Maximising the Internal Audit Efficacy

Internal Auditors are one of the four cornerstones of corporate governance—the others being Management, Statutory Auditors and the Board of Directors. These four cornerstones are not only intertwined but also inextricably linked to each other. Management is charged with the responsibility of maintaining internal controls, risks and compliance on behalf of the organisation's stakeholders and is held accountable for this responsibility by an oversight body (e.g. board of directors, audit committee, elected representatives). A dedicated, independent and effective internal audit function assists both management and the oversight body (e.g. the board, audit committee) in fulfilling the aforesaid responsibilities i.e. providing reasonable assurance. Be it an in-house internal audit function, or an outsourced function or mix of both, what is imperative is the need to introspect, evolve, adapt and improve continuously. This process must invariably compel the internal audit function to think out of the box. This article highlights some thoughts for enhancing the efficacy of the internal audit function. Read on …

We live in an era of significant corporate, economic and social transition as evident from the rapid globalisation of markets, business trade and the risk in the last few decades. Of course the risk of economic uncertainty has also increased simultaneously. Uncertain times also demand for more certain measures.

Globally boardrooms are now acknowledging that corporate governance has never been as important before as it is now. The four cornerstones of corporate governance are – Management, Statutory Auditors, Internal Auditors and the Board of Directors. All the four cornerstones are not only intertwined but also inextricably linked to each other.

Management is charged with the responsibility of maintaining internal controls, risks and compliance on behalf of the organisation's stakeholders and is held accountable for this responsibility by an oversight body (e.g. board of directors, audit committee, elected representatives). A dedicated, independent and effective internal audit function assists both management and the oversight body (e.g. the board, audit committee) in fulfilling the aforesaid responsibilities i.e., providing reasonable assurance.

Traditionally, the role of Internal Audit which originated from monitoring compliance has now moved to a more strategic role of being a Business Enabler. So, how does an internal audit function which is perceived as an objective source of independent advice actually deliver value addition; especially in an environment where managements globally are focused on obtaining maximum assurance from the Internal Audit function? Be it an in-house internal audit function, or an outsourced function or a mix of both, what is imperative is the need to introspect, evolve, adapt and improve continuously. This process must invariably compel the internal audit function to think out of the box.

CA. Purav Gala

(The author is a member of the Institute. He can be reached at pgala@raychemrpg.com)

Need for Enhanced Collaboration

Statutory Auditors relying on the work of Internal Auditors is a common practice well known and well heard of. It also finds mention in Standards on Auditing issued by the Institute of Chartered Accountants of India—*"SA 610: Using the Work of Internal Auditors"*. Statutory auditors seek and are provided access to the

work undertaken by internal auditors including the internal audit reports, the approach and methodology adopted the scope, the sample size, the working paper files, etc.

However the contrary, of internal auditors relying on the work of external auditors is yet to be heard of and, therefore, needs contemplation.

This brings us to the moot point—whether the work of internal auditors and external auditors can be synergised to avoid replication of each other's work? This is possible where the work of external auditors and internal auditors overlap. For instance, collaboration can be contemplated on the sample counts of data utilised by both the auditors during fieldwork irrespective of the fact that objectives of both the auditors are different.

Just as statutory auditors leverage on the work of internal auditors the contrary practice is something that needs a serious afterthought especially in times when internal audit team sizes today are limited, but the expectation of the board on controls and governance is increasing by the day. In practice, it may be difficult for statutory auditors to share the working paper files but what could be possible is sharing data in a summarised manner. For instance, if statutory auditors and internal auditors share their work programmes and scope of work in a collaborative manner, assurance can definitely be maximised. This is possible in case of an entity spread across multiple geographical locations. Such a step would not only benefit the statutory audit and internal audit functions, but also the board as well as the stakeholders. Another instance would be whether both the statutory auditors and internal auditors could jointly revisit the risk register and deliberate on the annual audit plan of internal auditors as well as the scope of work of statutory auditors. While this is practiced across many organisations, a formal presentation depicting the outcome of such exercise to the audit committee jointly by the internal auditors and statutory auditors can be contemplated. Such a practice would surely be immensely beneficial.

The remaining two cornerstones of corporate governance, namely management and the board of directors, should be informed of such enhanced collaboration. The benefit of such extended cooperation will accrue over a period of time—what is vital is to start taking small steps in this direction in letter and spirit.

Building Reputation for the Internal Audit team

Every function/department in a corporate has a perception built around it—it gets built by default and is dependent on the culture and values of the people belonging to the respective department/function.

Statutory Auditors relying on the work of Internal Auditors is a common practice well known and well heard of. It also finds mention in Standards on Auditing issued by the Institute of Chartered Accountants of India—*"SA 610: Using the work of Internal Auditors"*. Statutory auditors seek and are provided access to the work undertaken by internal auditors including the internal audit reports, the approach and methodology adopted the scope, the sample size, the working paper files, etc.

Likewise an internal audit department of an entity also carries a perception based on the characteristics, the nature, actions, approach and the culture of the internal audit team.

From an average auditee's perspective who would be subjected to internal audit reviews, the perception of an internal audit department always tends to be negative. This is inbuilt and cannot be changed in the first instance. For instance, the Internal Audit department gets perceived as one being similar to an enforcement agency, someone who cannot understand business better than the process owner, one who could be cynical and having a strong belief in theory than in practice. One of the vital challenges for the CAE is to break this thought cocoon embedded strongly in the minds of the internal clients. The very nature of internal audit activity makes it one of the most misconstrued functions in an organisation.

In today's times, one cannot deny that an internal audit function is not only a business enabler but also the eyes and ears of the management. It is the only function that has access and can interact with employees at all levels.

Therefore, it is imperative that an internal audit department creates the right PP—A Positive Perception. Implicitly it is this perception that goes a long way in enhancing the efficiency and efficacy of internal audit. A Positive Perception not only enables internal audit to act as a trusted advisor to the top management but also facilitate collaboration across the enterprise.

The IA department cannot be an exception to the maxim—Practice what you preach. The culture of the Internal Audit department must reflect honesty and independence. The department would be best seen and judged as being apolitical and sans any lineage. Risk

of contemptuousness exists due to the inherent power of the auditor's role. An internal auditor needs to be Firm, Fair and Assertive. An internal audit needs to be sensitive and understand the business needs. An internal auditor should be able to comprehend that whilst excessive controls can be detrimental to efficiency, leniency in implementing controls needs to be reported without hesitation. This is not possible without having an in-depth understanding of the business. A strong induction programme would actually help the internal auditors to understand the intricacies of business. To cite an instance, in case of a manufacturing entity, does the internal audit team sit on the shop floor and just spend a day or two to observe the complete process?

Effective communication by the Internal Audit team is the key in developing a 'Positive Perception'. An annual and comprehensive training and development programme for the complete internal audit team on enhancing soft skills is the need of the hour. This is an area where Chief Audit executives and leaders of consulting firms need to work and leverage it as a capability.

One of the options of building a Positive Perception would be to create a niche tag line or a departmental motto which would best describe the attributes of the internal audit department. The second option would be to obtain feedback from the process owners using a simple questionnaire form post-completion of an audit review. In some corporates internal auditors undertake a periodical assessment survey from various internal customers (auditees) on capabilities, trust, image, areas of improvement. A positive perception is stated to have been built in case the internal clients are of the belief that the internal audit department is not to pinpoint the deviations but rather listen to their concerns and handhold the improvement process. A simple thank-you note to the auditees appreciating their cooperation or perhaps appreciating the prompt action on an observation being taken by a young executive to his reporting superiors goes a long way in creating Positive Perception. What would matter is appreciation of such auditees by the senior management.

The IA department cannot be an exception to the maxim—practice what you preach. The culture of Internal Audit department must reflect Honesty and Independence. The department would be best seen and judged as being apolitical and sans any lineage. The risk of contemptuousness exists due to the inherent power of the auditor's role. An internal auditor needs to be firm, fair and assertive. An internal audit needs to be sensitive and understand the business needs.

Many corporates have a structured employee induction programme—an internal audit department should invariably form part of it in some way or the other. A leaflet/teaser on benchmark business practices, stressing the significance of internal controls, can also actually imbibe a positive perception to a great extent.

Having a guest auditor programme in place wherein functional experts from within the organisation actually are invited to undertake an audit engagement right from the start to the end is also a useful technique worth considering.

A benchmark endeavour would be to develop a mechanism by which internal audit could receive requests for internal audit/health check reviews from their internal clients. It is also imperative that internal audit continuously reviews its own work, approach and reporting for improvements. Whilst this may be undertaken it is equally significant that any new change/internal process improvement of the internal audit department should also be communicated to the management and the board. Very few Internal Audit departments in India actually undertake a quality assessment survey of their own department/functioning. A quality assessment survey of the Internal Audit department necessarily is an indicator of the significance that management accords to corporate governance.

Another approach for consideration by internal audit would be to incorporate positive confirmations in an internal audit report. This would be in case the audited area or the sample count of the audited work is *sans* any deviation. Whilst identified deviations must be reported, abetting process improvement by incorporating benchmark practices in the report is clearly expected of internal audit.

Setting the right pitch depends on the report writing style of the auditor. In a multifunctional, multi-location entity having a standard internal audit report format helps not only the CAE's but also the local management as well the senior management to comprehend audit non-compliances faster.

Having an internal audit section on the company intranet site containing articles of interest, latest information on internal audit, economy etc., would also go a long way in creating the positive perception of internal clients.

Mention must be made clearly that whilst all

attempts of creating a positive perception in the minds of the internal clients are laudable, the internal auditor must never in action or thoughts go overboard and compromise or dilute its functioning in any manner whatsoever at the cost of creating positive perception.

To conclude, using innovative approach and different modes of communication will only assist Internal Audit in creating a positive perception. This definitely will help it to achieve the role of business enabler in reality.

Whilst value addition vide internal audit reviews and reports is undoubtedly important and cannot be undermined, an astute internal auditor must adopt a consistent approach in undertaking follow-up reviews. It is advisable to request the auditees to commit a time-bound plan for implementing agreed recommendations *in lieu* of the audit observations mentioned in the internal audit report.

Follow-up Audit Reviews

Typical Internal audit reports highlight the prevailing internal controls weaknesses, the inherent need to eliminate risks arising from such weaknesses along with recommendations, the response of the management incorporating their view along with committed action plan to take corrective steps *in lieu* of such audit observations.

Management is responsible for establishing and maintaining a system of internal controls within an organisation. A strong follow-up audit review mechanism would definitely complement and enhance the assurance level of the management.

Whilst value addition *vide* internal audit reviews and reports is undoubtedly important and cannot be undermined, an astute internal auditor must adopt a consistent approach in undertaking follow-up reviews. It is advisable to request the auditees to commit a time-bound plan for implementing agreed recommendations *in lieu* of the audit observations mentioned in the audit report.

Recommendatory actions which are in the nature of process improvement must invariably find their way into an SOP document. Consider another example—A Human Resource audit review indicated the need to strengthen IT controls in the entity's ERP. In such cases whilst drafting the audit report it is important to bring both the functions, namely Human Resources and IT on board and entrust them the responsibility of corrective action jointly.

Undertaking qualitative follow-up reviews can actually enhance the intrinsic value of value addition. In normal circumstances, the internal audit function is expected to meet deadlines for completing routine audit reviews—giving rise to the challenge of focusing on qualitative follow-up audit reviews. A follow-up review also indicates the risk appetite of the management.

Consider an instance—the review of an entity's statutory compliance revealed that the entity was not availing tax benefits accorded by the law. The fact that the economic benefits were material and availment of which was being missed out found mention in the internal audit report. This prompted action by the management resulting in economic benefits for the entity. For an internal auditor nothing can be more gratifying than the fact that promised action has been taken on such observations.

Some recommendatory practices would be to perhaps provide annually to the management or the board a Flash Report containing non-confirmations (internal audit observations *in lieu* of which committed actions have been pending). The Flash Report could be graded perhaps with High Risk and Low Risk observations. Systematically using automation or customised software, contemplation could be had on whether to send email alerts to process owners reminding them of recommended action to be taken. Such a report could provide insight to the audit committee on an organisation's culture of managing the risks. In addition to a Flash Report the internal audit could also consider generating a repository framework of weak internal controls critically requiring immediate corrective action. This could be subjected to routine follow-up reviews to ensure that the corrective action is systemic.

Irrespective of whether the regulatory framework provides enhanced mandate to the internal audit function—the significance of the internal audit function from a management and a board perspective has increased by leaps and bounds. It is about time that internal audit functions start taking cognisance of innovative measures to enhance their efficacy and create value. While this may not be limited to enhanced collaboration, building reputation for the internal audit function, undertaking a qualitative follow-up audit reviews, it is steps like these which will augment that internal audit on to the centre-stage as a business enabler. The essence lies in embarking on the thought process. ■