



Dimensions of Internal Auditing

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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.

Introduction

Traditionally, people understand internal audit as an activity of self imposed internal check and audit which also supposedly involved the activity of going around telling people what they were doing wrong. However even if one sees it in a narrow sense, the contribution of the activity of internal audit is potentially of major importance as an effective internal audit system leads to improved accountability, ethical and professional practices, effective risk management, improves quality of output and supports decision making and performance tracking.

Historically it was always held that internal auditing is confined to merely ensuring that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether policies and procedures are in place and are duly being complied with. With changing times this concept has undergone a sea change with regard to its definition and scope of coverage.

Modern approach suggests that it should not be restricted to financial issues alone but also on issues such as cost benefit analysis, resource utilization and their deployment, matters of propriety, effectiveness of the management, etc. Internal audit is to be understood as an independent and objective appraisal service within an office/organization.

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Section 292A of the Companies Act, 1956

In addition, Section 292A of the Companies Act, 1956, requires public companies having paid up capital not less than Rs. 5 crores to constitute a committee of the Board, i.e., the Audit Committee. In terms of sub section 5 of the

said Section, the internal auditor is required to attend and participate at the meetings of such Audit Committees.

The Institute of Internal Auditors of UK and Ireland defines Internal Audit

The Institute of Internal Auditors of UK and Ireland defines Internal Audit as: "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 Institute of Internal Auditors New York

The Institute of Internal Auditors New York defines Internal Audit as: "Internal audit is an independent, appraisal activity within an organization for the review of accounting, financial and other operations on the basis as a basis of service to the organization. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls".

The above definitions of internal audit call for internal audit, to be an independent function within an organization placing greater emphasis on its objectivity. Thus internal auditing primarily provides an independent objective opinion to the management.

The findings of an independent focused internal audit function also brings to the fore its findings and recommendations which act as a tool to officers in a department to take suitable corrective action and help in plugging the loopholes which would otherwise go undetected for a considerable period of time. The definitions stress on two aspects of internal audit—assurance and consultancy. It is important that in fulfilling both these roles, internal audit remains independent of the project.

It is the management's responsibility primarily to manage the project and they should therefore make the decisions, but internal audit could act as a facilitator within this process. For example, management should identify the risks associated with the project and decide how to deal with them with internal audit, acting as a consultant on risk and control matters.

Internal Auditing Basic Principles

The golden principles that state the Code of Ethics for Internal Auditors in Government are Integrity, Objectivity, Competency, Confidentiality and Independence.



a. Integrity: Integrity is expected in aspects of the internal audit work. The principles of honesty and fairness are to be observed. The basic point that is raised here is that his report should bring with it an air of trust, reliance and fairness.

b. Objectivity: Professional competency and assessment of facts with utmost care is a pre requisite for a good internal auditor. An internal auditor should refrain from making reckless and irresponsible statements or resorting to expressions without proper evidence.

c. Competency: An internal auditor is expected to apply appropriate skill and knowledge combined adequately with experience. An internal auditor should refrain from undertaking works that are outside his scope or beyond the scope of his skill and competence. Performance of the audit and preparation of the report require due professional care by persons possessing adequate training, experience and competence in auditing. The majority of staff development, however, results from on the job training where auditors assist in the training of other, less experienced staff members. Each auditor must be responsible for continuing his/her education in order to maintain their proficiency. This involves keeping abreast of current developments in auditing standards, procedures and techniques.

d. Confidentiality: The internal auditor should safeguard all information received by him as most of them may be of confidential nature. There shall be no spill out of possessed information unless there is a statutory, legal and professional requirement to do so.

e. Independence: As the definition states, Internal audit is an independent appraisal activity. We need to carefully note here that the word "independent" is important, even though it gets neutralized by the fact that it is within an organization. Independence stands for an internal auditor being able to report on material facts and figures, uninfluenced by any favor or frown.

It is to be understood that the International Auditing Guidelines relating to "Using the work of an internal auditor" reads as follows "An internal audit function is part of the entity and irrespective of the degree of its autonomy and objectivity cannot be the prime criterion for independence". This is because the reporting relationship may influence his decisions and reporting patterns.

Objectives and Scope

As defined above Internal Auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is therefore to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analysis, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost. The members of the organization assisted by internal auditing include those in management and the board.

The scope of internal auditing should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of performance in carrying out assigned responsibilities.

The Internal auditors should:

1. Determine whether the existing system of controls is in harmony with the structure of the organization. As far as possible keeping the controls within the operating functions acts as a cost effective measure.
2. Review each control and analyze them in terms of costs and benefits.
3. Review the reliability and integrity of financial and operating information and the means used to identify measure, classify, and report such information.
4. Review the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on operations and reports, and should determine whether the organization is in compliance.
5. Review the means of safeguarding assets and, as appropriate, verify the existence of such assets. The objective of the management is to ensure that assets are reasonably and adequately protected against loss and that they are properly managed and accounted for. The safeguard of assets should not be restricted to mere pilferage but physical threats like fire, water, electricity, etc.
6. Appraise the economy and efficiency with which resources are employed.
7. Review operations or programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

Internal Audit Adding Value to the organization:

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 organization 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 organizations are looking for the internal audit function to assume a leadership role in assessing and managing their strategic risks, adding value to the organization and identifying operational improvement opportunities.

Risk Management

The business environment is increasingly throwing up newer challenges and opportunities with globalization, 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 organization 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 organize 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 to 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 organization 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 "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."

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

Layout:

- (i) Title.
- (ii) Addressee.
- (iii) Report Distribution List.
- (iv) Period of coverage of the Report.
- (v) Opening or introductory paragraph:
 - Identification of the processes/ functions and items of financial statements audited.
 - 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.
- (xiv) Internal auditor's signature with Membership Number.



About the Internal Audit Standards Board

The Internal Audit Standards Board was constituted as the Committee on Internal Audit in the year 2004, with the mission of reinforcing the primacy of the Institute of Chartered Accountants of India (ICAI) as a promoter, source and purveyor of knowledge relating to internal audit and other aspects related to it in the society so as to enable its members to provide more effective and efficient value added services related to this field to the Industry and others and help the latter to systematize and strengthen their governance process by systematizing and strengthening their control and risk management process.

The objectives of the Internal Audit Standards Board (IASB) are as follows:

- To review the existing internal audit practices in India.
- To develop Standards on Internal Audit (SIAs) to be issued under the authority of the Council of the Institute.
- To develop Guidance Notes on the issues relating to internal audit, including those arising from the SIAs, to be issued under the authority of the Council of the Institute.
- To issue Clarifications on the issues arising from the SIAs, to be issued under the authority of the Council of the Institute.
- To develop studies, reports, etc., on issues arising from SIAs, to be issued under the authority of either the Council of the Institute or of the Board.
- To undertake research in the field of internal audit.
- To organize/ provide technical assistance in, conferences, workshops etc., on the topics related to internal audit organised by the Institute.

Standards on Internal Audit

The Board has till date issued sixteen Standards on Internal Audit (SIAs) and the list is given in Appendix I. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India.

The Board may also, where it considers appropriate, take into consideration the international practices in the area of internal audit, to the extent they are relevant to the conditions existing in India.

Other Technical Literature

A list of other Technical Literature issued by the Board, both generic as well as industry specific is given in Appendix II. It includes either explanatory material on the Standards or it

Details the application of Standards in specific industries or situations in the form of Technical Guides. These Technical Guides provide guidance to internal auditors in resolving professional issues arising during the course of an internal audit while discharging their duties as internal auditors.

Appendix I

List of Standards on Internal Audit

- SIA 1 Planning an Internal Audit
- SIA 2 Basic Principles Governing Internal Audit
- SIA 3 Documentation
- SIA 4 Reporting

- SIA 5 Sampling
- SIA 6 Analytical Procedure
- SIA 7 Quality Assurance in Internal Audit
- SIA 8 Terms of Internal Audit Engagement
- SIA 9 Communication with Management
- SIA 10 Internal Audit Evidence
- SIA 11 Consideration of Fraud in Internal Audit
- SIA 12 Internal Control Evaluation
- SIA 13 Enterprise Risk Management
- SIA 14 Internal Audit in an Information Technology Environment
- SIA 15 Knowledge of the Entity and its Environment
- SIA 16 Using the Work of an Expert

Appendix II

List of Generic and Industry Specific Publications

- General Guidelines on Internal Audit
- Guide on Risk-based Internal Audit
- Guide to Internal Controls over Financial Reporting
- Guide to Implementing Enterprise Risk Management
- Technical Guide on Risk-based Internal Audit in Banks
- Technical Guide on Internal Audit in Aluminium Industry
- Technical Guide on Internal Audit in Oil & Gas (Refining & Marketing) Downstream Enterprises
- Technical Guide on Internal Audit in Upstream Oil & Gas Companies
- Technical Guide on Internal Audit of Telecommunications Industry
- Technical Guide on Internal Audit of Stock Brokers
- Technical Guide on Internal Audit of Intangible Assets.
- Manual on Concurrent Audit of Banks
- Manual on Internal Audit
- Training Material on Internal Audit
- Background Material on Due Diligence

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