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**EXTERNAL AUDIT AND RELATION BETWEEN INTERNAL AUDITORS,
SUPERVISORY BODY AND EXTERNAL AUDITORS
OF THE BANKING SECTOR IN THE REPUBLIC OF MACEDONIA**

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Abstract

There are different types of audit, such as financial audit, regulatory audit, operational audit of performances, audit of information systems, environmental audit and others. But basically, we distinguish two types of audit which will be the main focus of attention in this work. External audit, an Internal audit. In most countries, the external auditor from the public sector reports to parliament and, where relevant, the private sector auditor reports to government (e.g. ministry of finance) and/or the public sector external auditor (the supreme audit institution). An efficient system of internal audit is an invaluable source of information for the management of the bank, its supervisors and the quality of the internal control system in that organization.

Keywords: internal audit ,external audit, supervision,central bank external audit function

INTRODUCTION

There are different types of audit, such as financial audit, regulatory audit, operational audit of performances, audit of information systems, environmental audit and others. But basically, we distinguish two types of audit which will be the main focus of attention in this work.

- External audit, and
- Internal audit.

1. EXTERNAL AUDIT

The external audit is a review of the financial statements of an organization by independent legal authorized auditors.

The main objective of the external audit is to provide an opinion on the financial statements.

The word audit originates from the Latin word (audire) to listen. The auditor is defined as a listener: one who reviews the statements. Increased trade during the 19th century required greater funding, provided by many investors. That is how the practice of joint ownership of enterprises and establishing companies with limited liability begins.

The owners employed managers to manage their enterprises, and the managers gave a report for their work, usually once a year.

Usually the investors did not know anything or they knew very little about the business they invested in and for this reason they could not know anything more about the reliability of the financial statements which the managers submitted.

Thus, they nominated a third independent person to examine the accounts, to investigate and make checks when necessary, with an objective to give his opinion on its admissibility. The financial statements were submitted orally and after the hearing, the respected listener reported his opinion. These listeners later became known as auditors¹.

1.1. THE ROLE AND THE RESPONSIBILITIES OF THE EXTERNAL AUDITORS

The purpose of the external audit is to provide an opinion whether the financial statements objectively present the financial condition of the bank on a certain date, the results of its operation and the changes of its financial condition in accordance with certain accounting standards or regulations. In other words, the external audit provides an independent assessment of the overall condition of the bank at some point. The proper application of the external audit gives confidence in the bank's solvency through accurate financial information to shareholders and the National Bank, as well as for the other users.

The external auditors are independent individuals employed by an audit company to assess and evaluate the financial statements of the clients or other agreed evaluations. Most external auditors are employed by accounting companies and engaged during the entire year. They are called upon need and they do not come directly from the company, meaning they are external people.

Even though, by definition, the external auditors are not part of banks, and therefore they are not part of the internal control process, they have an important role on the quality and the improvement of the systems of internal control. The external auditors provide an important “feedback” for the effectiveness of the internal control systems during the

¹ With the expansion of business activities, the oral financial reports passed in written form, but the name auditor, listener, did not change.

performance of their audits, the regular discussions with the Executive Board, Governing Body, middle management and employees, as well as through the recommendations for improving the systems for internal control. Given the fact that the primary function of the external auditors is to provide an opinion on the reality of the annual account of the bank, they should decide whether during the performance of the external audit they can rely on the efficiency of the internal control process in the bank. Hence, it follows that they should have knowledge of the internal control system in the bank.

Basically, the external auditors are expected to provide assessment of the internal control systems as a basis for preparing accurate financial statements for the working of the bank. They are expected, in case of detecting material deficiencies, to inform the Executive Board, the Governing Body and the supervisory authorities by submitting confidential letters. The Governing Body and the Executive Board should provide implementation of the corrective measures for the identified weak internal control systems established and indicated in the report of the external auditors.

In accordance with the Law on banks, the financial statements and the registers are being checked and assessed by an authorized auditor who prepares an audit report pursuant to the audit regulations. According to the legal provisions, the authorized auditor assesses:

- The balance sheet;
- The profit and loss statement;
- The cash flow statement;
- The changes in amount of equity;
- The level and the changes of the allocated reserves for potential losses and the performed write-offs;
- The amount of the undertaken potential liabilities;
- The report on the effects of the consolidation;
- The functioning of the internal audit;
- The bookkeeping;
- The information system;
- The accuracy and the completeness of the statements which are delivered to the National bank;
- The adequacy of the accounting procedures of the bank; and
- The implementation of the legislation.

The external audit should provide not only: assurance of the reliability and the accuracy of the published financial statement of the entity which is subjects of audit, but also:

- assurance of the regularity of the basic transactions;
- assessment of the thriftiness, the efficiency and the effectiveness by which the administrative body performs its functions.

• Generally, the external auditors must constantly bear in mind the interests of the general public.

The National Bank of Macedonia, as a supervisory body in the country, may request additional explanations from the auditor, regarding the audit report. If the auditor determines that the bank is unable to meet its obligations or that the bank was working against the applicable regulations, the auditing company is obliged to immediately notify about it in writing to the Minister of Finance and Governor of the National Bank. Also, the audit company shall submit the report of the performed audits to the National Bank, the Governing Body of the bank and the Executive Board of the bank, and it shall submit the annual financial report also to the Ministry of Finance.

In accordance to the Law on banks, the National bank may not accept the financial reports of the external auditor, if it determines that they are not based on objective facts about the financial condition in the bank. If the National bank determines that the audit report is not based on objective facts regarding the financial condition in the bank, it will not accept audit report of that auditing company in the following three years. In such case, the National bank requires the bank to appoint another auditing company. In addition, all eventual expenses incurred in relation to the appointment of a new auditing company are submitted by the bank.

According to the international practice in the public sector, the external audit is performed by Supreme Audit Institutions (SAI). These are considered the highest auditing bodies in the public sector.

In an international context, the work of the SAI and the audit requirements prescribed by law, which need to be performed by SAI are regulated by Acts of supreme audit or by the Constitution of the country itself. In Europe, the audit authorities have adjusted their audit process from different historical forms and there are still various forms of external audit.

1.2 EXTERNAL AUDIT INSTITUTIONAL FRAMEWORK

The State audit office (SAO)² is the external office of the government. It began with its own operations in 1999 with the transfer of staff from the former ZPP, Payments bureau. The audit coverage is insufficient and it will take several years before the entire audit function will be covered³. The audit mandate includes all audit types, but the SAO focuses primarily on regularity audits and does not conduct performance audits. Given the present state of the SAO's development, this focus is appropriate. The SAO is not subject to an independent, external audit by a qualified auditor. For reasons of symmetry and to demonstrate leadership, the SAO should be subject to an annual external audit on its operations (Official Gazette in December 1997).

2. INTERNAL AUDIT

2.1. EVOLUTION OF THE INTERNAL AUDIT

The internal audit has evolved from basically an accounting oriented skill towards management-oriented profession. Now however, the internal audit is considered a separate discipline with far broader scope.

Modern internal audit provides services which include examination and evaluation of the controls, performances, risk and management of public and private entities. The financial issues represent only one aspect of the scope of the internal audit. In the past, these were considered enemies of the client, but now the internal auditors try to establish collaboration and productive working relationships with clients through activities which provide greater

² The SAO, a member of both INTOSAI (since 2001) and EUROSAI (since 2002), is committed to following INTOSAI standards in conducting its audits.

³ A more risk-based approach to the selection of audits is required.

value. Taking into consideration that this broadly based audit of all activities began to occur relatively recently, in general, it is considered a modern internal auditing.

2.2. DEFINITION AND OBJECTIVES OF THE INTERNAL AUDIT

The definition of the internal audit is subject to continuous development. The internal audit is an independent assessment function established within an organization in order to examine and assess its activities in the service of the organization. This statement is more a kind of an introduction than a definition. It has no indications regarding the responsibilities of the internal auditor, or stating that the audit is no longer only limited to control of the financial accounts.

In this context there is a new definition about internal audit. The new definition is not only an expression of the changes which occurred in the profession in the recent decades, but it directs the internal auditors towards greater and far more influential role in the future. The new definition is: Internal auditing is an independent, objective assurance and consultancy activity designed to add value and improve the functioning of the organization. It helps the organization to achieve its objectives by introducing systematic, disciplined approach to evaluating and improving the efficiency of the risk management, control and management process.

In the book on internal auditing by Sawyer⁴, the following definition is indicated in order to describe the broad, unlimited range of the modern internal audit:

The internal audit represents a systematic, objective assessment by the internal auditors of the various activities and controls within an organization in order to determine whether:

- (1) the financial and operating information is accurate and reliable;
- (2) risks for the bank are identified and minimized;
- (3) external regulations and generally accepted internal policies and procedures are being followed;
- (4) appropriate criteria of work are met;
- (5) resources are used in an efficient and economical manner; and
- (6) organization's objectives are met in an effective manner - all this in order to provide consultation with the management and to assist members of the organization in relation to the effective fulfillment of their management responsibilities.

This definition not only indicates the role and the objectives of the internal auditors, but it also identifies the opportunities and responsibilities.

Additionally, important requirements listed in the Standards are embedded in the definition and it contains the modern extended activities of internal auditors and the emphasis which is put on the added value and all other issues related to risk, management and control.

The internal audit is an independent activity of giving objective assurance and advice, established to contribute for value increase and improvement of bank's working. It helps the bank to meet its objectives by using a systematic, disciplined approach for assessment and improvement of the effectiveness in the processes of risk management, control and management.

The objective of the internal audit is to provide to the head of the public sector subject, a reasonable independent objective assurance and an advice in order to improve the working of the bank and to increase the effectiveness of the internal control systems.

⁴ Internal Audit Sawyer, Institute of Internal Auditors, 2003, p.10.

The role of the internal audit is to support managers in the bank to achieve the objectives of the bank. The internal audit realizes this support through a self-development of strategic and annual plans for internal audit of previously conducted objective assessment of the risks and execution of individual audits in accordance with the adopted internal audit plans. The purpose of the individual internal audits is assessment of the appropriateness, thriftiness, effectiveness and the efficiency of financial management and control system. The internal auditors conduct this by assessing the success of the determination, estimation and risk management of the subject in relation to: the compliance with laws, bylaws and internal acts and contracts, the reliability and completeness of the financial and operative information, the safety of the property and the information and the execution of tasks and achieving the goals.

The internal audit provides support for the managers in the public sector to achieve the objectives of the subject by making recommendations to improve working and work procedures and monitoring of the implementation of the measures taken by the manager of the subject from the public sector based on the performed audits.

The internal audit is conducted in accordance with the principles of legality, independence, objectivity, competence, professionalism, integrity and confidentiality and with the accepted international standards for Professional Practice of Internal Auditing, the bylaws, internal audit charter and the internal acts of subject of the public sector. The Internal Audit Unit has the authority to conduct internal audit in all organizational structures, programs, activities and processes in public sector entities.

2.3. INDEPENDENCE AND OBJECTIVITY OF THE INTERNAL AUDITORS

The internal auditor should be independent from the processing and performance of the activities reviewed. The internal auditors are independent when they can carry out their work freely and objectively.

The independence allows the internal auditors to provide impartial judgments are essential for the proper conduct of the audit. This can be achieved by delivering objective and appropriate status in the organization.

The organizational status of the internal audit should enable the realization of the revision responsibilities. Internal auditors should have support from management in order to cooperate well with the other employees and be able to perform the work without any interference.

The objectivity is an independent mental attitude which internal auditors should foster in performing the audit. The internal auditors should not subjugate their judgment during the audit about the opinion of others. Internal auditors should not be brought into a situation where they would feel incapable of making objective professional judgment.

The obligations of the personnel should be such to avoid potential and actual conflicts of interests and bias. The auditors should periodically inform the Director about potential conflicts of interests and bias and internal auditors should immediately notify the Director about all situations in which a conflict of interest or bias is present. In such case, the Director should then redeploy those auditors.

For example, persons who are transferred or currently engaged in the internal audit should not be appointed to control those activities previously performed, until a reasonable period of time passes.

Are internal auditors able to maintain their full independence? Probably not. Nor is it necessary. However, in respect of the issues which are subject to their audit, internal auditors

must provide a satisfactory level of independence in order to retain their objectivity, both in reality as well as in perception.

So, based on the above mentioned we can say that:

Internal (internal) auditors are employed in companies whose task is to assess and evaluate the system of internal controls. In order to retain their independence, they present their reports directly to the board of directors or the top management. Internal auditors are employed in companies, so they find cases of fraud or embezzlement more easily.

2.4. TYPES OF INTERNAL AUDIT

According to the area:

- financial audit, whose objective is control of the adequacy of the accounting system, the information provided by this system, as well as the financial statements arising from this system. More precisely, this type of audit represents verification the accuracy of the presentation of all accounting and financial statements as well as their compliance with the accepted criteria and standards. The quality of the accounting system as the most important information subsystem in a bank, is of great importance considering that it facilitates the implementation and monitoring of the achievement of objectives set by management;

- audit of compliance which has an objective to assess the quality and adequacy of the established systems for checking the compliance with laws, regulations, policies and procedures;

- operational audit (that is, internal audit of the system), whose goal is the assessment of the quality and adequacy of all established systems and procedures, critical analysis of the organizational structure in terms of adequacy of methods and resources in relation to the set tasks, systematical controlling of all operations in accordance with the established objectives and their implementation, identification of the opportunities for improvement and making recommendations for improvement, extension or termination of such activities;

- audit of the information system implies control of security, efficacy and availability of information system according to its elements, such as data, applications, technology, capacity and human resources, as well as an evaluation of the reliability and adequacy of computer controls, and

- audit of the management function, aimed at determining the quality of management and control of risks within the goals of the bank.

Given that the task of the Internal Audit Service is control and assessment of the efficiency of all activities and entities in the bank, it should not focus only on one type of audit⁵.

3. RELATION BETWEEN INTERNAL AUDITORS AND EXTERNAL AUDIT AND DIFFERENCES BETWEEN INTERNAL AND EXTERNAL AUDIT

The function of the internal audit does not exclude the need of external auditors, but rather it complements and contributes to their work. Internal audit, properly complemented by external audit, creates a comprehensive audit function which maintains the necessary internal controls and the proper performance of the overall banking activities. External auditors have an important influence on the quality of the internal control systems through the performance of their controls, the regular conversations with the Governing Body, the

⁵ Moreover, the most appropriate type of audit should always be applied depending on the objectives which need to be achieved by the audit.

Executive Board of Directors or the Audit Committee, as well as through the recommendations for improving the internal control systems.

In determining the procedures for operation and in planning the audit, the major benefit is the operation of the Internal Audit. However, one should emphasize that the responsibility for the opinion on financial statements is an obligation of the external auditors. The external auditors should be familiar with, and have access to, the reports of the Internal Audit Service, as well as to be aware of things that can affect their conclusions. Also, the external auditors should inform the internal auditors on any significant matters that may affect the work of the Internal Audit Service.

Mutual communication between internal and external auditors provides exchange of information on matters of common interest, such as exchange of opinions on audit techniques, methods of operation and interpretation of terminology, exchange of audit reports or letters to the Executive Board and Governing Body.

The differences between the internal and external audit can focus on the following aspects:

- 1/ the objective;
- 2/ continuity;
- 3/ independence; and
- 4/ reporting.

The differences in the objective can be summarized as follows: the purpose of external audit is to confirm whether the financial statements are presented objectively, while the objective of internal audit is to protect the value of the assets of the bank.

The continuity is a second important characteristic. It occurs since the internal audit is performed during the whole year, while the external audit is focused on one day – the date of the financial reports.

Besides the fact that the external auditor should be positioned in such a way, so that he will be **independent in his working**, his independence cannot be to a level such as the independence of the external auditor. The difference arises from the formal status: the external auditor is a special legal entity – he can and must not accept the engagement, unlike him, the external auditor is employed in the bank – he gets salary in the bank.

The differences in the reporting refer to:

- the form of reporting: the international audit standards strictly prescribe the types of audit opinion and the content of the report of the external auditor, while the internal auditor reports in a manner which best reflects his findings;
- the time of reporting: the external auditor reports once a year, while the internal auditor reports during the whole year, and
- users of the reports: the opinion of the external auditor is addressed to the shareholders and legally, he is obliged to deliver audit statement of the performed audit to the National bank, to the Governing Body and to the Executive board of the bank, and he should deliver the annual financial report to the Ministry of finance as well. In addition, users besides the indicated ones are also the investors, the banks, the clients and the employees as well as other users such as the Internal Audit Service. Users of the statements of the Internal Audit Service are the Executive board and the Governing body, as well as the Audit Board and the external auditors⁶.

⁶ Within the context of the presented differences, it is important to notice that in practice the tasks of the internal and the external audit overlap even more. In conditions of more intensive automation and development of the banking activities, the role of the internal auditor is even greater.

On the other hand, the external audit is getting characteristics of an internal audit. So, more and more frequently, the external auditor is continuously present at the clients office, not only at the end of the accounting period, the obligations of the external auditor regarding the examination of the internal control systems are becoming more numerous, and different reporting on different issued intended for the Executive Board and the Governing body are becoming more frequent. Hence, one can conclude that neither the external, nor the internal audit are static professions, but they develop and change proportionally to the changes in the surrounding in which the financial institutions are functioning.

4. INTERNAL AND EXTERNAL AUDIT FUNCTION OF NATIONAL BANK OF REPUBLIC OF MACEDONIA (CONTINUED)

Well-planned, properly structured auditing programs are the responsibility of the Board and Directors. They cannot delegate this responsibility and must establish, maintain, and operate effective audit programs. Audit programs are performed by independent and competent staff who are objective in evaluating the institution's control environment.

Effective audit programs:

- Provide objective, independent reviews and evaluations of the institution's activities, internal controls, and management information systems (MIS).
- Help maintain or improve the effectiveness of risk management processes, controls, and corporate governance.
- Provide reasonable assurance about the accuracy and timeliness with which transactions are recorded and the accuracy and completeness of financial and regulatory reports. The most common types of audits are financial, operational, compliance, and information systems or technology audits.

✓ Financial audit

The purpose of this audit is to determine whether the financial statements fairly present the financial position, results of operations, and cash flows as of a certain date or for a period ending on that date.

✓ Operational audits

This type of audit includes a review of policies, procedures, and operational controls (e.g., loan review) to determine whether risk management, internal controls, and internal processes are adequate and efficient.

✓ Compliance audits

This type of audit it is used determine whether the institution is complying with internal procedures, internal controls, and applicable laws and regulations.

✓ Information system or technology audits

This type of audit assess the controls over an institution's electronic data processing and computer areas. These audits focus on management, development and acquisition, support and delivery, data security, and physical security.

5. The relationship between the internal and the external auditors and differences between the internal and the external audit

The internal audit function does not exclude the need of external auditors, but to the contrary, the external auditors supplement and contribute to the work of the internal auditors. The

internal audit, adequately supplemented by the external audit, creates a comprehensive audit function, which enables the necessary internal controls and correct conduct of the overall banking activities (BANKING REGULATIONS DEPARTMENT SUPERVISORY CIRCULAR NO.1,2005)

The differences between the internal and the external audit may be focused on the following four aspects:

1. objective;
2. continuity;
3. independence; and
4. reporting

The differences in the objective may be sublimated in the following: the objective of the external audit is to identify whether the financial reports are realistically presented, while the objective of the internal audit is to protect the value of the bank's assets. Continuity is the second important difference. It occurs because of the fact that the internal audit is conducted throughout the year, while the external audit is focused on one particular day - the date of the financial reports. Despite the fact that the internal auditor should be independent in his/her operations, their independence cannot be as large as that of the external auditor. The difference arises from the legal status: the external auditor is an individual legal entity, who can, but does not have to accept the engagement. On the other hand, the internal auditor is an employee of the bank, who receives salary from the bank.

6. Four different models of external audit

In this section we try to identify unique models of external audit⁷. The practices with external audit identified here represent four different and unique models, with different roles for private and public sector auditors are presented in the Table 1.

Table 1 Source: OECD (1998), "Central Bank Audit Practices", *Sigma Papers*, No. 24, OECD Publishing.

Country	External Audit	
	Public Sector Auditor	Private Sector Audit
Germany	<i>Binidesrechnungshof</i> (Federal ('omit of Audit)	External auditors appointed by the Board of Directors
Ireland	Comptroller and Auditor General	No
Netherlands	No	Appointed by the Board of Directors
Sweden	Parliamentary Auditors	Working on behalf of Parliamentary Auditors

The types of external audit found in the four countries differ see Table 2

⁷ The requirement for an *external audit function* for the central bank is typically a legal requirement, contained in statutory acts and regulations governing central bank operations and explained in more detail in specific acts on audit

Table 2

Types of external audit⁸	Germany	Ireland	Netherlands	Sweden
Financial	x	x	x	x
Regularity	x	x	x	x
Performance	x		x	x
EDP	x	x	x	x
Projects	x			
Special				

Source: OECD (1998), "Central Bank Audit Practices", *Sigma Papers*, No. 24, OECD Publishing.

In most countries, the external auditor from the public sector reports to parliament and, where relevant, the private sector auditor reports to government (e.g. ministry of finance) and/or the public sector external auditor (the supreme audit institution).

7. COOPERATION BETWEEN THE SUPERVISION, THE EXTERNAL AND THE INTERNAL AUDITORS

The mutual cooperation of the supervisory authorities, the internal and external auditors improves the efficiency in the working of all three involved sides, whereas every party has its responsibility. The cooperation may be based on periodic meeting of the previously mentioned three sides. From the point of view of the supervising authorities, one can estimate that the Governing body should also be present at these meetings. During these meetings, each party provides the information which is of common interest, whereas special attention is paid to the areas which will be subject of control. Also, an issue of discussion is the implementation of the recommendations by the bank obtained from the supervising body, the external and the internal auditor.

The cooperation assumes trust between the three sides, otherwise, the cooperation would not function. Hence arise the expectations of the supervisory body to be informed by

⁸ The types of external audit found in the four countries differ:

- Audits of financial statements (mostly aimed at certification of the bank's accounts);
- Compliance or regularity audits (the assessment of management's compliance with laws and regulations, etc.);
- Performance audits or value-for-money, which investigate whether the objectives of the bank's activities were achieved and whether these were obtained in an efficient manner;
- EDP audits, which aim to assess the quality of computerised information systems;
- Audits of project developments, for example of EDP projects or construction projects, to assess the adequacy of management information (e.g. planning and progress feedback) required for the proper conduct of the project with a view of the (investment) risks involved;
- Special audits and investigations (e.g. fraud).

the bank about its decisions, facts and the developmental activities which would significantly affect the performances of the bank.

The internal audit which functions in a bank facilitates the work of the bank supervisors and improves the banking work. Strong internal control including internal audit, as well as an independent external audit system, is part of a solid business management, which in turn contributes to efficient and collaborative relationship between the bank management and its supervisors.

An efficient system of internal audit is an invaluable source of information for the management of the bank, its supervisors and the quality of the internal control system in that organization.

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