

HOW SHOULD INTERNAL AND EXTERNAL AUDITORS WORK TOGETHER?

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ABSTRACT

External auditors of financial statements and controls are facing increased scrutiny from their regulators. In response, public accounting firms are tailoring their audit procedures and guidance, along with their documentation requirements, with a keen focus on the avoidance of PCAOB comments and findings. As a result of this continuous improvement, external auditors are finding it difficult to utilize the work of internal audit to reduce their procedures due to the use of outdated audit plans. To ensure that internal audit procedures are being maximized by the external auditors, the communication between the two should be improved.

INTRODUCTION

External auditors of financial statements and controls are facing increased scrutiny from their regulators concerning the audit procedures being performed. As reported by the Wall Street Journal, Martin Baumann, chief auditor of the Public Company Accounting Oversight Board (PCAOB) stated, “when we look at an audit, the rate of failure has been in a range of around 35 to 40%.”[1] This failure rate has the potential to undermine public confidence in the work of external auditors and potentially the audit profession as a whole. Furthermore, such high failure rates could cause even more regulatory oversight and potentially structural reform to the audit industry. A common theme in most PCAOB inspection reports is that audit failures often result from the respective firms’ failure to accumulate and retain sufficient appropriate audit evidence to support its’ opinion. The PCAOB is basically stating that auditors often are not meeting their most fundamental responsibilities.

In response to increased regulatory scrutiny, public accounting firms are making continual improvements to their audit procedures and guidance, along with their documentation requirements, with a keen focus on the avoidance of PCAOB comments and findings. If the client’s internal audit department is not kept abreast of the updates, a knowledge gap develops between the groups. If the internal audit plans used are not up to par with the external audit firm’s standards, the external auditors find it difficult to use the work of internal audit to reduce their procedures. In such instances, the work of internal audit may be disregarded or redundantly performed by the external auditors. The two groups should actively seek to close the knowledge gap and seek a more symbiotic relationship through better communication.

To help ensure that internal audit procedures are being maximized by the external auditors, the communication between the two should be improved. As part of this process, both groups should seek agreement on certain elements of the audit prior to audit procedures being performed each year. If the two groups can achieve unity, they can cultivate a more collaborative relationship which will enhance the effectiveness and efficiency of the audit. Prior to the execution phase of the audit, both groups should seek to ascertain an agreement on key components such as risks, scoping, materiality, sample

sizes and general documentation standards. If internal audit executes on the shared parameters, much of the work they perform should prove valuable in reducing testing procedures and required modification of audit documentation performed by the external auditors. As the relationship is developed and as external audit is able to reasonably use and rely on the work of internal audit, the process will likely become more efficient resulting in less time spent by the external auditors on the engagement; and the quality of the audit process may be enhanced while the company potentially experiences a reduction in external auditor fees.

Internal auditors and external auditors can more effectively collaborate during the planning and execution phases of the audit by making certain adjustments to their communication process.

PLANNING PHASE

In many cases, the external audit team does not have advanced knowledge of the planned timing of internal audit's procedures and the scheduled dates for site visits. Internal and external audit should strive to coordinate on the planned timing of their procedures. If both groups are aware of the scheduling of certain procedures, they can accommodate each other by making revisions which enable both groups to participate in the process and work together to reduce redundant audit activities. This concerted effort will ease the burden on management and employees of the company and it will help cultivate a more productive relationship.

Internal audit should actively solicit input from the company's external auditors during the risk assessment process and scoping procedures, as these processes drive the internal audit plan each year. Knowledge sharing will result in the identification of risk areas which in turn will ensure that internal audit is designing appropriate procedures around the significant processes, accounts and locations. Additionally, the two groups should discuss the company's control structure and agree upon the key controls in place at the organization. This will help ensure that both groups are appropriately focusing their control testing procedures. Input from both parties will likely result in a more thorough and well prepared analysis enhancing the effectiveness of their work.

Internal audit should discuss materiality considerations with the external auditors to ensure that testing procedures will be designed and performed at a sufficient level. If the work is performed at an adequate level and in sufficient detail, the work will be utilizable by external auditors without significant additional procedures. The reduction of follow-up hours can lead to reduced external audit fees which will be perceived positively by the audit committee and management.

Internal audit and external audit should discuss management's subjective and complex estimates that could have a material impact on the financial statements and agree on the key assumptions and inputs used so that testing procedures will be properly designed and performed. Additionally, internal audit can use knowledge of the estimates to encourage management to enhance its documentation around the key inputs and assumptions.

EXECUTION PHASE

Before the performance and documentation of testing, whether it is controls testing, tests of details over an account or financial statement line item, or testing to obtain assurance over an estimate, the internal and external audit groups should discuss and agree upon audit documentation requirements. The two groups should ensure that they agree on the form and content of the planned documentation. There should be a discussion regarding any potential obstacles that may exist that could prevent the external

audit team from using internal audit's work and documentation. Internal audit should keep the obstacles identified in the forefront of their mind as they are performing and documenting their procedures. To facilitate the documentation process, internal audit should consider requesting an up-to-date template from the external auditors. This will ensure that future documentation meets the audit firm's standards, resulting in minimal follow-up by the external auditors.

Both groups should ensure they agree on appropriate sample size methodology. For both controls testing and test of details, the external auditor could provide specific guidance to internal audit to enable them to calculate appropriate sample sizes in accordance with the audit firm's guidelines. Alternatively, internal audit could request that the external auditors calculate the appropriate sample size using their specific templates so that no additional testing is required to be performed by the external auditors.

Regular meetings should be scheduled with members of internal and external audit present, specifically when working in a direct assistance capacity, so that the external auditors can work with internal audit staff directly to ensure that all testing procedures are being performed as expected. Additionally, the internal audit group should request feedback from the external audit team to ensure continual improvements are made throughout the audit process. External audit should make every reasonable effort to work collaboratively with internal audit to take full advantage of internal audit's work in accordance with applicable standards.

By improving the communication process between internal and external audit, the two parties can aspire to work collectively to enhance the effectiveness and efficiency of the audit process.

REFERENCES

[1] Chasan, Emily. *One in Three Audits Fail, PCAOB Chief Auditor Says*. Wall Street Journal, 24 January 2014. Web. 15 December 2014.