

Common Characteristics and Differences in External and Internal Auditing

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Abstract

Many scholars have shown that failure in leading big companies as well as the latest financial crises have led the auditing market to perceive traditional auditing more as a legal requirement rather than as a value added for the company. There are others that do not completely agree to this, but they all accept that the auditing as a profession should accept changes which will affect the value added for the company from auditing. Nowadays the companies are required more accountability rather that it was required before, perversely only financial reports were reported by the companies. Auditing is a process which confirms the statement provided by the company management regarding the information in financial statements that are real and accurate. Auditing has to be based on evidences and logical concept for better understanding. For companies that operate in the market, it is important to provide financial information that is consistent, reliable and complete for all users of the financial statements (banks, potential shareholders and the international community). In daily practice of entities we have two kinds audit, the internal and external audits. Usually, these are interlinked and complementary, with the ultimate aim that the (overall) audit is more effective and the reports that will emerge are fully arguable and meaningful. The internal audit has an important role which is to increase the effectiveness of internal control in private or public company. Internal audit has the responsibility of informing the management of the institution of deficiencies or weaknesses in the internal control system. External auditors are the fist line of the front for companies leadership. They play a key role in verifying the financial information provided to shareholders. External auditors inspect the financial statements prepared by the entity and provide assurance and independent opinion if these statements represent a true and fair view of the entity's condition for the year under review.

Keywords: External audits, internal audit, management, financial statement, and independent opinion.

Introduction

Every day we are witness of globalized economy, where a lot of international powerful companies have expanded the market in a lot of places in the world. The development of the world, especially in communication, is the reason that companies are audited continually.

During the period of times companies have been giving financial reports where financial statements are considered kind of passport for the company. Whether company is having bad or good performance it is reflected in the financial statements, where we also find out whether the company is capable of growing.

Users of financial statements such as management, shareholders, companies, state institutions, suppliers, customers etc., take important decisions for the based on these financial statements. The financial statements are expressed in figures and these figures can be resolved well, but to verify and evaluate these figures it is used the audit process. Audit is the process of verifying the direction statements included in the financial statements. In order to have the most effect, the audit should be based on a sound and more logical conceptual framework.

The party of interest considers the audit as a process that increases the confidence of the financial statements. Over the last decade, the nature of financial reporting has evolved to meet the needs of different users. Business and capital markets

have become more difficult, with greater complexity where the need for auditing is inevitable, sources of risk and insecurity as well as sophistication of systems have increased the risk of managing.

In light of these trends on the role and importance of users of financial statements, there have been questions about how auditors should apply audit concepts in order to obtain sufficient evidence to evaluate their financial statements and to support their opinion in the financial statements as a whole.

Audit is also a management advisory. The auditor during the audit will face various mistakes and frauds where in these findings the auditor gives directional recommendations and these recommendations need to be spiked with precision. The implementation of these recommendations from management affects the efficiency of companies.

The role and the function of external audit

The importance of research arises from the interest of academic researchers, practitioners, and regulators in the quality of external auditing. This interest is the result of numerous financial scandals and the reaction of lawmakers and professionals to these scandals.

External audit is an evaluation of business activities that is done on the basis of existing documentation. External audit deals with data verifications of accounting in order to determine the accuracy, authenticity and reliability of the financial statements.

An audit of the financial statements is a systematic process of collecting and evaluating evidence in relation to management assertions on economic actions and confidence-level events between these assertions and defined criteria of these objectives, and disclosure of results to interested users.

In this definition are included the following six elements:

- An audit should be planned and have a strategy to the stages of the audit process;
- Objectivity means the neutrality of the person that is performing the audit, as well as the quality of the audit;
- Collecting and evaluating evidence is the instrument of receiving facts and document that are based on audit findings and reports;
- Economic activities and events are business activities that are subject of audit from which the auditor draws conclusions and findings;
- The audit is done in accordance with International Standards on Auditing, and reviews whether the financial statements have been prepared in accordance with International Financial Reporting Standards, that means, the Financial Reporting Framework and applicable regulations;
- The audit process should be useful and the audit results are provided to all interested stakeholders.

It can be concluded that the objective of any audit is to provide interested users with an opinion on the compliance of the financial statements with the established criteria. This way the audit increases the reliability of the financial statements.

The role and the function of internal audit

Internal Audit is a process of verifications to reduce fraud, errors within the company. Internal Audit is an independent activity to provide objective assurance and advisory activity, designed to add value and to improve the organization's actions. Internal Audit helps the organization in meeting the objectives by promoting a systematic and disciplined approach to the evaluation and improving the effectiveness of risk management, controls and governance processes (Definition from IIA).

The growth and the globalization of businesses, market pressure to improve operations, rapid change in business conditions creates the need for control in order to ensure that control is as effective as possible and to detect risk properly. In order to meet this need, internal auditors are using continuous audit to maximize the efficiency of their work. The objectivity in evaluating the effectiveness of controls, risk management and governance processes are maintained independent by the auditor.

Internal audit is designed to provide reasonable assurance regarding the achievement of essential objectives such as:

- The effectiveness and the efficiency of operations;
- The reliability of financial reporting and management.
- Compliance with Laws and Regulations.

- Maintaining assets.

The complexity and size of organizations makes it impossible for the top managers to personally check if the organization is performing the activity effectively. In order to ensure that the organization is functioning effectively, it is imperative that the internal audit service should function in the organization.

Main differences between External and Internal Audit and their relations

Responsibility: External auditors are appointed on the basis of the status, to report independently the financial statements. In this way, their main responsibility is to report those who appoint them, e.g. shareholders.

Internal auditors are only responsive to Board of Directors and top management.

The primary objective (concern) of the external auditor is whether the financial statements do not contain anomalies, whereas the internal auditor's objectives vary according to the management requirements and, generally, less emphasis is placed on the materiality problem. External auditor is a contracted person from abroad and not an employee of an organization like the internal auditor.

Table 1: Relationships between internal audit and external audit

Factor	Internal Audit	External Audit
Objective	Risk management and control	Accounts = true and fair
The purpose of work	General systems that operate in the organization	Loss / Profit Accounts, Balances, Annual Reports
Independence	From operations with professionalism and status	From the company with status rights
Structure	Different: manager, employee, assistant	Partners, Managers, Trainers
Staff	Qualified persons trained in internal audit	Qualified Economists
Methodology	Systems based on risk evaluation and consulting work	Security and verification as well as some risk-based system evaluations
Reports	Explained, well-understood reports for all structures	Standardized, short reports for shareholders and account users
Standards	IIA and / or others	Based on different requests
Legislation	Usually non-binding but encouraged in many sectors	Legislation of the society and national legislation
Size	Generally large organizations	All registered companies and the public sector (small companies can make exceptions)

Source: The Finance Ministry of the Republic of Albania lectures of the case internal audit bases pg.32.

Auditor's recommendations increases the management quality of a company

Audit as a process influences the stability of the management of the company. The auditors except giving just opinions for the financial statements, they also give findings and recommendations in the Management Letter. The auditor during the engagement asks from the company whether the last year's recommendations by the auditor were applied. In this paper, we have taken for study 32 companies in Kosovo and analyzed the recommendations of the auditor.

Auditor Finding Analysis and Recommendations of Private and Public companies

Audit as a process in transitional countries has been understood as "police theory" but over time, companies have realized that auditing is a process that helps companies to increase the management efficiency of companies.

Auditor's recommendations are like instructors giving instructions on how to drive, and the auditor is an instructor who gives instructions on how to run the company.

We have investigated some private and public companies where the findings and recommendations given in the "Management Letter" have been received since the management letter is a document that is only provided to board members and the company, and they are not published and are not available outside the company.

In this study, 28 private companies and 4 public companies were taken into consideration, where in the management letter were analyzed the most frequent findings of private companies and public companies.

According to our judgment the management paper is a very important document in the audit process, as the auditor writes all the findings that he finds during the audit process and writes it to the management letter, as well as gives recommendations for these findings, where management should consider improving.

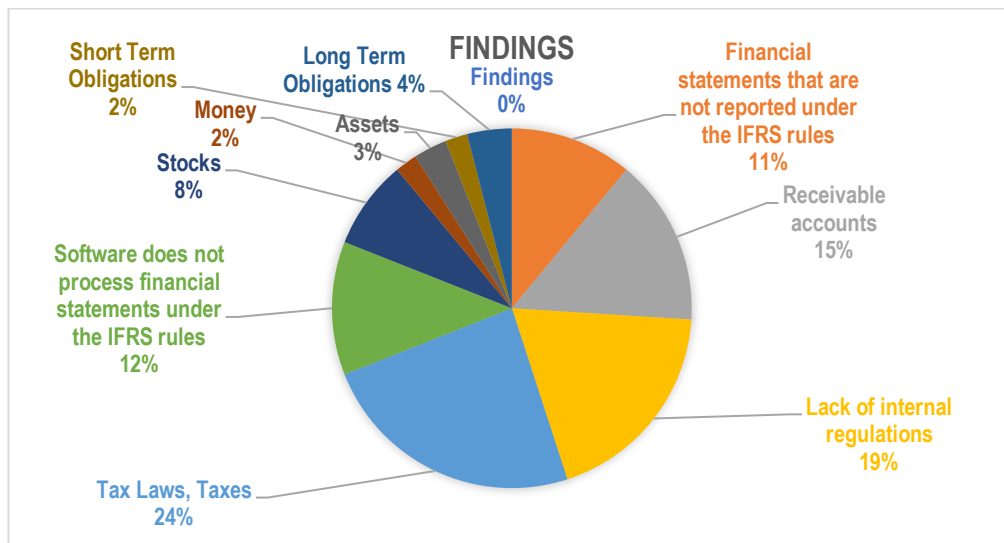
As we pointed out above in the 28 private companies and 4 public companies some of the auditor's findings were, as follows:

Table 2 Findings by the auditor for private companies

Findings	
Financial statements that are not reported under the IFRS rules	11%
Receivable accounts	15%
Lack of internal regulations	19%
Tax Laws, Taxes	24%
Software does not process financial statements under the IFRS rules	12%
Stocks	8%
Money	2%
Assets	3%
Short Term Obligations	2%
Long Term Obligations	4%

Private Companies:

Graph 1 Findings from the auditor for private companies



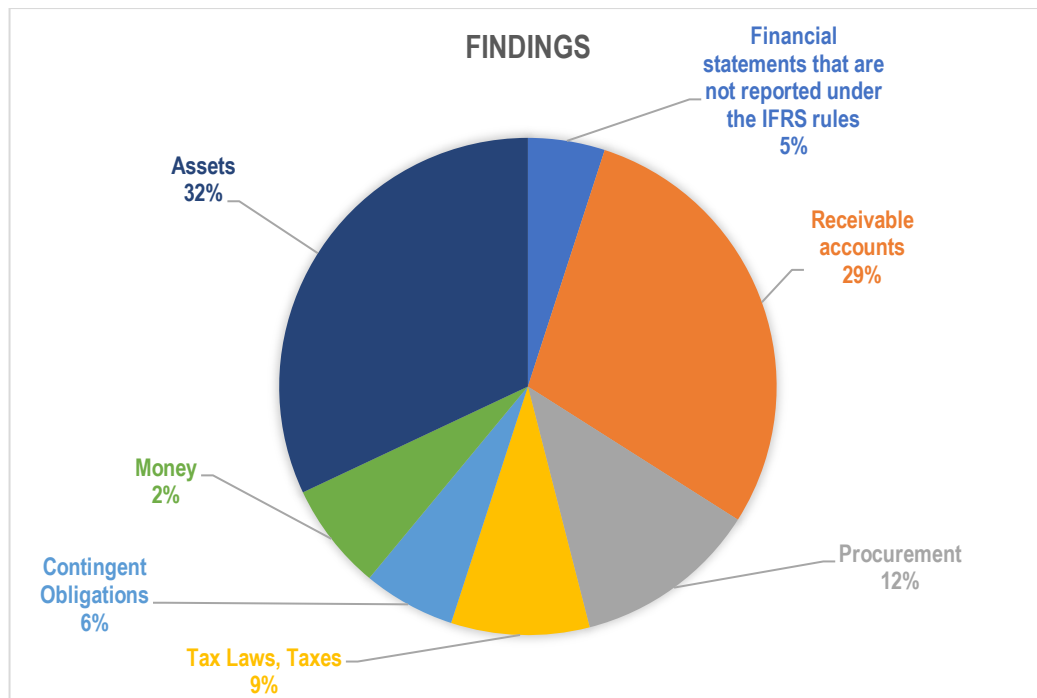
Public Companies:

Table 3 Findings of the auditor for public companies

Findings	
Financial statements that are not reported under the IFRS rules	5%
Receivable accounts	29%

Procurement	12%
Tax Laws, Taxes	9%
Contingent Obligations	6%
Money	7%
Assets	32%

Graph 2 Findings from the auditor for public companies



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According to the data of public and private companies, regarding the compilation of financial statements based on International Standards for Financial Reporting, out of 24 private enterprises, 11% do not present the IFRS financial statements, while in public enterprises this percentage is lower 5%.

In Kosovo, until 2013, companies submitted financial statements to the Tax Administration in Kosovo, where the latter was not strict and unified for submitting financial statements. Most small and medium-sized companies have submitted financial reports only to the comprehensive income statement. But with the entry into force of the Financial Reporting Law, these companies are required to prepare IFRS financial statements.

During the audit, the companies presented a comprehensive income statement where the auditor recommended to have all IFRSs compiled. Other findings are receivable accounts where these accounts affect the efficiency of the enterprise, if the company increases sales at the same time it also increases the receivable accounts the company in the future will have problems with the cash flow as well as on the items of accounts that appear in the balance sheet (there are a lot of financial positions which realistically are old more than a year). Their collection is difficult to recover and therefore the auditor recommends that he or she proves, that means, to know approximately how much the company was able to collect this value.

We faced a lot of cases with sales growth. When there is a missing of cash simultaneously with the lack of cash the companies get a loan. The auditor recommends that the problem in this case is that even that their sales have been increasing the problem is that they took a loan. 28 private companies 15% have problems with receivable accounts.

A problem with public companies is that the receivable accounts are very large in the balance sheet accounts, that are older than 2008. With the government's decision and with the approval of the law on forgiveness of public debts Law no. 05 / L -043 on 22.07.2015 public companies according to this law until December 31, 2008 are free of all debts, but despite this law being implemented the companies did not delete these debts to the assets in the financial statements.

Another finding that is repeatable in private companies is that every company has to have internal rules to operate the management system in the company and must have the internal legal infrastructure where the employees of the company operate according to these internal regulations. 19% of companies do not have any internal regulations, while public utilities in recent years have drafted internal regulations although they still have to work because they are not properly completed.

At the public companies there are very sensitive department like procurement, where the auditor is very careful in this department because large amounts of purchases are made in public companies and auditors have to observe whether the procedures have been followed in accordance with the Public Procurement Law. 12% of private software companies do not process reports as required by international standards. The auditor has given the recommendations to have the ability to adapt and generate reports under IFRSs.

The auditor of the public enterprise observed also the failure to respect the fiscal laws in Kosovo where the findings are 9% in public enterprises, and 24% at private enterprises. Many times based on our experience the auditor's recommendations have influenced the enterprises to make corrections on tax and helped to not get fined by the Tax Administration of Kosovo-ATK.

The auditor often finds irregularities in the cash registers, 2% in private enterprise while in the public enterprise 7%. Assets of private companies are 3%, while public companies are 32%. The question arises is why do public companies have so many recommendations for assets? The reason is that in 2007 all public companies have revalued the assets- assets where the company that did the valuation was not licensed in Kosovo and the auditor was reserved for the valuation of these assets. Public companies have not defined all the properties they had before the last war in Kosovo. The auditor expresses reservations that some properties of the public enterprise are usurped.

In some companies dealing with food business activities, the auditor has found that the sales managers have made deceptive receivable accounts, where substantial amounts (to the audited enterprise) have been debt, whereas after the customer's confirmation of the debt, it turns out that this client does not owe. Sales managers did not end up paying debts but used the customer's payments for their own purposes by deceiving the company's owed debt. This case is worth mentioning because it has had large amounts of value, where the owners were very pleased with the auditors observation.

Conclusion

The audit of the company is the generator of enterprise development, but at first it was difficult to develop collaboration between auditors and the company, as they were convinced that the auditor had a bad intention for the company. But the development of the profession in a continuous and professional manner (always in the interest of the companies) has influenced the actors to understand the audit as a promoter for development.

The audit process has had different challenges, especially with the global crisis, where part of the blame was also thrown on non-professional auditors. The auditor should be professional in his judgment to decide on his actions in accordance with professional standards. Most companies have collaborated with auditors and throughout the work of auditors have been detected many nonconformities.

The audit as a process increases the credibility of the financial reporting presented by the company and increases the cooperation with partners such as enterprises, investors, other institutions etc. In modern times and with the expansion of the global market the auditor is a very important factor in the company's performance. Nowadays, the audit has become a very powerful pillar for company efficiency.

Audit plays an important role in managing companies in the best possible and most efficient way. Public and private companies, by applying internal and external auditing, have increased management system efficiency within their company. Companies that have an organized audit system have fewer findings and recommendations from external auditors, while companies that do not have an organized audit system have many nonconformity and mistakes, and their financial reporting is unreliable because these systems are not subject to audits. During the data collection for this study we observed that companies that have an audit system have fewer penalties from the tax administration and state control institutions.

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