INTERNAL AUDITING, RISK MANAGEMENT
&
RISK REPORTING

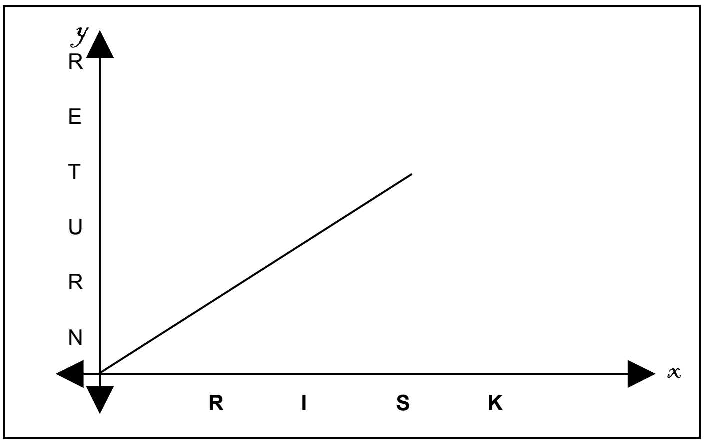
Meaning

One of Today is better than two of Tomorrow,
One in Hand is better than two in Bushes,
High Risk the Financial High Returns, says Law,
It's the Risk which makes the Business Paces.

'Profit Earning' & 'Wealth Maximization' are some of the prime motives of any profit-motive business organization. Management of every organization works deliberately day and night in order to earn sufficient returns on investor's investments and to safeguard their equity, assets and returns. They have to perform several functions in order to: -

I) Earn sufficient returns on investments;
II) Safeguard the assets of the company;
III) Evaluate the growth prospectus of the company;
IV) Wealth maximization of the company, etc.

To achieve the above enlisted objectives the management has to from time to time take several steps & decisions. It does not always happens that management decisions provide the company with good margin of safety, sometimes it may even break even or go below the Break Even Point. The reason is because every decision is associated with contingencies and uncertainties and it has to get through various economic fluctuations.
Risk is independent, where as Returns are directly associated with risks i.e. High Risk High Returns. There is direct relationship between risk and returns, graphically: -



As per AAS-1 "Basic Principles of Governing an Audit", Para-2 ***"An Audit is an independent examination of the Financial Statements of an entity, whether profit oriented or not, irrespective of its size and legal form when such an examination is conducted with the view of expressing an opinion thereon".***
In common parlance & for a layman the term INTERNAL AUDITING refers to an independent examination by the personnel of an enterprise, of the transactions and events and state of affairs carried out by an enterprise throughout the year.

It is a perpetual evaluation conducted by the management of an entity with respect to.: -

(i) Adequacy and Effectiveness of existing internal control systems;
(ii) Accuracy, Authenticity & Viability of the financial statements and other records &

(iii) Implementation & Execution of significant accounting policies adopted by the management.

"THE INSTITUTE OF INTERNAL AUDITORS", Florida, USA defines Internal Auditing as- ***"An independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of the internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed".***

Evolution & Compliance

In Late 1930's with the drastic and rapid evolution of corporate sector throughout the world, entrepreneurs felt the need of an *'Intra-Organizational Evaluatory System'* and they were in search of such a system through which they can easily locate all the loopholes that have perpetrated into their internal control system. To stifle this desire and to end the search of those entrepreneurs, there came into existence, Internal Auditing System. Later on in 1941to regulate and govern the issues related to internal auditing practices, there was laid the foundation stone of **"THE INSTITUTE OF INTERNAL AUDITORS (IIA)", in Florida, USA.** This organization was the sole body in the entire world governing the profession of internal auditing; this institute from time to time has conducted various professional courses, organized seminars, meetings etc. to enhance the professional standards of their members and to improve the quality of services rendered by their members to their clients.

With the development of worldwide trade, business and commerce, it was now time for other nations also to adopt and establish Internal Auditing Systems, thus various nations like have framed their Internal Auditing Standards under the purview of IIA to establish sound, controlled and regulated Internal Auditing System in their nation.

With the introduction of (MAOCARO 1975) Manufacturing And Other Companies (Auditor's Report) Order 1975, Internal Auditing sector has gained due importance in India. It was then when law enforced certain entities to establish Internal auditing System in their enterprise. As a result of this three decades ago the "**INSTITUTE OF INTERNAL AUDITORS OF INDIA"** had laid its foundation stone in Bombay under affiliation of its parent body i.e. Institute of Internal Auditors, Florida, USA and now is operating effectively throughout the nation vide its six chapters at Bombay, Delhi, Calcutta, Madras, Bangalore and Hyderabad. It is the governing body responsible for propagation of various standards for internal auditing in India. The requirement of internal auditing was kept intact later on in 1988 also when MAOCARO 1975 was abolished and MAOCARO 1988 entirely replaced it and it is intact now olso when MAOCARO 1988 has been completely replaced by CARO 2003 i.e. Companies (Auditor's Report) Order 2003.

Besides this there are certain other acts and statutes also which lays the requirement for internal auditing system or which tries to explain the relationship of internal auditing with that of statutory auditing system, they are as under: -

The Companies Act 1956

Section 581ZF of the Indian Companies Act 1956 talks about Internal audit that-Every producer company shall have internal audit of its accounts from the person as defined under Section 2(1)(b) of The Chartered Accountants Act 1949 (38 of 1949).

Companies (Auditor's Report) Order 2003 (CARO 2003)

On 12th June 2003, the Central Government of India vide Notification No. GSR (480)E have introduced the said order by exercising powers conferred to them u/s 227(4A) of The Companies Act 1956. The order clearly specifies that unless otherwise exempted all the companies are covered under the said order. As per Clause 'vii' of CARO 2003 the statutory auditor of every company (covered under the said order) is required to report on the Internal Audit Function of an enterprise. As per Para 2 of the said order every private limited company whose-

- Paid up share capital & reserves exceeds Rs. 50 Lakhs;
- Borrowings exceeds Rs. 25 Lakhs and
- Turnover exceeds Rs. 5 Crores at any time during the previous year.

are covered under the order.

Auditing & Assurance Standard-7 (AAS 7)

AAS-7 "Relying upon the work of Internal Auditor" issued by the Auditing and Assurance Standard Board of ICAI states the relationship between the statutory auditor and Internal Auditor of an enterprise. It also states that how the work of an internal auditor can be used by the statutory auditor and how both the auditors can co-ordinate and complete the assignment in timely and orderly manner. This auditing and assurance was applicable from April 1st, 1989 and is applicable to all those enterprises where internal audit function subsists.

Sarbanes Oxley Act, 2002 (SOX)

Section 404 of SOX requires management's development and monitoring of procedures and controls for making their required assertion regarding the adequacy of internal controls over financial reporting as well as the required attestation by an external auditor, regarding management's assertion. Section 302 deals with management's quarterly certification of not only financial reporting controls, but also disclosure controls and procedures. The Act in itself places the responsibility for the compliance of the provisions with the management, which in no case be delegated or abdicated. Although the internal auditors are required to be extensively involved in the SOX project owing to the fact that the project falls within the natural domain of internal auditor's expertise they are not directly responsible for its compliance as the Act does not place any responsibility on the internal auditors. However, for all practical purposes the internal auditor shall support the management in the discharge of these responsibilities. The internal auditor's role in the organization for complying with SOX can be significant, but it should be compatible with the overall mission and charter of the internal audit function. Regardless of the type and level of involvement, it should not impair the objectivity and capabilities of the internal audit function for covering major risk areas of their organizations. Thus the internal audit function's role should be one of support through consulting and assurance.

Internal Auditing, Risk Reporting & Risk Managemen

There is a very close end relationship between Internal Audit Functioning & Risk Reporting. As we have already seen the objectives of Internal Audit function is to detect and disclose loopholes and flaws that have penetrated or subsists in the Internal Control system. Besides, we have also seen the direct relationship between Risk and Return. Therefore, it is interpreted that the close end function of internal audit function is Risk Reporting, based on which management can exercise Risk Management.

Risk reporting is reporting of all anticipated risks, their classification, effects and consequences. Risk affects firm's cash flows and their probabilities and hence risk reporting is defined as the disclosure of the firm-specific variance of future cash flows. Risk arises when expected cash flow differs from actual cash flow. It is the probability of realising a cash flow less than anticipated that creates a risky situation. Risk reporting is expected to describe all these probabilities of future anticipated cash flows. Hence, risk reporting could be defined as probabilistic forecast disclosure.

Risk reporting can be classified as:

i. *Internal and external*

ii. *Voluntary and mandatory*

Internally, the corporate board and other higher authorities expect a detailed analysis of corporate risks and their effects. External reporting of risks is done to inform stakeholders, especially stockholders of the risks faced by their entities, steps taken to mitigate and control them and the mechanisms adopted. A voluntary risk report is discretionary and is decided by a manager's penchant for risk reporting and Mandatory is then when risk reporting is required by any law or statute.

Risk Management (RM) involves forecasting the risks involved in decision-making and initiating measures to control them like risk insurance, risk reduction, etc. It is a continuous process of identifying risk factors, analysing risks, deciding upon measures of risk handling and controlling their effects'. It includes such activities as risk identification, risk quantification, risk insurance, risk mitigation and risk control. There is a very close relationship between Risk Reporting and Risk Management. The management of risks calls for a comprehensive disclosure of risks faced and measures taken to alleviate risks. It can be said that risk reporting is an information system that helps people involved in risk management process to discharge their functions in an effective and efficient manner. RM is impossible without risk reports.

Risk Reporting & Other Related Disciple.

Risk Reporting & Corporate Governance

A good Corporate Governance is said to be ineffective with the absence of risk reporting and risk management. A perusal of the recommendations of important committees like Cadbury, Hampel, Smith, Higgs, Combined Code of UK, etc. all point to one important fact that the corporate board has a significant role in establishing adequate internal control structures and risk management framework. The OECD Principles of Corporate Governance, May 1999 highlighted the need for risk reporting.

Risk Reporting & AS/IFRS

Though risk reporting is assuming importance in the wake of global integration of businesses and stock markets, emergence of derivatives and other risk products and increasing number of corporate scandals, etc., there is no specific accounting standard issued either by the IASB or by the FASB. However, each of these agencies has risk reporting disclosure requirements under specific accounting standards. *IFRS–7 on 'Financial Instruments: Disclosures'* covers exhaustively the disclosure of nature and extent of risks arising from financial instruments. Similarly, *IFRS–4 on 'Insurance Contracts'* prescribes the disclosure requirements in insurance contracts. IAS–1 encourages enterprises to present, outside financial statements, a financial review by management, which should describe and explain the main features of the enterprise's financial performance and financial position as well as the principal uncertainties it faces. IAS–21 encourages the disclosure of an enterprise's foreign currency risk management policy. IAS–37 requires that information is provided about risks for which provisions have been recognised in the balance sheet. *AS–11 (Revised) on 'The Effects of changes in Foreign Exchange Rates'* and exposure draft on 'presentation of financial instruments' deal with risk reporting but only to a little extent. AS–11 expects companies to disclose their foreign exchange risk management policies and framework.

Risk Reporting & German Accounting Standard 5

The German Accounting Standards Board issued GAS–5 on 'Risk Reporting' in 2000, which was applicable from 31st December 2000. The standard is applicable to all parent organisations, which are either limited liability companies or enterprises equivalent to such companies and to enterprises, which are required to present consolidated financial statements. The standard prescribes that information should be presented in a self-contained section of the group management report.

Conclusion

Risk reporting is the inevitable consequence of the mandatory insistence to adopt risk management framework, increased failure rate of corporate, stakeholders' expectations, and changed role of corporate boards, etc. As a result, companies are required to report risks related to all their decisions, and mechanisms implemented to identify, monitor and control them besides effectiveness of such mechanisms, etc. Risk reporting is another example where fairness and transparency principles dictate corporate actions.

In India, risk management framework has been made mandatory by SEBI as a result of *The Narayana Murthy Committee* recommendations. Under the MDA report, managements of companies are called upon to describe 'risks and concerns'. However, the results so far have not been satisfactory. There is only cursory description of the risks without any detail identification of the types of risks faced. Therefore, the ICAI may think of issuing an independent accounting standard on the lines of GAS–5. Such a step can be an extension of the efforts made so far in improving governance standards as well as reporting practices of Corporate India. More than that, possibility of Enron like situations can be prevented with better and adequate risk reports.