

# Significance of Internal Audit for Enterprise Management: Aligning Traditional Practices with International Experience

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## Abstract.

In this article importance of internal audit for enterprise management was revisited. It comparatively studies the traditional and modern internal audit functions and analyzes the impact areas in consistent with changing business environment. Deriving from the findings and lessons from international practices, it provides a renewed internal audit functions which have a direct linkages with decision making and priority setting in an enterprise.

**Keywords:** internal audit, enterprise management, risk management, assurance.

## 1. Introduction

Any shifts in an integrated global business environment impact on all markets with both direct and collateral or sometimes hidden effects. Geography, sector and type of any market player seem meaningless for borderless impact channels. Despite common-root origins of market changes, business governance and enterprise-wide operations distinguish across countries and even country groups. Common difference often encountered in business structure and government-fixed regulatory framework which controls the business environment and labor relations in an entire economy. Changes in legislature and overall macroeconomic condition pose uncertainty and risks for business' stability which can be tackled with a sound internal audit function. Consequences of market volatility, legislative adjustments and structural transformations in an entity and a whole economy can be mitigated through a properly organized and timely revised internal audit performance.

Organizations establish an internal audit function to provide continuous review of the effectiveness of risk management, control, and governance processes (IAA-Australia, 2014). The internal audit function is one of the fundamental checks and balances for sound corporate governance (Laker, 2004). Internal audit provides an independent assurance for effective operation of risk management, governance and internal control processes in an organization. It looks beyond financial risks and statements to consider organization's growth, reputation, its influence on the overall environment and labor relations. However, recent continuous developments in international business environment have progressively changing the role of internal audit in an entity. Increasing regulations and expansion of businesses across the globe into new markets exposed businesses to greater regulatory and compliance risks. Tightening regulatory environment and supervisory procedures created even more compliance responsibilities which increases the burden for internal audit function in order to stay stable in a globalized market environment.

Modern business practices require multifaceted sophistication in business structure, strategy, performance and prudent objectives with flexible, reliable and practically relevant internal audit and control functions. Cutting edge internal audit practices mitigates the hazards and unexpected risks from non-systemic economic changes and non-compliance troubles through timely analysis, monitoring, consulting and guidance. Internal audit functions add the greatest value and contribute well into the future by enhancing the ability to keep pace with business change and being adaptive to risk landscape. It can play the central advisory role within the enterprise, as it can provide strategic insights for improving business performance and identify enterprise-wide cost efficiencies, potential and existing risks. This ensures multiple benefits and opportunities for an enterprise such as enhanced efficiency and ability to act properly. This article studies the relevance and significance of internal audit for an enterprise at firm-level and country-level analysis by means of comparative investigation of best practices in international experience. It provides insights into risk management and business performance tools of internal audit.

## 2. Literature Review

Internal audit and its impact on enterprise's smooth governance is a study of limited scope. There is a bunch of literature focused on internal audit structure, reporting and consultancy which are not capable of presenting a clearer view of relevance of internal audit for an enterprise from standpoint of business performance and management. However, there are many valuable publications international audit companies, especially by Big Four, which can be a key literature and guidance for companies to run a proper internal audit function and appropriate use of internal audit results for decision making and management.

Number of literature has begun increasing significantly after global financial crisis that was marked with downturn in all markets around the world. Increased risk scope and widened impact areas exceeded the need for internal audit research. Institute of Internal Auditors (2009) proposed new guidelines for internal audit and enterprise-wide risk management framework deriving from changes in new business landscape. Considering the

linkages of internal audit and corporate governance, IAA suggested that assurance and consulting roles of internal audit contributes to enterprise-wide risk management in a variety of ways through less coordinated approaches. In their studies, Ernst & Young (2014) experts found that enhanced role of internal audit function leads to move quick movement in driving competitive value across the enterprise. Deloitte (2012) linked the renewed importance of internal audit with increased number of high profile frauds surfaced after economic slowdowns. In its Three Lines of Defense mechanism, IIA Australia (2014) proved that internal audit mechanisms are important, co-ordination of the various assurance activities will provide a holistic assurance environment. Internal audit features prominently in that assurance environment, and it is a cornerstone of good corporate governance in enterprises and can play an important role to improve management and accountability.

### 3. Renewed Relevance of Internal Audit in Enterprise Management

Internal auditing is 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 (IAA, 2005). The ever increasing regulations and expansion of organizations across the globe into new markets exposed the organizations to greater regulatory and compliance risks (Deloitte, 2012). In consistent with these changes, the role and responsibility of internal audit have varied in scope and authority in different enterprises, which reflect a clear trend that internal audit is gaining strategic and central position in enterprise management. As enterprises work towards halting the downturn process in the market and business environment, internal audit functions looked towards for support to develop an overall knowledge of the enterprises' processes, risks, control systems and personnel which can contribute to an effective stability or recovery policy. Therefore, updated relevancy of internal audit in an enterprise requires reclassification of increased functions and responsibilities. In traditional literature, internal audit functions are often classified as assurance and consultancy. Previous generation of literatures, often called "pre-crisis", divided it them into assurance, consulting and control functions. Most experts and practitioners state that roots of these harsh challenges came from improper functioning and organization of internal audit services in large companies which caused a big fail in international markets. Doubled need for prudent internal audit required clearer and in-depth internal audit performance after turbulence in financial markets and global business environment. Actions and revisions for prudent internal audit services led to the recognition of one more ad hoc function aimed at regulation of assessment of business structure, condition and perspectives by finding gaps and inconsistencies, non-compliance and inappropriate management decisions which may affect soundness and stability (Figure 1).

Figure 1. Renewed internal audit functions for effective enterprise management



Source: Abdieva, 2016.

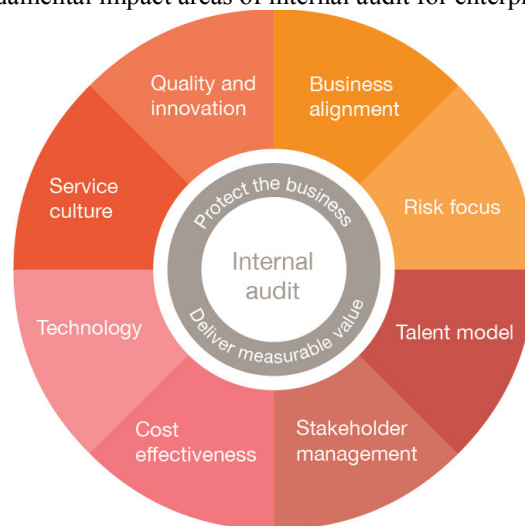
Traditional functions keep its value, but new functions originated from its stems as internal audit services were developed and globalized. Assurance function is an objective examination to provide accurate and current information to stakeholders about the efficiency and effectiveness of its policies and operations, and the status of its compliance with the statutory obligations. Where assessment and recommendations, oversight and advisory services functions are an expanded cluster substitution for consulting function. These functions assess and propose recommendations for effectiveness of existing controls and demonstrate clear-cut decision making with regard to ethics, compliance, risk, economy and efficiency in enterprise's management process. Development in internal audit brought a new generation of modern services rooted from expansion of service scope. Traditional consulting function of internal audit is reflected in diversified form of three separate functions which are interconnected and interdependent. There is a hotly discussed debate among key auditing and consulting companies over new

classification of internal audit functions, as they are too close and difference among them are practically similar. Most of audit companies remained loyal to traditional view and they still offer only two types of services, although they see that internal audit practices are still in transformation and development in parallel changes in global business environment.

#### 4. Importance of Internal Audit in Changing Business Environment

Across industries and geographies, company stakeholders have become more engaged with risk issues and have been seeking to improve their ability to define and communicate a clear, firm-wide risk appetite (PwC, 2012). In global business environment risk landscape is growing and rapidly changing as new risks emerge, challenges associated with more traditional risks continue to evolve. Continued economic uncertainty, increase in regulatory requirements, and financial market disorder and turbulence fuelled the concerns over traditional risks e.g. fraud and ethics, mergers and acquisitions, new product promotions, and business continuity. To cope with these challenges effectively, enterprises must utilize more sophisticated and integrated risk management practices. Significant part of these challenges could be neutralized by means of internal audit functions. Firm-level environment analysis and evaluation is an integral element of internal audit which is accountable for stakeholders and top management. Along with stakeholder's satisfaction internal audit influences the management process in enterprises with different effective tools. Properly organized and utilized functions stimulate enhanced quality and innovation, business alignment, risk focus, talent model, stakeholder management, cost effectiveness, technology and service culture (Figure 2). Impact areas of internal audit in enterprise's management are different in scope and number. Abovementioned eight fundamental impact zones are crucial for running business by meeting requirements of dynamic business environment and responding to existing challenges.

Figure 2. Eight fundamental impact areas of internal audit for enterprise management



Source: PwC, 2015.

Considering the renewed functions, impact zones and general condition in business community internal audit functions:

1. facilitates identification and aligning the most critical risks via comprehensive risk assessment;
2. coordinates and ensures an optimal circumstance for risk management and compliance measures through shifting risk landscape;
3. provides recommendations to manage risks, control and improve business performance for stakeholders along with reporting on existing insufficiencies;
4. manages resource capacity through timely monitoring and control over operations in an enterprise.

These four key functional attributes are always subject to change depending on the condition in an enterprise and a whole business sector in the economy. International experience proved that internal audit functions sometimes fail in identification, assessment and mitigation of particular risks faced by an enterprise. In order to enhance risk management practices, enterprises should revise their internal audit practices and procedures, and should provide wider data accessibility for internal auditors. Selection of internal audit team, allocation of functions and excise schedule for internal audit reporting are seen as the core action to introduce a qualitative internal audit function. Only in this case, internal audit-stakeholder relations bring positive effect in management.

## 5. Conclusion and Recommendations

Research findings and study results always give different conclusions. However, importance of internal audit for enterprises management is out of any discussions and debates. Only functional matters and business impact areas are of hot scientific and empirical debate. Role of internal audit in enterprise's functioning is always recognized and regularly supported by board and audit committees. Moreover, recent economic tightening urged importance of internal audit and equally required to be functionally relevant and active in decision making in full accordance with situation in the market where the enterprise operates. It at least doubled the burden of internal audit in terms of service quality and relevance. Following recommendations are proposed to improve and strengthen the position on internal audit in enterprise in a wider scope:

1. In an environment, in which enterprises are redesigning their business strategy, high-performing internal audit functions are required to operate at the forefront of the management of enterprises' most relevant risks. Therefore, leading internal audit functions should develop a strategic plan in consistent with enterprise's short- and long-term development strategies in order to identify risk horizon.
2. Internal audit team, as mentioned above, should be highly skilled and experienced. They should have sufficient knowledge, investigation techniques and applicable laws.
3. In leading corporations of the planet internal audit service has a big say in decision making and strategy setting processes. They have direct contact, data access and several incentives to implement the function adequately well. It is very important that internal audit functions should be sufficiently funded, staffed and trained.

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