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Coordination and Cooperation between Internal and External Auditors

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Abstract
Effective coordination and cooperation between internal and external auditors leads to several benefits for them and also for the clients whom they serve. It increases both the efficient and effective of audit and decreases audit fees. Professional bodies have confirmed their importance and their potential contribution in improving auditors' works. However, this issue has not been extensively studied yet and need more research especially in developing countries. This paper discusses the professional standards which relating to, the benefits of, and the role of corporate governance in enhancing coordination and cooperation between auditors. Issues are analyzed by providing recommendations that could enhance it. This paper has argued that coordination and cooperation between auditors in the organization are both affected in and affected by their relationship with other corporate governance parties, and depended on the support of both audit committee and senior management, which could provide insights for future research.
Keywords: internal auditing, external auditing, coordination between auditors, cooperation between auditors.

1. Introduction

Internal audit is often part of the organization which aims to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA, 2012, Sec. 2100) whereas, external audit is not part of the organization, but are engaged by it, and aims to provide an independent opinion on the overall fairness of the annual financial statements. Although, the scope of internal auditors differs from external auditors, they share in evaluating the internal control system as a common goal for both of them, and their aims from this evaluation are different. The external auditor aims to implement the second standard of field work standards, evaluate risk control, and identify the audit sample while, internal auditor aims to provide recommendations that assist to develop and improve the internal control system. This share in some goals increases the importance of, and the need for coordination and cooperation. This view is supported by Lin, Pizzini, Vargus and Bardhan (2011) who based on data collected from 214 U.S. firms found that, the disclosures of material weaknesses reported under Section 404 of the Sarbanes-Oxley Act of 2002 are positively associated with coordination and cooperation between internal and external auditors. The benefits of coordination and cooperation are extended to include some benefits for the audit client. This view is supported by Felix, Gramling and Maletta (2005) who found that coordination efforts of auditors in the organization unable to maximize the effectiveness of internal auditors' contribution to the financial statement audit and increase overall efficiency. Similarly, Peter Wilson, the IIA president (1988) confirms that cooperation between the external and internal auditors is necessary to ensure the most appropriate coverage of all major systems, and effective reporting of results. However, the issue of cooperation and coordination between internal and external auditors has not been extensively studied yet and needs more research especially in developing countries (Al-Twaijry, Brierley & Gwilliam, 2004; Fowzia, 2010; Abbass & Aleqab, 2013). The study's originality is its reviews the relevant standards issued by audit professional bodies and the findings from previous studies, and provides some recommendations that could enhance the coordination and cooperation between auditors in the organization. The following section discusses audit standards that relate to the cooperation and coordination between internal and external auditors, followed by the benefits of coordination and cooperation, the impact of corporate governance is addressed in the fourth section, the fifth section shows some ways to improve the coordination and collaboration between internal and external auditors, followed by a conclusion.

2. The Impact of Professional Bodies on the Coordination and Cooperation between Auditors

Professional bodies for audit such as the American Institute of Certified Public Accountants (AICPA), the International Federation of Accountants (IFAC) and The Institute of Internal Auditors (IIA), have recognized the importance of internal audit and its potential contribution to external auditors' works.

In 1975, Statement on Auditing Standards (SAS) 9, *The Effect an Internal Audit Function on the Scope of the Independent Auditor's Examinations*, issued by the AICPA, was the first professional standards which aimed at setting guidelines for external auditors when relying on the works performed by the internal auditors. SAS 9 requires external auditors consider the internal auditors' objectivity, competence and work performance before relying on internal auditors' works.

In 1991, the AICPA has issued the Statement on Auditing Standards (SAS) 65, *The Auditor's Consideration of* *the Internal Audit Function in an Audit of Financial Statements*, which provided more attention to the relationship between auditors in the organization. This Statement requires external auditors to acquire an understanding the internal auditor's role when assessing their client's control structure and modify the audit procedures accordingly (Reinstein, Lander & Gavin, 1994). In addition, SAS 65 has given more confirmation, and more details about the issue of evaluating the internal auditor competence, objectivity and work performance. In 2009, International Standard on Auditing (ISA) 610, *Using the work of internal auditing*, issued by IFAC requires external auditors to evaluate; 1) objectivity; 2) technical competence; and 3) due professional care of internal auditors. Moreover, 4) effective communication between internal and external auditors; and 5) internal audit scope. Furthermore, 6) the assessed risks of material misstatement at the assertion level; and 7) the subjective level in internal audit evidence.

The Institute of Internal Auditors (IIA), the international professional body of internal auditors, has adopted International Standards for Professional Practice of Internal Auditing (ISPPIA). These standards were reviewed constantly, and the latest revision was in October 2012 and applied on January 1, 2013. The ISPPIA requires the chief audit executive to share information and coordinate activities with the external auditor to ensure proper coverage and minimize duplication of efforts (IIA, 2012, Sec. 2500). The Practice Advisory (2050 – 1: Coordination) requires the chief audit executive to communicate the results of this coordinating to both senior management and the board, including any relevant comments about the external auditor's works.

3. The Benefits of Coordination and Cooperation between Internal and External Auditors

The main purpose of coordination and cooperation between internal and external auditors is to improve the effectiveness of audit and minimize the audit cost (Ho & Hutchinson, 2010). Engle (1999) indicated to the following three main benefits which are; a) meaningful audits has a significant impact on achieving organizational objectives, b) the external auditor who depends on internal auditors' work has a significant ability to decrease his fee, and c) reduce the disagreements between the external auditor and senior management that may occur regarding the application of accounting principles. The present paper argues that the coordination and cooperation between auditors may impact primarily on service to audit clients, fraud detection and the audit fees. Each of these is discussed next.

3.1 The Impact of Coordination and Cooperation on Audit Client

Effective coordination and cooperation between auditors leads to a range of benefits for them, and also for the clients whom they serve (Fowzia, 2010), and enhances audit efficiency without a loss of effectiveness. Morrill et al. (2003) consider the coordination of external and internal auditors can provide total audit coverage more efficiently and effectively. On the same note, Ester Gras-Gil et al. (2012) found that greater involvement of internal auditors in reviewing financial reporting leads to improved quality financial. Similarly, Schneider (2009) argued that the main benefit of coordination between auditors is increasing the effectiveness of audit and decreasing the audit's cost. In here, the current study adds that the existence of evaluating the internal control system as a common objective for both internal and external auditors should enhance the coordination among them. According to the Practice Advisory (2050 – 1: Coordination), the planned audit activities of internal and external auditors should be discussed to maximize audit coverage and minimize duplicate efforts. This discussion provides a better service to audit clients through the integration of efforts and ensure that the audit scope covers the whole organization activities. Similarly, coordination and cooperation lead to integrate the knowledge of both parties, the external auditors can benefit from internal auditors' knowledge about the environment and control system in the organization while the internal auditors can benefit from external auditors' knowledge about similar businesses or organizations. Share knowledge between internal and external auditors, without any doubt, leads to better service to audit clients. Furthermore, both internal and external auditors are some of the corporate governance parties, and their coordination and cooperation enhance the corporate governance. This view is supported by Gramling, Maletta, Schneider, and Church (2004), who confirm that the collaboration among corporate governance parties helps to maintain the effectiveness of corporate governance. Due to the fast rate of technological advances (Fowzia, 2010), both internal and external auditors are recommended by using similar techniques, methods, and terminology, which help both in achieving their work and to depend on each other works (the Practice Advisory, 2050 – 1: Coordination).

3.2 The Impact of Coordination and Cooperation on Fraud Detection

In recent years, professional bodies such as AICPA (SAS No. 53, SAS No. 82, and SAS No. 99) and IIA (IIA, 2012, Sec. 1210. A2) have required both internal and external auditors for the importance of fraud detection (Coram, Ferguson & Moroney, 2006). Schneider (2009) argues that internal auditors' knowledge about the environment and control system in the organization is more than the external auditors so; internal auditors are more able to discover the fraud compared to their external auditors. Similarly, Hillison, Pacinl and Sinason (1999) confirm that internal auditors can be an entity's main line of defence against fraud, in contrast, external auditors often unable to detect and report the occurrence of employee fraud. Moreover, Beasley, Carcello, Hermanson, and Lapides (2000) say the investment in internal audit has been effective as companies with internal audit function are less prone to financial fraud than companies without it. Coram et al (2006) found that organizations with internal audits are more likely than those rely solely on outsourcing to detect fraud within their organizations. This view is supported by the KPMG's Fraud Survey (2003) which found that 65% of fraud discovered in government and industry in the United States by internal auditors and only 12% by external auditors. Similarly, KPMG Malaysia Fraud Survey Report (2009) found that 30% of the frauds discovered, in 2008, in Malaysian companies by internal auditors and only 8% by external auditors.

According to the above discussion, the role of internal audit in the fraud detection is clear, which should increase the importance of coordination and cooperation between auditors in this issue. This view is supported by The Panel on Audit Effectiveness (2002), which confirmed the importance of existence a high level of coordination and collaboration between internal and external auditors that lead to reduce fraud risks.

3.3 The Impact of Coordination and Cooperation on External Audit Fees

There is no consensus among researchers about the impact of coordination and cooperation between auditors on external audit fees. The findings of previous studies examined this issue were mixed. Some researchers (Wallace, 1984; Wallace & Kreutzfeldt, 1991; Felix, Gramling & Maletta, 2001; Schneider, 2009) suggested that coordination and cooperation have a significant impact on reducing the external auditor fees. Wallace & Kreutzfeldt (1991) noted that the total external audit hours would increase an average of 10% without internal audit functions involved in audits. Also, Wallace (1984) indicated that the reliance on internal auditing led to a 10% reduction in the audit fee. Felix et al. (2001), based on 70 of non-financial companies, found that the organizations whose external auditors depend on internal auditors' works save an average of $215,961 or 18% of the external auditor fees. In contrast, other researchers (Hay & Knechel, 2002; Goodwin-Stewart & Kent, 2006) found that the external auditor fees are higher in the organizations which have internal audit departments. Goodwin-Stewart & Kent (2006), based on 401 listed companies in Australia, found that the existence of both audit committee and internal audit fee have a negative impact on reducing the audit fee. Their findings were justified as the reason for the level of audit quality required by audit committees. On the other hand, Stein, Simunic and O'keefe (1994) found no significant relationship between external audit fees and the level of coordination and collaboration between internal and external auditors.

Reduce the audit fee can be a secondary objective of coordination and cooperation between auditors, however, the primary objective is to increase the effectiveness of audit activities. Recently, a few studies (Ho & Hutchinson, 2010; Abbass & Aleqab; 2013) found a negative association between external audit fees and internal audit characteristics. These characteristics include the internal audit organizational status, work performed, competence, and professional due care. These studies revealed that the higher in internal audit characteristics led to the higher in external auditors' reliance on the work performed by internal auditors. This reliance could lead to a decrease in the audit sample size and its processes, which minimize external auditors' efforts and so fees.

4. Corporate Governance and the Coordination and Cooperation

The effectiveness of corporate governance needs the coordination and cooperation among the four parties, which include: the audit committee, senior management, external auditors, and internal auditors (Gramling et al., 2004). Therefore, the coordination and cooperation between auditors affect in and is affected by the relationship with other corporate governance parties. Although the coordination and cooperation between auditors can be established, they are nevertheless contingent on the support of both audit committee and senior management. Open and candid communications between external and internal auditors and also between each other and also with both audit committee and senior management, and encourage feedback during the communication process, and neither interference nor restriction in internal audit scope of senior management and its overall acceptance and appreciation, without any doubt, enhances this relationship. On the other hand, the existence of an effective audit committee can be enhanced this coordination and cooperation through supporting internal auditors' objectivity and reducing senior management interferences. It is clear that, when senior management is committed to strengthening internal auditing and when there is an effective audit committee in the organization, the level of external auditors' confidence in internal auditors' objectivity will be raised, and lack of such an environment has a negative impact on the coordination and cooperation between auditors. However, no sufficient attention has been given, in prior literature, to examine the impact of both audit committee and senior management on the relationship between internal and external auditors, to the best of the researcher's knowledge, only Fowzia (2010), who examined the cooperation between internal and external auditors on nationalized and foreign banks in Bangladesh, and found that this cooperation promoted through management and the audit committee. Although, the importance of Fowzia's empirical findings, it did not provide sufficient theoretical justifications for that. Thus, the logical argument in this paper contributes to fill this gap and provides insights for future research.

5. Some Ways to Improve the Coordination and Cooperation

To improve the coordination and cooperation between internal and external auditors, the effective communication becomes critical and requires some terms such as should be frequent, open, direct, and timely. This communication may be written; electronic; face to face; telephonic or combination of all above. Wood (2004) suggested that effective communication requires; 1) meetings are held between internal and external auditors periodically, 2) the external auditor has access to relevant internal audit reports and should be informed about matters that could impact his/her work, and 3) the external auditor informs the internal auditors of any matters that may affect the internal auditor's work. On the same note, Wilson (1988) confirms that the cooperation between the external and internal auditors should involve: 1) periodic meetings to discuss matters of mutual interest; 2) assess to each other's audit program, and exchange of audit reports; and 3) common understanding of audit techniques, methods, and terminology. Fowzia (2010) confirms on the importance of confidence between internal and external auditors on enhancing the coordination and cooperation between one another. In this point, the current study adds that; 1) open and candid communications with the audit committee and senior management, and encourage the feedback during the communication process. Moreover, 2) the role of an audit committee in coordinating the audit effort that can ensure total audit coverage and to be more efficiently and effectively, this coordination includes periodic meetings between audit committee with both internal and external auditors to discuss matters of mutual interest. Furthermore, 3) the improvement of coordination and cooperation could also be by setting the overall tone in the organization of acceptance and appreciation its results, and to implement its recommendations.

6. CONCLUSION

Since internal and external auditors have some common goals, an effective coordination and cooperation between them can be beneficial. This helps them to reach their objectives and provide a better service to audit clients. In fact, professional bodies recommend both internal and external auditors by improving the level of coordination and cooperation between each other, and the professional standards that related to that were discussed in this paper. Besides that, the benefits of this coordination and cooperation on both quality and cost of the audit; and the role of corporate governance on the relationship between internal and external auditors have discussed. This paper confirms on the importance of both audit committee and senior management on improving the coordination and cooperation between internal and external auditors, which should consider a beginning point to; a) formulate testable hypotheses; b) develops research questions for more detailed; and c) enable deeper understanding of both practice and theory of these coordination and cooperation and open a new area for research.

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