information processing.
5. Physical control over vulnerable activities
6. Determination and review of measurement tools and performance indicators
7. Proper division of duties
8. Proper execution of transactions and events
9. Accurate and timely registration of transactions and events.
10. Restriction of the right to entry and responsibility for resources and registrations
11. The right documenting of transactions and internal control

2.4 How should an effective control look like?

Internal controls should satisfy three basic criteria:

1. Be suitable (e.g. control should be conducted in the right place and in line with respective risks).
2. Function in a sustainable manner, namely be coherent with projections during the entire period (which means it requires careful implementation by all participants at all times even when the staff members are not at work or when there is a huge workload).
3. Be cost-effective (the cost of implementation of controls should not top the benefits that derive from them).
However can we have a perfect internal control system?

What is the level of assurance of fulfillment of objectives by such internal control?

We have absolute assurance. Relative Assurance...reasonable assurance?

By the definition: internal control represents a mechanism that ensures achievement of objectives. A perfect internal control should be able to guarantee certain achievement of objectives.

However, objectives cannot be met in all cases based on projections for many reasons, which are related to internal control itself. Based on the analyses and comparison of objectives to be achieved in public or private sector we would reach the conclusion that:

There is no perfect internal control system, because there are internal restrictions which are naturally uncontrollable.

The very definition of internal control indicates that, regardless of form and function, the internal control structure of an entity can only give reasonable assurance, so not absolute assurance, for achievement or implementation of objectives. Here are some influencing indicators:

- a. Poor judgment (unsuitable) human errors
- b. The ability or possibility the management has to avoid (violation) controls.
- c. Covert agreements between two or more employees in order to avoid controls.
- d. The need for cost-benefit analyses when there is a decision to implement a certain internal control system.

3. WORKING METHODOLOGY

This study was analyzed through reports of internal audit departments of different public and private organizations.

During the study, we have noticed that accountability increased from year to year. Where the entity has internal audit unit they had assurance in building a control system which gives a level of assurance which is much greater than the one in entity that do not have internal audit unit. During the interview with internal auditors, we were informed in the beginning of internal audit function there was a misunderstanding between management and the auditor, because, management viewed the auditor as some sort of “spy” for the owner or the managing board. However, with the development of processes and awareness rising of the management, this concept was changed and now the internal auditor is viewed as a filter for errors and mismanagement of the organization. Over time, management realized that the better the internal audit functions, the more effective and efficient the organization function is. We have analyzed the internal audit reports of several private and public entities where those with functional internal audit over years have less recommendations, which implies that the audit regulates the system and division of duties in the entity where it increases the assurance and transparency in the entity where errors and frauds are reduced significantly.

4. FINDING ANALYSIS

Based on the study presented in this paper, we can state that study analyses were conducted in both public and private institutions where we have come out with the following findings:

- In 2008 after the declaration of independence of the state of Kosovo, the laws and regulations oblige the public enterprises to have audit department within them. Public and private institutions before 2008 did not give attention to audit, as a consequence irregularities were found and there was lack of an effective internal and external control. In the recent years the role and importance of the internal and external audit was increasingly understood and this led to increase of efficiency of management and quality of financial reporting.

CONCLUSION

The above information indicates that there is improvement. This shows that audit is a strong pillar for effective management and control in the entities. When analyzing auditors' reports we observed that there was increase of accountability and transparency in financial reporting of many organizations. Through auditors' recommendations, many organizations managed to increase the level of financial reporting and reduce material errors in financial statements.

According to applicable laws, the internal audit makes an audit plan whereby it audits every sector of the organization namely both current and non-current assets, short-term and long-term liabilities, revenues and expenditures and assesses whether the organization is acting based on applicable laws and regulations. On the other hand, the Law on Internal Audit adopted in 2009 contains sufficient legal basis for regulation of internal audit. This law regulates responsibilities and mandate of internal audit units, and guarantees complete independence during the exercise of mandate by internal auditors. The purpose of this Law is to establish bigger and more efficient control over expenditures and public finance as well as ensure that all public expenditures will be subject to internal audit in a systematic manner. The Law also regulates responsibilities and mandate of internal audit units which are created in every public organization according to procedures and criteria foreseen in the Law on Internal Audit. The Audit Committee is an independent advisory body for senior management in the public sector and supporter for internal auditors. (The Law on Internal Audit Units – Article 4 *ibid*: Article 7)

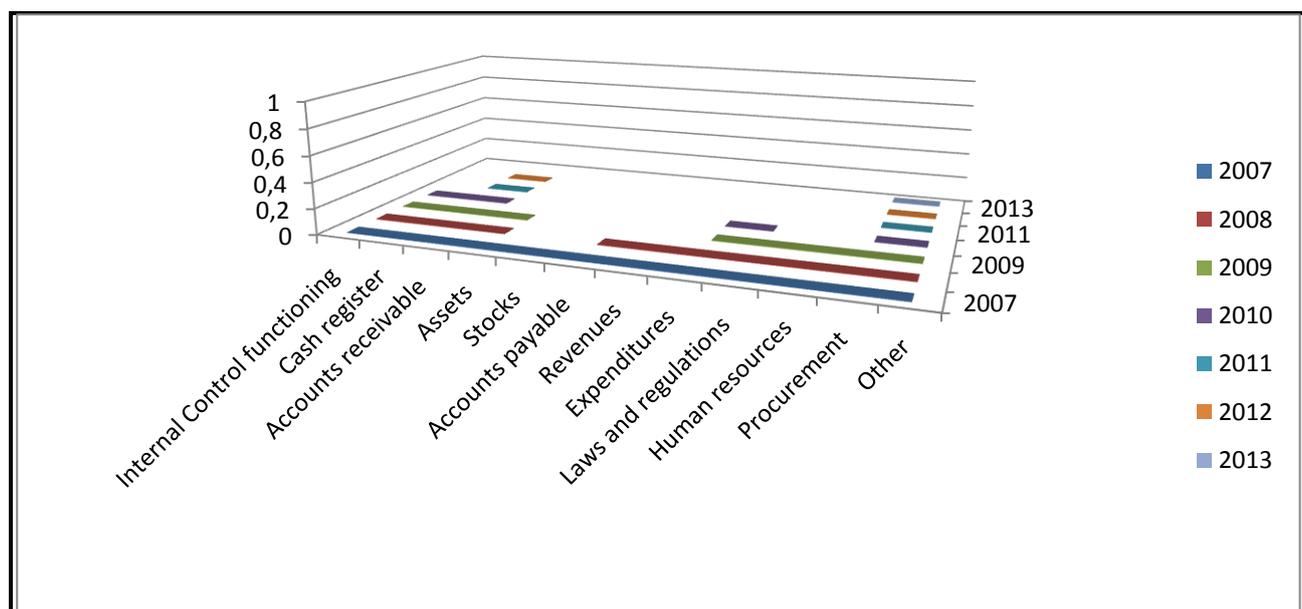
APPENDIX

Based on the study presented in this paper, we can emphasize that following audit analyses conducted in both public and private institutions came up with the following findings

Type of Company	Public	Private
No.of tested companies	12	25

Years	2007	2008	2009	2010	2011	2012	2013
Average number of findings and recommendations made by the internal auditor	21	19	15	13	10	7	5

Findings and recommendations made by the internal audit department during 2007-2013							
Entries in financial statements	2007	2008	2009	2010	2011	2012	2013
Internal Control functioning	√	√	√	√			
Cash register	√	√	√	√	√	√	
Accounts receivable	√	√	√	√	√	√	
Assets	√	√	√				
Stocks	√						
Accounts payable	√	√					
Revenues	√	√					
Expenditures	√	√	√	√			
Laws and regulations	√	√	√	√	√		
Human resources	√	√	√				
Procurement	√	√	√	√	√	√	√
Other	√	√	√	√	√	√	√



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