THE IMPORTANCE OF THE INTERNAL AUDIT SYSTEM TODAY

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Abstract: One of the key areas of internal audit activity is the identification and analysis of potential external and internal risks in the development and implementation of new projects, as well as the preparation of recommendations aimed at reducing the level of risk or minimizing possible losses. Internal auditors also monitor the expenditure of financial resources for various projects or programs (for example, a capital construction project or a product launch program), and analyze the company's financial and management reporting in terms of their reliability and timeliness. In addition, auditors evaluate signed contracts and the fulfillment of contractual obligations by the parties, and they are involved in assessing control systems within existing and newly implemented information systems.

Keywords: audit, audit inspections, trust, skeptisizm, objectivity, internal audit, register, financial reporting, internal control.

Any control activity, including internal audit, emerged as a natural necessity. Although internal audit has ancient roots, until 1930 it was not perceived by enterprises and external auditors as a significant process. The main reasons for its recognition were, first, the establishment of the U.S. Securities and Exchange Commission (SEC) in 1934, and second, simultaneous changes in the objectives and methods of external auditing. During this period, the United States and other countries were only beginning to recover from a deep economic crisis.

The SEC, whose main function was to regulate the activities of companies included in its register, required that the financial statements of such companies be audited by certified independent auditors. As a result, this requirement created the necessity for companies to establish internal audit departments, whose main purpose was to assist independent auditors.

At that time, external auditors focused not so much on identifying deficiencies in internal control or employee errors, but rather on forming an opinion on the reliability of the company's financial statements. The SEC's regulations encouraged the use of sampling inspections and the broader application of internal control procedures. Thus, the reduction in the volume of sampling directly depended on the effectiveness of the company's internal control system.

In those years, internal auditors generally focused on verifying accounting records and detecting financial errors and inaccuracies, serving as assistants to independent auditors or as a kind of "shadow support." As early as the 1930s, Walter B. Meigs noted that internal auditors were hired either to perform routine tasks in identifying accounting errors or to travel to remote branches of corporations as company representatives. Initially, internal auditors essentially helped employees prepare repetitive accounting documents. This attitude toward internal audit persisted in many organizations until the early 1970s. For example, in the late 1960s, many retail companies referred to employees responsible for balancing daily cash receipts as "auditors."

However, it became clear that such a situation could not continue indefinitely, and there arose a need to enhance the potential of internal auditors and use their work more effectively. The turning point came with the publication of Victor Brink's book Modern Internal Auditing on the eve of World War II, which was later released as a separate edition in the United States. In 1942, the **Institute of Internal Auditors (IIA)** began its activity. The first branch of the organization was founded in New York, followed shortly thereafter by another in Chicago. The Institute was established by specialists who held positions as internal auditors within companies, and its main objectives were to exchange

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professional experience and to acquire new knowledge in the field of auditing. Today, the membership of the Institute of Internal Auditors worldwide exceeds **200,000 professionals**.

Initially, the profession was in its infancy, then underwent decades of transformation, and today internal auditing represents an entirely different practice compared to its early stages.

As mentioned earlier, for a long time many regarded internal auditing as having little importance, and some even perceived it negatively. Some saw it as a dull part of accounting, while others viewed it solely as an activity that involved checking employees' work and reporting their mistakes. The author hopes that this textbook will contribute to changing such perceptions of internal audit.

In fact, internal auditing is a globally recognized, prestigious, and highly professional field. Its status has never been as high as it is today. The demand for talented specialists in internal auditing significantly exceeds supply at all professional levels. As of 2016, the number of IIA members worldwide had already surpassed **185,000** people.

Nevertheless, as with the creation of any other corporate division, the formation and development of internal audit depend on the decisions of the company's founders. In other words, the founders must assess the usefulness of the services that the internal audit function can provide.

In 2008, the Institute of Internal Auditors developed the **"Internal Audit Value Proposition"** model, aimed at precisely defining the contribution and value of internal auditing. This model was presented by the IIA in the form of a diagram (see figure below).

Internal Audit Value Proposition (According to the Institute of Internal Auditors)

Trust = *Governance, Risk, and Control.* Internal audit ensures a high level of trust in relation to corporate governance processes, risk management, and the internal control system. This enables an organization to achieve its strategic, operational, financial, and compliance objectives.

Skepticism = *Catalyst, Analysis, and Evaluation.* Internal audit serves as a catalyst for improving the effectiveness and efficiency of the organization by applying professional skepticism, conducting analytical procedures, and providing recommendations based on an objective evaluation of business processes.

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Objectivity = *Integrity, Accountability, and Independence.* Through integrity and accountability, internal audit provides senior management and leadership with independent advice, acting as an objective source of information.

This **"value proposition"** of internal audit clearly demonstrates why it is one of the most important elements of a corporate governance system.

The need for an internal audit function arises from the fact that in large corporations, top management cannot personally exercise day-to-day control over operations while simultaneously managing lower-level divisions. Internal audit provides information on the organization's performance and verifies the reliability of managers' reports. Its main purpose is to prevent resource losses and to facilitate the implementation of necessary internal improvements.

The growing global interest in internal audit is associated with several factors.

First, internal audit today can enhance the efficiency of companies that have certain development potential but cannot always fully realize it.

Second, major corporate scandals in the United States and Western Europe have demonstrated the limitations of external audit and confirmed that even the largest firms can face bankruptcy.

Third, the presence of internal audit as an integral component of effective corporate governance increases a company's investment attractiveness, sending a positive signal to potential investors.

Furthermore, the desire of owners and management to systematize business processes and optimize resource use also contributes to the necessity of internal audit. Its presence is particularly important for owners who delegate operational management to professional managers, as it allows them to maintain oversight without direct involvement in company operations.

Finally, short- and long-term plans for entering international capital markets dictate the need for internal audit departments, since the rules of major stock exchanges require the presence of such a function as a **mandatory condition for listing securities.**

Internal audit thus serves as a **control mechanism** established within an organization in the interests of its owners, ensuring compliance with accounting rules and the reliability of the internal control system as defined by the organization's internal regulations.

In 1999, the Board of Directors of the Institute of Internal Auditors (IIA) approved the modern definition of internal audit:

"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."

The key elements of this definition include the following:

- Supporting the achievement of organizational objectives;
- Assessing and enhancing the effectiveness of risk management, control, and governance processes;
- Providing assurance and consulting services aimed at improving performance;
- Independence and objectivity;
- Applying a systematic and consistent approach.

The well-known economist **V.V. Burtsev** gives an even broader definition of internal audit: it is an activity carried out within a company's management system and its specialized control bodies to assist governing bodies (the general meeting of shareholders, the board of directors or supervisory board, and the executive body).

This raises an important question: to what extent is internal audit necessary for business owners and managers?

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The decision to establish an internal audit function is made by the company's owners. It depends on several factors: the division of ownership and management functions, the size and organizational structure of the enterprise, and the level of risks inherent in its activities.
In cases where owners simultaneously act as managers and are able to control all aspects of the business on their own, the need for internal audit may not arise. However, as management processes become more complex, owner-managers often develop an illusion of complete control over company operations. In practice, however, comprehensive control is physically impossible to maintain — this is precisely what creates the need for internal audit as a key element of corporate governance. For example, in Europe and the United States, the combination of ownership and management functions is typical mainly for small, and sometimes medium-sized, businesses. In large and many medium-sized enterprises, these functions are usually separated: owners focus on defining strategy and development directions, while operational management is entrusted to professional executives. Regardless of the manager's qualifications, owners still need reliable oversight of the company's activities — following the principle of **"trust, but verify."** In such cases, internal audit serves as one of the most effective control tools.

Internal audit is essential not only for the owner but also for the company's management. The task of managers is to achieve organizational goals in the most efficient way and to manage the business effectively. The success of this task depends largely on two factors:

1. Does the manager have the necessary information to make the right management decisions?
2. Is there an effective control system to ensure that these decisions are properly implemented?

Managers, being responsible for daily operations, are not always able to objectively assess situations. Even when a manager believes they control all processes effectively, they usually lack the time or specialized skills to gather and systematize all the required information.

By its nature, internal audit has access to all aspects of a company's operations and possesses tools for summarizing and analyzing information. Therefore, close cooperation with internal audit increases the effectiveness of management decisions. Internal audit acts as an objective source of information, helping managers view business processes from a new perspective and evaluate the quality of decisions made.

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