ESSAY TOPIC

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"What is the Role of the Internal Audit Function in Establishing and Ensuring Effective Coordination among the Audit Committee of the Board of Directors, Executive Management, the Internal Auditors, and the External Auditors?"

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INTRODUCTION

"The audit committee of the board of directors, executive managers, external auditors and internal auditors are the cornerstones of the foundation upon which effective corporate governance must be built," (Bishop, 2002).

Ensuring that these entities perform their roles effectively is therefore pivotal for the survival of the organization. The financial catastrophes of the last decade revealed the extent to which ineffectiveness in any of these entities can adversely affect the business. These corporate upheavals have driven external regulators to find ways of promoting greater accountability, disclosure and transparency - key components of corporate governance, in an effort to restore the trust and confidence of stakeholders and in particular shareholders. Establishing and ensuring coordination among the audit committee, executive managers, external auditors and internal auditors is therefore critical since sound corporate governance hinges on the successful interaction between these entities (Bishop, 2002).

With a mandate "to add value and improve an organization's operations," the internal audit function needs to take a proactive role in establishing and maintaining such coordination (Pickett, 2003). Herein is an opportunity for adding greater corporate value, through synergy at the very top, among those with tremendous potential to impact on the sustainability of the organization.

This essay will examine the role of the internal audit function in establishing and ensuring coordination between the audit committee of the board of directors, external auditors, executive management and the internal audit function.

IS COORDINATION A NECESSITY?

In general, coordination within an organization refers to *"the quality of collaboration across departments"* (Daft, 2000). It has the idea of organizational networking which allows for direct contact between individuals, and shared effort both internally and externally in order to achieve objectives, find solutions to problems and meet the needs of all stakeholders in a more timely and efficient manner (Hastings, 1993). It also involves the strategic use of two important organizational assets intellectual capital and information. The following discourse will consider whether coordination is necessary for the audit committee, executive management, external auditors and internal auditors.

Audit Committee

Following the collapse of Enron, the efficacy of the audit committee came under scrutiny, with reports indicating that the committee only met 60 minutes quarterly. This was inadequate given the size and complexity of the business operations at the time. Nevertheless, it has highlighted the need for greater audit committee involvement in the organization (Moeller, 2002). Coordination is therefore necessary for the audit committee in its effort to change this image.

Continuous and meaningful interaction with management is crucial for the audit committee, as it will facilitate an understanding of the business, which will allow it to successfully monitor the company's financial reporting process (Steinberg and Bromilow, 2000).

The Sarbanes Oxley Act (SOA) has resulted in additional responsibilities for the audit committee which include establishing a code of conduct for corporate executives, a whistleblower function, and monitoring a formal evaluation of internal control as well as prior approval of non audit services by external auditors, just to name a few (Moeller, 2002). The scope of the additional responsibilities placed on the audit committee further highlights the need for coordination.

Executive Management

Management is an important part of the coordination equation since they are responsible for setting the *'tone at the top'* (Blackburn et al, 2002). Coordination with the audit committee is necessary for management to ensure that this 'tone' is reflective of the organization's values and objectives. As they coordinate with the audit committee, management can ensure that they are implementing policies from the board as stipulated and can give timely feedback.

Additionally, SOA requires that management publicly states its responsibility for internal control and provide an evaluation of the internal control structure (Pickett, 2003). Among other requirements, the act is also very stringent on disclosure to the auditors and audit committee by chief executives, of major internal control weaknesses and changes, which can have a significant effect on the organization (Moeller, 2002). Being responsible for implementing and maintaining effective internal control, managers need to coordinate with internal audit to evaluate the internal control effectiveness and with external audit to ensure that internal controls adequately support the financial reporting process.

Given the complexities of operating in today's business environment, with issues such as globalization, rapid technological advancement, corporate social responsibility among others, interaction with internal auditors is necessary for providing management with support in identifying, assessing and managing risks and opportunities confronting the organization (O'Regan, 2003). Internal auditors can help bring a balanced approach to risk assessment by ensuring that managers do not expose the organization to risk, unduly, or that opportunities are not lost due to a manager being risk averse.

The International Federation of Accountants (IFAC) is working towards the harmonization of accounting standards internationally (O'Regan, 2003). The drive for global convergence in accounting standards means that there are imminent accounting changes which management needs to be aware of as they occur. Consequently, coordination with external auditors is necessary to ensure that the accounting policies and practices implemented within the organization are up to par.

Managers will also need to coordinate with each other for effective risk management and decision-making. In this case, coordination will give them a more holistic view of the impact of their decisions.

Internal Auditors

Internal audit has the responsibility of ensuring that the board, senior management and audit committee adequately understand its procedures and processes and on an ongoing basis has to report any changes implemented in compliance with SOA (Moeller, 2002). With continuous collaboration, the internal audit function will provide these entities with real time disclosure of pertinent issues in compliance with SOA Section 409.

Also with internal audit taking on a more consultancy role, there must be coordination with management, which will create awareness and understanding of management needs enabling the department to offer consultancy services, which will add value to the organization (Plumly and Dudley, 2002).

Notwithstanding the changes occurring in the role of the internal audit function, there is still need to provide assurance services. Business scandals such as World Com highlighted the issue that the internal auditors were focused on value added activities, and had failed to evaluate control effectiveness (Blackburn et al, 2002).

In addition, in a study carried out by Nagy and Cenker (2002), it was found that in some internal audit departments where resources were limited the shift to consultancy had left a gap in the assurance function

and that internal and external audit had not adequately coordinated their activities to ensure that the assurance role was kept up to standard. Coordination with the audit committee and management is a control to ensure that the internal audit function does not neglect its assurance role and that it is adequately equipped to carry out both functions. This is especially significant since SOA Section 404 no longer permits the external auditor to carry out its own evaluation of internal controls (SOA, 2002).

Subsequent to 1997, there was little coordination with external auditors, the only interaction being through presentations at an annual meeting. The external auditors rarely received internal audit reports identifying inefficiencies in internal control. This lack of coordination made the conditions ripe for the World Com accounting fraud to occur and underscored the need for effective coordination between internal and external auditors (Blackburn et al, 2002). Moreover, both the IIA Performance Standard 2050 and the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards (SAS) 9 and 65 promote coordination between the internal and external auditor (Sawyer, 2003).

External Auditors

External auditors are responsible for expressing an independent objective opinion on the financial statements. Management is responsible for financial reporting and the implementation of all internal controls.

With SOA Section 404, external auditors are now restricted to providing attestation of management internal controls report. They are not themselves required to evaluate internal control effectiveness (SOA, 2002). Therefore, it is necessary that the external auditors coordinate with managers and internal auditors.

Being convinced that internal audit is sufficiently competent and independent the external auditors can place reliance on internal audit work carried out and as such need to coordinate with them (Engle, 1999). This can greatly assist in the planning and execution of the audit.

One of the concerns addressed by SOA was the need for more regular reports of external auditors to the audit committee. Before the act, there was limited communication between external auditors and the audit committee. In some instances, reports on pertinent issues such as changes in accounting methods used, if reported on at all lacked detail (Moeller, 2002). SOA Section 204 now requires that auditors report regularly to the audit committee on accounting policies and practices used, alternative treatments presented to management for consideration and the auditors preferred method (SOA, 2002). Coordination is necessary in this regard, as it would foster compliance to this reporting requirement of SOA by strengthening communication links between the audit committee and external auditors.

THE ROLE OF THE INTERNAL AUDIT FUNCTION IN ESTABLISHING EFFECTIVE COORDINATION

The Institute of Internal Auditors (IIA) Performance Standard 2050 stipulates:

"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 effort"*(IIA, 2004).*

Furthermore, Redrup et al (1999), state that the audit committee of the board, external auditors and executive management are all customers of the internal audit function. Therefore, it follows that internal audit should be at the forefront of the drive to establish and ensure effective coordination within the organization. Nevertheless, effective coordination does not just happen it takes concerted effort on the

part of those who are involved. The following considers the role of internal audit in ensuring effective coordination among these entities.

Develop and Promote a Philosophy of Coordination

As a department, continually striving for excellence, the internal audit function needs to integrate coordination as part of its whole process. It should therefore be develop and promote a philosophy of coordination that considers all its customers. The philosophy of coordination internal and external audit outlined in Statement of Internal Auditing Standards (SIAS), No. 5 can provide guidance in developing such a philosophy.

If it is to effectively lead the coordination effort, internal audit needs to have a vision of what it wants to achieve through coordination and may even consider its incorporation in the core goals or objectives of the department. Without a vision of coordination, efforts will be ad-hoc and short lived with little accomplishments.

Once developed, the chief audit executive (CAE) should communicate this to internal audit staff, customers and other stakeholders. Since coordination is not just the responsibility of the CAE. It is important that every internal audit staff member understands the key role that coordination plays in the department's effectiveness. Failure to obtain support from staff will lead to the coordination efforts falling apart.

With some adaptation, the model of Total Relationship Management (TRM) will be useful for developing effective coordination. The main thrust of this all-inclusive approach to relationships is *to facilitate, create, develop, enhance, and continuously improve appropriate internal and external relationships with customers, employees and collaborator"* (Zineldin, 2000).

Zineldin (2000), points out that TRM is a strategy and a philosophy. It is *"total", because it considers and co-ordinates "all" activities - including internal and external relationships, networks, interactions and co-operations..."* As a strategy, it is useful because it underscores the need for high quality products, services and internal and external relationships.

Zineldin (2000) continues, TRM **".. is a philosophy because it should be used to communicate the idea that a major goal of management is to continuously improve the total quality and to plan and build appropriate close and flexible long-term relationships with the parties who contribute to the organization's success and long-term growth. It should also guide the overall thinking in the organization, in decision making as well as in execution of predetermined plans."**

TRM emphasizes:

- Integrating and coordinating internal relationships
- High quality external relationships
- Continuous improvement of the products/services and processes;
- The responsibility of each individual in the organization for the continuous improvement process (Zineldin, 2000)
- By utilizing TRM, internal audit can develop and promote a philosophy of coordination.

Build Coordination into the Structure of the Internal Audit Function

Already the CAE has the responsibility of pursuing coordination as prescribed by IIA Performance Standard 2050. As the drive for greater coordination progresses, given the complexity of the organizations

within which the internal audit function operates, the CAE may propose the formal incorporation of coordination within the internal audit structure.

The structure of the Internal Audit Service (IAS) within the European Commission is an example of how to do this. The IAS has a division specifically dedicated to Coordination and Communication and has a director who has relationship management as part of his portfolio of responsibilities (Baker, 2004).

Some organizations may consider the appointment of an officer with responsibility for coordination. Already some organizations have included a statement on internal and external audit coordination within the audit charter in keeping with the standards. However, the CAE should seek to have an explicit statement on coordination within the audit charter that goes beyond internal and external audit coordination to also include coordination with the audit committee and management. This will be a positive step and will provide the internal audit function with the authority for pursuing coordination with these entities vigorously.

Plan for Coordination

The CAE should ensure that there is a plan for coordination. Coordination efforts will require use of organizational resources whether intellectual capital, financial, or technological and as such must provide value to the organization. The Internal Audit department needs to translate the vision of coordination into long, medium and short term plans in order to monitor and evaluate performance.

Provide Excellent Leadership

With external auditors, confined to providing only auditing services as a result of SOA, added respect and responsibility has been conferred on internal audit departments for their role in evaluating internal control and in promoting good corporate governance practices (Moeller, 2002). Hence, the internal audit function needs to grab this opportunity and set the pace by taking a proactive role in coordination.

In short, Internal Audit can make coordination a reality through the example set.
Internal Audit managers should by their actions, demonstrate they are supportive of and actively engaged in the department's coordination effort. A high level of professionalism in the core services internal audit provides to management, the audit committee and external auditors will win the respect which will open the door to greater coordination with these entities. Being well prepared and present for all scheduled meetings with these entities is a crucial preliminary step in communicating internal audit's commitment to coordination.

The internal audit function also has to seek out opportunities to coordinate with management by getting them involved in their audit process, being open and transparent, and by sharing information so that management is fully informed (Ridley and Chambers, 1998). Such an attitude will encourage trust and increase the likelihood of managers being open as well.

Train and Educate, to Effectively Coordinate

A primary area of focus for internal audit in this coordination drive is education. To gain commitment it is important that managers, the audit committee and external auditors all understand the need for coordination not just with the internal auditors but also with each other. The internal audit department can gain support from management, by promoting coordination as it facilitates the implementation of the Total Quality Management (TQM) principle of *'getting it right the first time'* (Ridley and Chambers, 1998).

Seminars, informal meetings and workshops involving managers, auditors and the audit committee, are just some of the ways to do this. Publications can are also a useful means of education. Through education, internal audit can seek to dispel any myths related to coordination and promoting a philosophy of coordination that will benefit all stakeholders (Wood, 2004).

Training is also important, as the entities need to be equipped in order for coordination to be truly effective. Such training includes the use of information technology to facilitate network communications.

Communicate, Communicate, Communicate!!!

Communication is vital for any organization as it provides networking between people and organizations (Zineldin, 2000). For coordination to be effective, it is important that the entities have the right information at the right time. To allow for the free flow of information effective communication must be a priority. In this regard, a focus on corporate communication is necessary as it provides a framework for effective coordination (Cornelissen, 2004). Internal audit should carry out an audit of existing communications system to ascertain whether it will adequately support the coordination effort.

In this digital age characterized by rapid convergence of information and communication technology, there are many innovative options for communication which internal audit needs to explore.

Just Do It!

Coordination necessitates effective action. Internal Audit can establish coordination among management, the audit committee and external auditors through various means. Net- meetings, use of multimedia, formal corporate meetings, newsletters, bulletin boards, email and office visits are just some ways of facilitating coordination. In the case of the internal entities, using enterprise resource planning systems would encourage effective coordination especially among managers (Daft 2000). Allowing limited access to external auditors through a network would also be useful in that it would give them an understanding of the overall organization which would aid in the audit.

Coordination with external auditors may take the form of*:*

"..audit planning, sharing audit reports and using complementary auditing methodologies and software tools…..sharing knowledge of organizational risks, performing segments of works on behalf of external auditors…" (O'Regan, 2003).

For large multinational organizations with remote subsidiaries, internal and external auditors have a shared program of visits to reduce the encumbrance of excessive travel (O' Regan, 2003).

As already mentioned, networks need to be developed linking managers, internal audit, external audit and the audit committee. This will provide real time sharing of relevant information. Internal audit needs explore the use of networks such as intranets, extranets and the Internet among others to establish and ensure communication and make the necessary recommendations to management where these are not already in use (Hargie and Tourish, 2002).

THE ROLE OF THE INTERNAL AUDIT FUNCTION IN ENSURING EFFECTIVE COORDINATION

Once internal audit has done the initial work in establishing effective coordination, it must now ensure that there are mechanisms in place for this to continue.

Actively Involve All Entities

While internal audit has to be proactive and do all within its power to establish coordination, once set in motion it is important that coordination involves all entities for it to be sustained. All executive managers should be involved and should be actively sharing information with each other and with the rest of the entities. The audit committee also needs to play its part as well as external auditors.

Continuously Monitor and Improve Coordination

Internal audit should recognize coordination as critical for providing its core services to its customers and must therefore take an approach of continuous improvement. Taking this approach would require constant monitoring and evaluation of the coordination effort. This would take the form of feedback, satisfaction surveys, complaints and questionnaires involving executive managers, audit committee and external auditors (Drummond-Hill, 2002). Internal audit should also make the review and evaluation of its coordination efforts part of its quality review process.

It should evaluate the extent to which its efforts at promoting coordination are adding value and improving the operations of the organization. It should obtain feedback from executive managers, the audit committee, external auditors and internal auditors on their view of how well the coordination effort is progressing, how it has improved their ability to carry out their responsibilities and their suggestions for improvement.

Any improvements and resulting increased efficiency and effectiveness reported to the Audit Committee. Through this, the internal audit function can ensure that coordination is effective.

BENEFITS OF COORDINATION

Effective coordination has the following potential benefits to the organization namely:

Fosters a Culture of Transparency and Accountability

"Enron debacle is a wake up call... It shows good governance will not come by writing best codes, we needed to create a culture of transparency." (Mehra, 2nd International Conference on Corporate Governance, cited in Van Den Berghe, 2002)

Creating such a culture is a top management issue and requires commitment and active participation from those with the responsibility of oversight within the organization. Coordination between the audit committee, executive managers, internal audit and external audit helps to build trust as it creates openness that allows for the free flow of information and access to processes and procedures utilized in the conduct of their responsibilities. Such transparency from the very top can permeate through the organization transforming the organizational culture to one characterized by openness.

Coordination has the potential of creating strong accountability relationships. As management are in constant contact with the audit committee it provides an opportunity for greater oversight of management processes through relationships ensuring that there is compliance to organizational regulations and that decisions taken by management consider risk and are in line with the corporate strategy. Sawyer (2003), identifies non-compliance to corporate directives and procedures as a symptom of management fraud. Hence, by fostering transparency and accountability, coordination has the advantage of deterring managers from committing fraud or providing a means of early detection of fraud.

Additionally it reduces the likelihood of incongruence of decisions and actions by different managers. In this way, as stated earlier, it facilitates the TQM principle of *"getting it right the first time."*

Results in a More Effective Reporting

Coordination with management ensures that recommendations made by internal audit are relevant, timely and add value to the organization. The involvement of the audit committee means that there can be follow up on the implementation of audit recommendations. The committee can also follow up unresolved audit issues with management on a timely basis (Steinberg and Bromilow, 2000).

More Efficient Operational Processes

Cooperation between the internal and external audit results in more timely and cost effective work by the external auditors as it prevents duplication of effort. Additionally, by using internal auditors in the execution of the audit the organization can save tremendously especially in the case of large multinational corporations (O'Regan, 2003). This results in a more effective use of the total audit resource (Redrup et al, 1999).

Coordination involving management can reduce the likelihood of significant accounting errors, poor decisions, and untimely implementation of board directives.

An Opportunity for Enhancing the Image of Internal Audit

One of the reasons for the massive turn to the outsourcing of the internal audit function in the 1980s was that senior management and the audit committee did not understand the difference between internal and external audit and in some cases management were better able to work with external auditors. Additionally they felt that the role of the external auditors was superior to that of the internal auditors who were simply concerned with issues of compliance (Moeller, 2002). However, post SOA, new opportunities have emerged for internal audit to demonstrate its true value to the organization.

With reference to the introduction of the Financial Expert on the audit committee, Moeller (2002) puts it this way,

"The designated accounting and financial expert on the audit committee needs the help of internal audit to explain internal control issues within the organization to better assess audit risks and to plan and perform effective internal audits."

By being leaders in coordination, internal audit can enhance the image of the department, as this would facilitate a better understanding of the role of internal audit by the audit committee and management. By building trust through continuous interaction, effective coordination also has the potential of transforming the traditional view of internal audit as being a watchdog to that of a partner (Sawyer 2003).

Improves Independence

Coordination allows the audit committee to maintain its independence in fulfilling its duties, as interaction with internal and external auditors creates a balance of information received from management (Steinberg and Bromilow, 2000). In the same manner, coordination will also enhance the independence of the other entities.

CHALLENGES AND BARRIERS TO EFFECTIVE COORDINATION

As with any effort there are challenges which internal audit will face in pursuing effective coordination. Some of these challenges or barriers to effective coordination are as follows

Lack of Openness

For the coordination effort to bring maximum benefit to the organization there must be a willingness to be open about weaknesses and problems as well as strengths. However due to status and power differences managers may be unwilling to share problems as they may fear how such issues will be perceived. A climate of trust will create the conditions for sharing both strengths and weaknesses (Daft, 2000).

Focus on the Entity's Own Needs and Goals

In particular, executive Managers, the audit committee and external auditors may be inward looking being focused on their immediate needs and goals and may fail to be interested in coordinating beyond the basic requirements. The challenge is to find innovative ways to change the philosophy, to that of thinking corporate value. Internal audit can overcome this challenge by educating each entity on the potential benefits of coordination and its importance to organizational performance.

According to Powell and Yager (2004):

"A key defining aspect of coordination… is how to efficiently bring together two or more diverse groups so their interactions with each other are favorable and outcomes are improved."

While internal audit has to encourage management, the external auditors and the audit committee to consider the corporate value to be added through coordination, it must on the other hand, ensure that the it considers all entities in the coordination effort. Effective coordination should result in the enhanced performance of each role, the achievement of organizational goals and objectives and the maximization of the interests of all stakeholders.

Unwillingness to Coordinate

While the internal audit function can do all in its power to coordinate and facilitate coordination between itself and the other entities discussed it will be a challenge to ensure that the entities coordinate with each other. For various reasons, there may not be commitment to the coordination effort on the part of all the entities involved. As with any effort, which yields value, ensuring coordination will take persistence on the part of the internal audit function.

Lack of Commitment from the Board

Given the scope of the coordination effort pursued by internal audit, it may require significant changes and as such, commitment from the board is necessary. Internal audit may be unable to get the required support whether budgetary or otherwise to make coordination successful. However, internal audit can overcome this barrier by carrying out a cost benefit analysis to demonstrate that coordination is worth the investment. Once there is commitment from the very top, coordination is more likely to be successful.

Conclusion

In this twenty first century, opportunities are opening for the internal audit function to be a truly revolutionary function within the organization. It is in a position to add value like never before. Coordination among the audit committee to the board of directors, executive management, external auditors and the internal audit function is yet another chance for the department to demonstrate its true worth to the organization. Despite the challenges, all the entities involved will benefit from coordination.

In view of the fact that these entities are the cornerstones of the foundation for building a sound corporate governance structure, the internal audit function should do all in its power to both establish and ensure effective coordination among them, as this would enhance corporate sustainability.

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