Internal Audit—Key Focus Areas in Today's Times

Today's global world is changing at such a fast pace that it is being termed as VUCA, i.e., the environment is marked with volatility, uncertainty, complexity and ambiguity. The marketplace is full of challenges thrown up by increased risk, due to expanding operations in emerging markets, increased regulatory demands, and increased focus to be competitive in price and quality. These multiple drivers create a dynamic environment, full of challenges as well as opportunities for internal auditors to demonstrate their value, and meet the heightened expectations of the stakeholders. The focus of internal audit should largely align with the risks currently facing the organisations, arising from compliance with laws and regulations, adoption of emerging technologies, and an increasing proportion towards strategic risks and risk management assurance. Read on to know more…

It is of utmost importance that internal audit engages in ongoing assessment to identify and filter activities that internal audit can perform to improve the effectiveness of governance, risk management, compliance and control processes of the organisation. By establishing a common, integrated discipline around regulations, risks, policies, issues and controls, internal auditors can demonstrate that they are well equipped to better leverage information, gain operating efficiencies, and provide greater transparency into regulatory, legal, operational and overall business risks. The key focus areas for internal auditors have been described in this article, which are meant for helping to develop and update internal auditors, and be well prepared to meet the challenges of an increasingly complex and intrusive environment.

CA. Shiwaji B. Zaware and CA. Jyoti Singh

(The authors are members of the Institute. They can be reached at sbzaware@icai.org or jyoti@icai.in)

Enterprise Risk Management

Globalisation has completely changed both the risks that organisations face and the manner in which the risks are managed. Enterprise Risk Management (ERM) can prove to be a strategic competitive advantage if it is used to identify specific action steps that enhance performance. COSO's 2010 Report on ERM "Current State of Enterprise Risk Oversight and Market Perceptions of COSO's ERM Framework" summarises that the state of ERM appears to be relatively immature. Only 28% of respondents describe their current stage of ERM implementation as "systematic, robust and repeatable" with regular reporting to the board. The survey results indicate the expectations for improving risk oversight in these organisations are coming from a number of sources. Collectively, these results suggest that 59.1% of the full boards and 63% of audit committees are making "Moderate" to "Significant" to "A Great Deal" for more senior management involvement in risk oversight. Internal audit also appears to be placing additional expectations on executives regarding risk oversight. For those entities with an internal audit function, 65.4% of the respondents indicated that internal audit is

making "Moderate" to "Significant" to "A Great Deal" of requests for more senior management involvement in risk oversight.

Over the years, the practice of ERM has evolved by broadening and expanding the tools and concepts. ERM should be intrinsically linked to the entity's business strategy—which encompasses an organisation's established vision, mission, and objectives; it is the process for defining operational imperatives; and its philosophies, policies, plans, and initiatives for development. Greater vigilance is required from internal auditors to identify new risks, assess their exposure and ensure that the organisation is responding in a manner that is consistent with its defined risk appetite and tolerances. Internal auditors should assist decision-makers in arriving at the most appropriate treatment of risks and then the monitoring and review of risks and controls. Some good risk management practices that internal auditors should try to embed in the organisations are:

- Key risks indicators for all lines of business have been established that predict and model risk assessment.
- Standardisation of self-assessment and other reporting tools across the business.
- Optimisation of controls to improve effectiveness, reduce costs and support increased business performance.
- Business level key risks matrices have been established.

Corporate Governance

Increasing corporate governance requirements will make audit committee members to work closer with internal audit and rely for their independent business insight. The "2012 Thomson Reuters Governance, Risk and Compliance Survey" stated that the survey results overall suggested that only 18% of internal audit functions devoted time and resources to corporate governance as one of their top three areas of focus. Respondents from both Asia and Middle East considered corporate governance to be more important, with a third of internal auditors currently recognising it as one of their top three areas of focus. The Thomson Reuters Special Report on "Culture, Corporate Governance and the Internal Auditor" cites recent audit failings which are as follows:

Firm	Internal Audit Finding	Sanction
Mitsui Sumitomo Insurance Company - 2012	The UK FSA found that repeated internal audit recommendations, including review of corporate governance and board and executive committee effectiveness, were ignored.	Firm fined £3.345 million CEO fined £119,000 and banned
Oracle -2012	US SEC charged Oracle Corporation with violation of the Foreign Corrupt Practices Act after Oracle India Private Limited, Oracle's Indian subsidiary failed to seek transparency in its dealing with a distributor, and audit appropriately third-party payments made by distributors on its behalf. The required audit assurance would have enabled the company to check that payments were made to appropriate participants.	$2 million settlement penalty
Peregrine Financial Group 2012	Peregrine Financial Group (U.S), a futures brokerage collapsed in July 2012 soon after a $ 215-million shortfall in customer funds was discovered after the CEO confessed to having run a multi-year fraud. There appeared to have been large gaps in the controls and corporate governance framework in place which were not highlighted by the internal audit function or other risk and compliance functions.	Former CEO could face a sentence of up to 50 years in prison
UK Car Group Limited (UKCG) - 2012	The UK FSA found failures to adequately address, respond to or rectify issues identified in audits. The FSA considered UKCG's actions fell short of required standards to take reasonable steps to ensure the suitability of the advice and recommendations provided to its customers, by failing to deal appropriately with concerns raised in internal audits.	Firm fined £91,000

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Zurich Insurance - 2010	The UK FSA found that the firm did not ensure that the internal audit function in South Africa was aware that UK customer data was being held and processed. It also found failings regarding adequate reporting procedures to ensure that any UK-related issues arising from an internal audit in South Africa were promptly brought to the attention of relevant persons in the UK.	Firm fined £2.275 million.
Satyam – 2009	The Indian Central Bureau of Investigation arrested the internal auditor of former Satyam Computer Services Ltd. for helping senior managers to falsify the accounts.	Criminal prosecutions pending and financial results 2002-08 restated
UBS -2009	The UK FSA found failure to implement in a timely manner significant recommendations from group internal audit reports relating to the international wealth management business.	Firm fined £8 million

Internal auditors should be well-equipped to audit corporate governance and also give an opinion about whether or not it is operating effectively in the organisation. The European Confederation of Institutes of Internal Auditing (ECIIA) in its paper "*Corporate Governance Codes on Internal Audit*" has recommended that the governing body of an organisation should be responsible for strategic risk oversight. The board and audit committee should be required to, among other things, define a clear delegation and accountability for risk management and internal control through the "Three Lines of Defence" model. Under the first line of defence, operational management has ownership, responsibility and accountability for assessing, controlling and mitigating risks. As a second line of defence, the activities are covered by several components of internal governance like compliance, risk management, quality and other control departments. Internal audit forms the organisation's third line of defence. In this model, internal audit assumes responsibility for providing overall assurance to the organisation's board of directors and senior management.

Information Technology

The changing technology landscape exposes an organisation to huge risks and also potential risks which should be suitably addressed. Emerging technologies such as social media, cloud computing, cyber security, big data, etc., pose risks which impact the procedures and working of organisations at all levels. The technology industry findings from Protiviti's 2012 Internal Audit Capabilities and Needs Survey findings suggest that internal audit's activities over the next year will centre on four overarching priority areas:

(i) Increasing the use of technology to audit key business process controls (e.g., cash receipts/ applications, revenue recognition) more effectively
(ii) Addressing and managing existing and emerging risks holistically
(iii) Enhancing efficiency through technology-enabled auditing
(iv) Nurturing internal collaboration and networking externally.

Internal auditors should move from manual, time-intensive auditing to technology-enabled auditing practices that enable the review of virtually every transaction and piece of data on a continuing basis. Increasing use of technology has lead to automation of processes and shrinking of audit evidence. Internal auditors should set their audit strategy as auditing through the system, and not the traditional approach of auditing around the system. Many internal audit departments are making more use of data analytics to analyse complete populations of data and develop more efficient and reliable testing approaches. These are useful in determining what to audit, how to audit process efficiently, and to monitor risks across business operations. These tools support benchmarking across functions within an organisation and consolidate and link data from different systems into a single analysis.

Some good risk management practices that internal auditors should try to embed in the organisations include the provision that key risks indicators for all lines of business have been established that predict and model risk assessment and there is standardisation of self-assessment and other reporting tools across the business.

Fraud and Corruption

The complex and dynamic business environment has increased fraud vulnerability of organisations. Internal audit should play the role of an enhanced arm of corporate governance by strengthening internal control systems, commensurate with the extent of the potential exposure/risk in the various segments of the organisation's operations. The "Report to The Nations on Occupational Fraud and Abuse – 2012 Global Fraud Survey" by ACFE estimates that the typical organisation loses 5% of its revenues to fraud each year. Applied to the 2011 Gross World Product, this figure translates to a potential projected annual fraud loss of more than $3.5 trillion. It also mentions that as in the 2010 Report, management review and internal audit were the second and third most common methods of fraud detection. Further, internal audit was one of the most diverse detection methods across regions, uncovering as few as 10% of cases in Africa and as many as 23% in Europe.

By increasing information technology driven continuous monitoring to identify key indicators in real time, internal auditors can provide a heightened awareness of management corruption, which primarily consists of conflicts of interest. Historically, most financial statement frauds have involved senior management, who are in a position to perpetrate fraud by overriding controls and acting in collusion with other employees. Important areas of internal audit analyses are as follows:

- Accuracy and completeness of reports to the Audit Committee, which should include all instances of management fraud
- Off-balance sheet entities
- Discretionary reserves in general, and in particular, period-end entries to these accounts
- Related party transactions
- Revenue recognition issues such as, questionable or unusual patterns at period ends
- Conflicts of interest and perquisites
- Insider trading activity and disclosures
- Quality of earning analyses

Internal auditors should assess that a strong code of conduct, standards of ethical behaviour and fraud policy exist. They should test and monitor the design and effectiveness of fraud programs and internal control over financial reporting. Recent surveys have shown increased use of data analytics by internal auditors for fraud prevention, detection and investigation activities.

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Regulatory Compliance

The government oversight burden and pressure for increasing transparency is increasing at a rate much faster than in other areas. Organisations are enormously concerned about regulatory oversight and expectations around effective compliance. The probability and impact of the risks that the legislation represents depends on the robustness of risk and compliance management within the organisation. This requires integrated role of management assurance, legal and compliance department and the internal audit and other independent assurance service providers. Internal audit is responsible for reviewing the adequacy and effectiveness of the functioning of controls implemented by management to ensure compliance with applicable laws and regulations. They can play an important role in ensuring the adequacy of the following:

- Legislations that should be reviewed
- New processes being put in place as a result of compliance requirements
- New systems being put in place to support and monitor compliance.

The internal auditor should consider compliance with the provisions of those laws and regulations, generally, recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as, tax and laws regulating the reporting framework. Further, it is also important to ensure compliance with other laws and regulations that are fundamental to the operating aspects of the business like, compliance with the terms of an operating license, compliance with

regulatory solvency requirements, or compliance with environmental regulations.

Business Continuity Management

Effective Business Continuity Management has gained prominence and organisations that earlier had survived a significant disaster or disruption may now find the same event pushing their existence to the brink. Large scale events such as the March 2012 Japanese earthquakes and tsunami significantly challenged the existence of some companies, but there are smaller, less impactful events also that would question the ability of some organisations to react and recover. Internal auditors can conduct business continuity program integration and governance audit. They can evaluate the organisation's overall business continuity plan, including programme governance, policies, risk assessments, business impact analysis, vendor/third party assessment, strategy/plan, testing, maintenance, change management and training. The business continuity planning process should adequately address activities and resources covering an organisation's people, facility, technology, telecommunications and vital records.

Sustainability

A growing number of organisations are choosing to report on sustainability and the Securities and Exchange Board of India (SEBI) has mandated inclusion of business responsibility reports within annual reports for listed entities. Implementing and maintaining a sustainability management system in an organisation is a continuous process. Internal auditors can play an important role in formulating the sustainability policy and strategy, planning and risk management phase, and also in the implementation and operation phase. Knowledge of widely accepted standards and best practices in the field of sustainability are essential to compel recognition of the internal auditor's proficiency by the management. Internal auditors should concentrate on testing the adequacy and effectiveness of relevant processes, and review the consistency of actions taken in various phases of the sustainability management system. It is also necessary to ensure that sustainability aspects are included in the organisation's risk management. In case of any violation of laws and regulations or established standards for human rights and environmental issues, there are chances that the reputation of an organisation may be harmed. Some examples from the past include huge oil spills from tankers, explosions at nuclear or chemical plants, and human rights violations in construction industry, etc. COSO' Thought Leadership Paper "*Demystifying Sustainability Risk: Integrating the triple bottom line into an enterprise risk management program*" states that in just a few short years, sustainability has gone from a feel-good initiative to a strategic imperative. Momentum is building for a more integrated approach to sustainability and the risks that it poses.

Way Forward

These highlighted areas require that internal auditors should develop their strategy based on the mantra of SPEED, i.e., Simple, Practical, Effective, Economical and Duplicable. Further, stress should be more on areas which are non-financial in nature since these areas are also not very specifically covered by external auditors. Internal auditors should perform SWOT Analysis of the organisation and then should focus on strengthening weak areas, tapping the opportunities, minimising threats to the enterprise and encashing on strengths. It could not be denied that there are various limitations or hurdles hampering effective functioning of internal audit. Some of them are as follows:

- Maintaining independence in case of in-house internal audit function
- Defining scope of internal audit covering all major areas and activities of the organisation
- Ensuring timely reporting
- Lack of follow-up action by the management on the recommendations of the internal auditor in some instances
- Increasing situations of conflict of interest/fraud by senior management

The best way for internal auditors to enhance their value is to ensure that they adopt best practices and processes in carrying out internal audit engagements. Standards on Internal Audit issued by the Institute of Chartered Accountants of India focus on the principles to be followed, the objectives to be achieved and the essential considerations for the internal auditor in planning, conducting, documenting and reporting on internal audit. The Companies Act, 2013, has also mandated internal audit for certain class of companies which will be notified in the Rules to the Act. Internal audit is a very important function and communication and implementation of suggestions of internal audit would lead to improved quality of governance, risk and internal control structures, and in the longer run which will also be evident in improved profitability of the organisation. ■