

UNDERSTANDING INTERNAL AUDITING



PEEYUSH SHARMA & Co., Chartered Accountants

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“ We Believe we will be successful if our clients are successful”

About the Author

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Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

Evolution of Internal Audit

Understanding the evolution of internal audit is important because the old image still exists to some extent for modern internal auditors. K. H. Spencer Pickett, a noted author in the field of internal audit, has identified the following stages in the evolution of modern internal audit:

As a Sibling of External Audit

In the initial stages, internal audit began as an extended arm of an external/statutory audit of financial statements. The main, but rather restricted, function of the internal audit at this stage was verifying the reliability of the financial information included in the financial statements. The internal audit function in this stage of evolution could not understandably add much value to functioning of the entity.

As a Cross Check

In this stage of its evolution, internal audit was also required to test nonfinancial information and transactions in terms of their correctness and compliance with the laid down policies and procedures.

As a Probity Police

At this stage of its evolution, the internal audit came to be more concerned about the probity aspects of the transactions especially those involving liquid and highly movable assets such as cash, stocks, etc.

As a Non Financial Systems Police

As the global economy surged forward full steam, the need for having a full fledged, strategically directed internal audit emerged as an inevitable service that could assist management in decision making, moving away from being merely a police on financial transactions. Thus, emerged the modern internal audit where the latter was established as a separate function, in house or outsourced, with clearly laid down missions and objectives to be achieved. As of today, internal audit undeniably is the backbone of a sound corporate governance system.



Need for Internal Audit

Increased size and complexity of businesses

Increased size and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations.

Enhanced compliance requirements

Increase in the geographical spread of the businesses has also led to crossing of political frontiers by businesses in a bid to tap global capital. This has thrown up compliance with the laws of the home country as well as the laws of that land as a critical factor for existence of businesses abroad.

Focus on risk management and internal controls to manage them

Internal auditors can carry out their job in a more focused manner by directing their efforts in the areas where there is a greater risk, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources.

Intensive use of information technology

Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting.

Unconventional business models

Information technology (IT) is invariably embedded in all spheres of activities of a modern business enterprise today, from data processing to resource planning to online sales and ecommerce. Use of IT has, however, increased the threat of data thefts or losses on account of systems failure or hacking/ espionage, as well as the need to comply with the cyber laws, etc.

Stringent norms mandated by regulators to protect investors

The regulators are coming up in a big way to protect the interests of the investors. The focus of the latest regulations being ethical conduct of business, and enhanced corporate governance and financial reporting requirements, etc.

An increasingly competitive environment

Whereas deregulation and globalisation have melted the political as well as other barriers to entry in the markets for goods and services, free flow of capital, technology and knowhow among the countries as well as strong infrastructure has helped in bringing down the costs of production and better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.



Defining Internal Audit

The following definition of internal audit, as described in the Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India, amply reflects the current thinking as to what is an internal audit:

“Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.”

The above definition highlights following facets of the internal audit

- Internal auditor should be independent of the activities they audit. The internal audit function is, generally, considered independent when it can carry out its work freely and objectively. Independence permits internal auditors to render impartial and unbiased judgment essential to the proper conduct of audits.
- Internal audit is a management function, thus, it has the high-level objective of serving management's needs through constructive recommendations in areas such as, internal control, risk, utilisation of resources, compliance with laws, management information system, etc.
- Internal audit's role should be a dynamic one, continually changing to meet the needs of the organisation. There is often a need to change audit plans as circumstances warrant. These changes may include coverage of new areas, assistance to management in solving problems, and the development of new internal audit techniques.
- An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. Thus, it contributes in accomplishment of objectives and goals of the organisation through ethical and effective governance.
- Risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor plays an important role in providing assurance to management on the effectiveness of risk management.
- Internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated. Thus, the examination and appraisal of controls are normally components, either directly or indirectly, of every type of internal auditing assignment.



Internal Audit – Indian Scenario

Clause 49 of Listing Agreement

The Securities and Exchange Board of India (SEBI) has introduced certain mandatory as well as certain recommendatory corporate governance provisions in Clause 49 of the Listing Agreement applicable to listed entities. Some of the important requirements of Clause 49 pertaining to internal audit are as follows:

The Audit Committee is required to review:

- The adequacy of the internal audit function, if any, including the structure of internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit, including appointment, removal and terms of remuneration of the chief internal auditor.
- Internal audit reports relating to internal control weaknesses.
- The findings of any internal investigations by the internal auditors into matters where there is a suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.

The Audit Committee is also required to discuss with the internal auditors any significant findings and follow up thereon.

The CEO and the CFO is required to certify to the Board of Directors that:

- They accept responsibility for effectiveness of internal controls and that they have disclosed to the auditors and the Audit Committee deficiencies in the design and operation of the internal controls and steps taken for rectification of the same.
- They have indicated to the Audit Committee and the internal as well as external auditors as to the following aspects:
 - Any significant changes in internal controls.
 - Any significant changes in the accounting policies and instance of significant fraud, if any, and that the same have been disclosed in the notes to the financial statements.
 - Instances of any significant fraud and involvement, if any, therein of the management or any employee having a significant role in the internal control systems of the company.

Thus, it is amply evident from the above that the management, especially the functional management as well as the Audit Committee needs extensive support from the internal audit function to give it the primary assurance about controls and compliances before giving the required reports/ certificates or to appropriately review the necessary aspects and make informed decisions.



Section 177 of the Companies Act, 2013

In addition, Section 177 of the Companies Act, 2013, requires that the board of director of every listed company and such class or classes of companies, as may be prescribed, shall constitute Audit Committee. In terms of sub section 5 of the said Section, the audit committee may call for the comments of the auditor about the internal control systems, the scope of audit, including the observations of the auditors and review of the financial statements before their submission to related issue with the internal and statutory auditors.

Companies (Auditor's Report) Order, 2003

The Central Government, in terms of the power vested under Section 227(4A) of the Companies Act, 1956 had notified the Companies (Auditor's Report) Order, 2003. Clause (vii) of the said 2003 order requires the auditor to report as follows:

“whether in case of listed companies and/ or other companies having paid-up capital and reserves exceeding Rs. 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.”

Though the clause does not by itself mandate internal audit in the subjected companies, yet a company to which the same is applicable, would incur a negative remark from the auditor if it does not have an internal audit system.

Companies going in for tapping the international capital market, especially, those seeking listing in US stock exchanges, NASDAQ, NYSE, etc., also need a strong internal audit function to meet the stringent corporate governance and internal control requirements of those stock exchanges. In this context, the US companies, having US public as investor also needs to comply with the requirements of Sections 302 and 404 of the Sarbanes Oxley Act of 2002.

Others

Section 581ZF of the Companies Act, 1956 requires that every Producer Company shall have internal audit of its accounts carried out by a chartered accountant, at such interval and in such manner as may be specified in articles.

The Securities and Exchange Board of India has mandated complete internal audit on a half-yearly basis for stock brokers/trading members/ clearing members.

IRDA (Investment) (Fourth Amendment) Regulations, 2008 has introduced requirements of quarterly internal audit for insurers.



Internal Audit

Adding Value to the Organisation

The traditional internal audit model has been transaction-based and cost-driven. Today, internal audit is undergoing significant change in migrating from a reactive, historically focused function to a proactive group that takes a risk based focus. Internal audit is in the unique position of being able to see the organisation as a whole – “the forest from the trees”. It is often privy to the inner workings and culture. From the management and Audit Committee perspective this point of view is invaluable. Leading organisations are looking for the internal audit function to assume a leadership role in assessing and managing their strategic risks, adding value to the organisation and identifying operational improvement opportunities.

Risk Management

The business environment is increasingly throwing up newer challenges and opportunities with globalisation, disruptive technologies and rules being continuously rewritten. New risks are hence coming up frequently. Risk management is the process of measuring or assessing risk and developing strategies to manage it. The 21 century internal auditors have the following vital areas of responsibility in the field of risk management:

- Review operations, policies, and procedures.
- Help ensure goals and objectives are met.
- Understanding the “big picture” and diverse operations.
- Make recommendations to improve economy and efficiency.

Hence, the internal audit report is on the management of significant risks of the organisation and the assurance is on these risks being managed within the acceptable limits as laid down by the Board of Directors. To give this assurance, the internal auditor conducts:

- A process audit on risk management processes at all levels of the organisation, viz., corporate, divisional, business unit, business process level, etc., put in place by line management so as to assess the adequacy of their design and compliance.
- A transactional audit on the significant risks so as to assess whether the risk response puts the risk within acceptable limits.

Providing Assurance Regarding Internal Controls

Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. The internal audit function constitutes a separate component of internal control with the objective of



determining whether other internal controls are well designed and properly operated. The internal auditor's role is to examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness. Thus, the focus is towards improving the internal control structure and promoting better corporate governance.

Compliance

Internal auditor plays an important role in evaluating the organisation's compliance with external regulations. It can brief management on the actual or potential impact of identified compliance concerns and also facilitate the establishment of corrective actions related to gaps in compliance programs. Internal auditor can also assist in establishing mechanisms and processes to consistently enforce compliance requirements. It can also be instrumental in managing the relationship with external review agencies.

Fraud Detection

Fraud is an ever-present threat to the effective utilisation of resources in an organisation and the risk of fraudulent activities has always been an important management concern.

Existing fraud needs to be detected and potential fraud prevented to the extent practicable. The primary responsibility for prevention and detection of fraud rests with management and those charged with governance. The internal auditor's role is to help the management to fulfill its responsibilities relating to fraud prevention and detection.

Internal audit is in a unique position to identify potentially fraudulent situations during the course of audit and, thus, plays a strong role in preventing fraud and other illegal acts.

Consulting and Operations

Internal auditors have a unique talent in their ability to assimilate large amounts of information and organise it in a way that makes it easy for many people to understand.

Management is responsible for establishing operating or program objectives and goals, developing and implementing control procedures, and accomplishing desired results. Internal audit ascertains whether such objectives and goals conform with management plans and whether they are being met. Internal audit's role is to assist management in establishing better policies and procedures.



Internal Audit Report **A Key Communication Tool**

The development and issuance of internal audit report is perhaps the most important phase of the total internal auditing process and the major means by which persons both inside and outside the organisation are apprised of internal auditor's work. It is a means to elicit management action, and communicate crucial messages to executives and board level readers. The internal audit report

The internal audit report includes the following basic elements, ordinarily, in the following layout:

- (i) Title;
- (ii) Addressee;
- (iii) Report Distribution List;

"Contains a clear written expression of significant observations, suggestions/ recommendations based on the policies, processes, risks, controls and transaction processing taken as a whole and management's responses."

"Should be appropriately addressed as required by the circumstances of the engagement. Ordinarily, the internal auditor's report is addressed to the appointing authority or such other person as directed."

- (iv) Period of coverage of the Report;
- (v) Opening or introductory paragraph:
 - Identification of the processes/ functions and items of financial statements audited; and
 - A statement of the responsibility of the entity's management and the responsibility of the internal auditor;
- (vi) Objectives paragraph – statement of the objectives and scope of the internal audit engagement;
- (vii) Scope paragraph (describing the nature of an internal audit):
 - A reference to the generally accepted audit procedures in India, as applicable;
 - A description of the engagement background and the methodology of the internal audit together with procedures performed by the internal auditor; and
 - A description of the population and the sampling techniques used;
- (viii) Executive Summary, highlighting the key material issues, observations control weaknesses and exceptions;
- (ix) Observations, findings and recommendations made by the internal auditor;
- (x) Comments from the local management;
- (xi) Action Taken Report;
- (xii) Date of the report;
- (xiii) Place of signature; and
- (xiv) Internal auditor's signature with Membership Number.



Internal Audit – Basic Principles

Integrity, Objectivity and Independence

Like any other profession, the profession of internal audit also is based on certain fundamental principles, which constitutes the life and blood of this profession. The internal auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should not only be independent in fact but also appear to be independent. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity. For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference.

Confidentiality

The internal auditor, in the course of his work, invariably comes across information that is confidential and/or critical to the working of the entity. The internal auditor should respect the confidentiality of such information and should not disclose the same to a third party without the specific authority or unless there is a legal or professional duty to do so. The internal auditor should, therefore, ensure that there are adequate policies and mechanisms to protect the confidentiality of the information.

Due Professional Care, Skills and Competence

The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit. Due professional care signifies that the internal auditor exercises reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subject to internal audit, assessment of risk management, control and governance processes and cost benefit analysis.

A member of the Institute of Chartered Accountants of India, carrying out an internal audit activity, would apart from other requirements, additionally be governed by:

- (i) the requirements of the Chartered Accountants Act, 1949;***
- (ii) the Code of Ethics issued by the Institute of Chartered Accountants of India; and***
- (iii) other relevant pronouncements of the Institute of Chartered Accountants of India.***



Internal Auditing **In Today's Organisation**

In modern business environment, the internal audit function has become a major support function for management, the Audit Committee, the Board of Directors, the external auditors, and other key stakeholders. When properly designed and implemented, the internal audit function can play a key role in promoting and supporting effective organisational governance.

Relationship with the Audit Committee

Audit committees need to oversee accurate financial reporting and disclosure, and help to sustain regulatory compliance, strengthen internal controls, and improve risk management. Aligning audit committee objectives with those of internal audit helps to unify oversight and allocate limited resources in the most efficient and effective ways. Internal audit is likely to appreciate a closer working relationship in assessing risks, planning the audit process, and interacting with experienced board members about emerging business risks. The internal audit function provides audit committees with relevant reports and ongoing updates. They identify new risks and are entrusted to conduct high-level reviews in strategic ways. Audit Committees have a great deal to gain by developing and empowering internal audit, and by working more closely with internal auditors to improve organisational oversight.

Relationship with the Management

The early internal audit literature, e.g., Sawyer, often portrayed internal auditors as the “eyes and ears of management”. The basic role of internal audit service to management starts with understanding management problems and needs. Management often calls upon internal auditors to provide them assurance that risks are effectively identified and monitored, organisational processes are effectively controlled, and organisational processes are efficient or effective. The internal auditor while performing audit provides timely observations arising from internal audit that are significant and relevant to their responsibility, as described in the scope of the engagement, to the management. For this purpose, it is essential that internal auditor establishes communication channels with management through its planning process, through participation in various advisory meetings and boards, and through frank discussions with management over the results of audit.

Relationship with the External Auditor

At no other time have the roles and relationships between internal and external auditors been so important. Both have a key role to play in helping to maintain confidence in the governance of an organisation. Both internal and external auditors need to operate alongside each other more effectively to meet the expectations of the stakeholders. Frequent and enhanced communication and co-ordination between internal auditors and the external auditors is critical to ensure that collective efforts are in the best interests of all stakeholders. An internal audit function can contribute positively to success and competitive advantage by helping management to ensure that there are effective processes in place to manage risk to an acceptable level and to achieve objectives. In organisations where there is strong corporate integrity and a high regard for governance, internal audit makes a significant contribution. On the other hand, external auditor provides assurance to shareholders, and to the Board, that financial performance, as reported in the financial statements, is true and fair. While external auditors start with financial statement ending result, internal auditors start with the basic activities and work forward to achieve organisational objectives.

Co-ordination of internal and external audit work increases economy, efficiency, and effectiveness of the overall audit process.



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