

# Internal Audit

## Importance of Reengineering the Internal Audit Function – An Aid to Strengthen Governance

*South East Asia is fast emerging as the epicentre of economic growth in the backdrop of a Volatile, Uncertain, Complex and Ambiguous global economy that is causing disruption to traditional localised businesses. The exponential growth of new format of businesses namely start-ups are changing the ground rules wherein business lifecycle gets shortened. Timing of entry/ exit of the business operators and valuation thereof are under constant evolution. Within the entities, “Enterprise mobility” is making the traditional workspace boundaries disappear and is redefining business processes. The emergence of business mobility – is a situation where a person can operate from anywhere with the help of mobile phone, laptops and cloud-based data access systems in a globally connected world. Under these conditions, it is the business objective rather than the control objective that overweighs strategic decisions. Corporate functionaries across the world, consider internal auditor as an important functionary having a suggestive role in matters related to internal controls and evaluating process vulnerabilities. This narrative discusses the express and implied expectations from Internal Audit functionaries. Read on...*



### Has Internal Audit Function Reached a Make or Break Situation?

Internal Audit has evolved organically with a voluntary option to management to adopt standards, framework and implement policy guidelines as suited to the work conditions without veto powers to the internal auditor in business decisions. The financial reporting gaps and accounting scandals in Indian Companies over the last decade has added fuel to fire, in impacting the independence of the function and credibility of the internal auditor.

On 10<sup>th</sup> April 2015, with reference to one of biggest financial scandals in the history of Corporate India, the news headlines flashed quote “‘The nine... men convicted’ and included the global head of entity’s internal audit team. The reason being that

he failed to brief the audit panel, of irregularities in (Indian) company’s books. The CBI said that the Chief of Internal audit function had connived with the alleged ‘Accused’ by not raising an alarm over accounts being inflated. He did not stand up against the management when they denied access of software highlighting irregularities for an independent audit.” unquote. The indictment of the Chief Audit Executive (CAE) in this financial scandal, in an Indian company, has opened the Pandoras box in terms of evaluating the way audits are conducted, audit findings reviewed, approved, documented and reported to governing body. Motives were attributed to the scope exclusions, non-release of audit reports/and shredding of working papers.

This makes one ponder on whether the internal audit function has reached a make or break situation? Perhaps, it would be most appropriate to examine the traditional role of internal audit as an assurance function and what are the expectations:

- a) Whether the controls are working as designed?
- b) Are the laid down controls the most efficient in present area of operation?



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- c) Is the financial and operating information accurate and reliable?
- d) Has the risk appetite in the organization been duly assessed?
- e) Are statutory compliances mechanism reliable?
- f) Is there adequate adherence to applicable corporate policies?
- g) Are assets/ resources being used efficiently and economically?

The above objectives need to be supplemented with robust audit methodologies in terms of:

- a) adequate procedures for compliance and substantive checks
- b) well-structured 'alert' mechanism in-built in the audit process
- c) rationale defined for exclusions of audit findings from the main report
- d) optimum allocation of resources for conduct of effective audits
- e) effective process of obtaining a periodic 'Action Taken Report' from clients
- f) policy for retention of working papers
- g) timely release of audit reports and briefing the audit committee members

The appropriate positioning of the Internal Auditor in the organisation aids in upholding the independent status of an audit function. Also, audit committees generally prefer independent interactions with the management representatives and the Internal Auditor.

## Resurgence of Internal Audit Function

The Companies Act, 2013, SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 and related regulations have enhanced the role of Chartered Accountants and other finance professionals in the sphere of compliance to regulations. This has cast an increasing fiduciary responsibility on the Key Managerial persons that include the Chief Executive Officer, Chief Financial Officer, Company Secretary and Others. In this context, internal auditor plays an important role as an aid to management in gauging the effectiveness of the control environment.

### **The Companies Act, 2013, SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 and related regulations have enhanced the role of Chartered Accountants and other finance professionals in the sphere of compliance to regulations.**

Accordingly, Section 138 of the Companies Act, 2013 stipulates the conditions/ rules for classes of companies requiring Internal Audit and suggests compliance to this rule within 6 months of commencement of such section.

The section further defines an internal auditor, who can either be a Chartered Accountant or a Cost Accountant or such other professional as may be appointed by the Board to conduct Internal audit of the Company. For this sub-section, Chartered Accountant means a Chartered Accountant, who is a member of the Institute of Chartered Accountants of India (ICAI) and has a valid certificate of practice and Cost Accountant means a member of The Institute of Cost Accountants of India or Other professionals, as may be decided by the Company's Board, may also be appointed as an Internal Auditor.

### **Standards and Framework - Proactive Institutional Initiatives**

The ICAI has taken proactive steps in forming the "Internal Audit Standards Board". The Board's main objective is to review the existing/emerging internal auditing practices worldwide and identify areas in which Standards on Internal Audit (SIAs) need to be developed. These are to be supplemented by guidance notes, implementation guides, Industry specific / issue based Technical Guides, Practice Manuals, Studies and other papers for guidance of the members. The Board also envisages research-based dissemination of knowledge in the field of internal audit. The Standards on Internal Audit would be classified and numbered in a series format, as follows:

- (i) 100 Series: Standards on Key Concepts
- (ii) 200 Series: Standards on Internal Audit Management
- (iii) 300–400 Series: Standards on the Conduct of Audit Assignments
- (iv) 500 Series: Standards on Specialised Areas

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(v) 600 Series: Standards on Quality Control

(vi) 700 Series: Other/Miscellaneous Matters

The Framework governing Internal Audit lays down the principles and boundaries for the audit activity. It aims at standardisation in discharge of Auditors' responsibilities. It defines internal audit "as providing independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives".

Every Internal Auditor is bound by a written Code of Ethics, issued by an organisation and/or the

professional institution of which he is a member. This commits the Internal Auditor to ethical Standards applied with utmost integrity and sincerity. The ICAI also plays an important role in upholding highest standards of discipline for its members through laid down code of conduct rules. Organizations too have evolved internal standards in measuring the performance of internal audit functionaries in tune with the business and control objectives.

Audit functionaries could refer the published standards on Internal Audit by ICAI, a brief reference to key SIAs are summarised as under:

SIA No.	Focus Area	Synopsis of Key Features
2 (Rev.)	Basic principles governing Internal Audit: (Revised (SIA 2): November 2018)	<ul style="list-style-type: none"> <li>• Independence</li> <li>• Integrity and Objectivity</li> <li>• Due Professional Care</li> <li>• Confidentiality</li> <li>• Skills and Competence</li> <li>• Risk Based Audit</li> <li>• Systems and Process Focus</li> <li>• Participation in Decision Making</li> <li>• Sensitive to Multiple Stakeholder Interests</li> <li>• Quality and Continuous Improvement</li> </ul>
210	Managing the Internal Audit Function	<ul style="list-style-type: none"> <li>• Define overall plan, scope and methodology on a periodic basis</li> <li>• Oversee and monitor various audit assignments</li> <li>• Proper planning, execution, reporting of findings</li> <li>• Closure of reported observations</li> <li>• Plan, acquire, engage and review the performance</li> <li>• Training and development of professional staff talent and other resources</li> <li>• Identify, source, engage and manage external experts/technical solutions</li> <li>• Communicate and engage with all key stakeholders regarding progress and achievement of objectives</li> <li>• Develop and maintain a quality evaluation and improvement program</li> </ul>
220	Conducting Overall Internal Audit Planning	<ul style="list-style-type: none"> <li>• Supersedes parts of standard on Internal Audit (SIA) 1 and (SIA) 15</li> <li>• An Audit Universe and a risk-based planning exercise</li> <li>• Overall internal audit plan at entire entity level</li> <li>• Annual Internal Audit (Engagement) Plan w.r.t. overall objectives</li> <li>• Presented to the highest governing body</li> <li>• For Part of Internal Audit is outsource – as per terms of engagement</li> <li>• Knowledge of the entity, Technology Deployment (its business and operating environment)</li> <li>• Continuously monitoring of the above during execution</li> <li>• Resource Allocation: IT tools, data mining and analytic procedures, and the expertise</li> <li>• Work schedule to estimate the time required for each audit assignment</li> <li>• Compliance of audit procedures shall be adequately documented</li> </ul>

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SIA No.	Focus Area	Synopsis of Key Features
310	Planning the Internal Audit Assignment	<ul style="list-style-type: none"> <li>• Supersedes parts of standard on Internal Audit (SIA) 1 and (SIA) 15</li> <li>• Sub-set of the Overall Internal Audit Plan</li> <li>• Is called an “Internal Audit Assignment Plan”</li> <li>• Internal Audit Assignment Plan shall be reviewed &amp; approved by the Chief Internal Auditor (or Engagement Partner, in case of external service provider)</li> <li>• Risk based planning exercise prior to beginning of an assignment</li> <li>• Assignments specific to a part of the entity’s auditable unit such as, the business activities or processes</li> <li>• Specific in nature, covers manner of audit assignment</li> <li>• Assignments generally completed in a short period of time</li> <li>• Internal Audit Assignment Plan</li> <li>• Align with objectives of overall Internal Audit (Engagement) Plan and stakeholder expectations</li> <li>• Scope, coverage and methodology provide reasonable assurance</li> <li>• Allocate adequate time and resources</li> <li>• Audit procedures conducted in an efficient and effective manner</li> <li>• Comprehensive knowledge of the Auditable Unit, technology deployment to determine nature and depth of audit procedures and tests to be conducted</li> <li>• Understand operations with management and process owners</li> <li>• Exchange relevant information with the Statutory Auditor (SIA 610)</li> <li>• Continuously monitoring of the above during execution</li> <li>• Resource Allocation: IT tools, data mining and analytic procedures, and the expertise</li> <li>• Compliance of audit procedures shall be adequately documented</li> </ul>
320	Internal Audit Evidence	<ul style="list-style-type: none"> <li>• Supersedes Standard on Internal Audit (SIA) 10</li> <li>• Information used in arriving at conclusions</li> <li>• Information collected from entity records and processes</li> <li>• Information from audit activities and testing procedures</li> <li>• Deals with process of collection, retention and reviews</li> <li>• Nature, timing and sufficiency of the audit procedures</li> <li>• Aid in the supervision and review of the internal audit work</li> <li>• Sufficient and appropriate to form basis of audit findings</li> <li>• Written process on manner of evidence gathered, reviewed, documented and stored</li> </ul>
330	Internal Audit Documentation	<ul style="list-style-type: none"> <li>• Supersedes Standard on Internal Audit (SIA) 3</li> <li>• Written record (electronic or otherwise), of audit procedures, evidence obtained</li> <li>• Conclusions on the basis of procedures and evidence</li> <li>• Includes “work papers” or “working papers”</li> <li>• Validate findings, support basis of observations and conclusions</li> <li>• Aid in supervision and review of internal audit work</li> <li>• Documentation must stand scrutiny and be conclusive, not requiring follow-up clarifications or additional information</li> </ul>

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SIA No.	Focus Area	Synopsis of Key Features
		<ul style="list-style-type: none"> <li>• Record nature, timing of audit activities and testing procedures</li> <li>• Complete and sufficient to support the analysis</li> <li>• Written process explaining documentation process is prepared, reviewed, stored and finally discarded</li> <li>• Work paper files to be completed prior to issuance of final report</li> <li>• Ownership and custody of the internal audit work papers</li> <li>• Written documentation policy and process on audit work papers</li> <li>• Work paper files approved with cross reference to Audit Program</li> </ul>
	Conceptual clarity of the following terms is necessary:	<ul style="list-style-type: none"> <li>• Audit Universe, Audit Mandate, Audit Programme</li> <li>• Scope of Audit Coverage – Entity, Audit Area, Period of coverage, Periodicity</li> <li>• Audit Approach &amp; Methodology</li> <li>• Audit Checklist, Audit Questionnaire, Flow Charts</li> <li>• Audit Query and Client (Auditee) Responses to Queries</li> </ul>
4(old)	Reporting	<ul style="list-style-type: none"> <li>• To establish standards on the form and content of the audit report</li> <li>• Listing of Audit observations</li> <li>• Statement of material facts</li> <li>• Criticality of observation</li> <li>• Diagnosis of root cause</li> <li>• Authority and Responsibility for the issue raised</li> <li>• Auditee Action plan</li> <li>• Target Date of completion of Agreed Action Plans</li> <li>• Audit Closure and release of Audit Report</li> <li>• Periodic Follow-up on Auditee Action Taken Report</li> <li>• Reporting to Management (client)</li> <li>• Effective reporting to the satisfaction of the audit committee members</li> </ul>
	Hygiene measures in release of audit reports	<ul style="list-style-type: none"> <li>• Justifications for audit exercise overdue beyond a year</li> <li>• Reasoning for delayed release of audit reports</li> <li>• Reason for withholding of draft audit reports</li> <li>• Reporting on 'red alerts' as pointers to any aberrations</li> <li>• Period of retention of reports and supporting document</li> <li>• Internal Audit function procedures in line with regulations</li> <li>• Reason for change in scope of audit or exclusions</li> <li>• Justification of deletions of audit findings in final report</li> </ul>
8(old)	Terms of Engagement	<ul style="list-style-type: none"> <li>• To provide guidance for audit activity carried out in house or by an external agency</li> <li>• Internal auditor and auditee to agree on terms of engagement before commencement</li> <li>• Define scope, authority, responsibilities, confidentiality, limitation and compensation of auditors</li> <li>• Approved by Board of Directors or Audit Committee</li> <li>• Terms to be reviewed by auditor and audit committee periodically and modified suitably, if required</li> <li>• Key Terms: Scope, Responsibility, Authority, Confidentiality, Limitations, Reporting, Compensation, Compliance with Standards</li> <li>• Withdrawal from engagement – for any change in engagement terms</li> </ul>

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SIA No.	Focus Area	Synopsis of Key Features
11(old)	Consideration of Fraud in an internal audit	<ul style="list-style-type: none"> <li>• Primary responsibility for prevention and detection of frauds rests with management and those charged with governance</li> <li>• Understanding of the control environment</li> <li>• Assess fraud risks in the light of policies and procedures</li> <li>• Information and communication</li> <li>• Controls are effective in prevention, timely detection and corrections of fraud/ wrongdoing</li> <li>• Continuous monitoring mechanism</li> <li>• Prompt communication to management of actual or potential fraud situations arising during the course of the audit procedures</li> <li>• Document fraud risk factors and identify additional audit checks</li> </ul>

These standard guidelines enable an audit functionary to defend his work and opinion on audit findings. It is imperative that the Internal Auditor must spell out the standards adopted by organisation in the audit report and ensure adequate compliance procedures that would enhance overall performance of audit function.

### Increasing Role of Audit Committees

The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It is desirable to conduct a qualitative assessment of the performance of the Internal Auditor as

appointed under the Companies Act, 2013. The periodicity of such reviews could depend upon the type of entity, size, scale of operations and regulatory requirements for reappointment or extension of services. For this purpose, Company Board may consider the nature/ volume of business of company; qualifications, experience and capabilities of such person being appointed as auditor and scope of internal audit.

There is no standard methodology in evaluating the performance of an Internal Auditor. An attempt is made to design an illustrative format in conducting such assessments on a 5-point scale. (level 5 being the highest level of execution excellence).

Internal Auditor Assessment Report for Financial Year: 20__ (Appointed U/s. 138 of the Companies Act, 2013)									
Entity: _____ Limited				Entity Code:					
Internal Auditor (Name): CA. _____				CA. Membership No. _____					
Director (Assessor) Name:				DIN Ref:					
Assessment Criteria				Execution Excellence Scores					
				1	2	3	4	5	Noting's
Managing the Internal Audit Function									
Conducting Overall Internal Audit Planning									
Internal Audit Documentation									
Status of Release of Final Audit Reports									
Delivery on Audit Mandate (Terms of engagement)									
Special Assignments (investigative)									
Communication of Critical Audit Findings/Red Alerts									
Overall Satisfaction with Auditors Performance									
				Total Scores					
Assessment (date): dd/mm/yyyy:				Signature					
Board Meeting (taken on record): dd/mm/yyyy:				Director (Assessor)					

**Note:**

- (1) This is an illustrative format, based on the standards on internal audit formulated by ICAI.
- (2) (Visit the ICAI website on [https://www.icai.org/new\\_post.html?post\\_id=597&c\\_id=145](https://www.icai.org/new_post.html?post_id=597&c_id=145) for a detailed reading of the Standards on Internal Audit and exposure drafts.)
- (3) The Disciplinary Committee/ Ethical Standards Board of the ICAI or relevant provisions of the Companies Act, 2013 refer to the individual person (Chartered Accountant or Cost Accountant) and for this purpose an audit firm or an internal audit department or function refers to the Internal Auditor (as appointed under the regulations).

The global standards on Internal Audit lay emphasis on the specific role of Chief Audit Executive (head- of the internal audit function) in allocation of resources, driving quality of audits, timely release of reports and reason for exclusions from scope of audit coverage. In the Indian context, the designated Internal Auditor of the entity, is required to demonstrate astute professionalism, align the audit coverage and work alongside the management as a friend, philosopher and guide. And in the eventuality of any financial irregularity or incident of management override of controls, is responsible to escalate the matter to the highest governing body in the organization.

  
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### **Dynamics of Change in Communication - Real Time Alerts**

The traditional long form audit reports have given way to alternative modes of communication

such as in-built embedded algorithms (routines) in the operating system and accounting applications. These software programmes are designed in a manner that can trace deviations from established processes and trigger system generated emails on a real-time basis to the auditors and the senior management followed by a diagnostic review of these aberrations.

*‘Auditors raised red flags on ....in past three years’* reads the headlines in the Economic Times dated 2<sup>nd</sup> November 2018, wherein the importance of flagging alerts is brought out as a line of defence for auditors caught amidst the allegations of professional negligence and it stated, quote *“Auditors of beleaguered ... Leasing & Financial Services company had raised at least half a dozen red flags in the past three years, two auditor’s privy to the development said. These warnings range from concerns about the manner in which asset sales were being carried to company’s ability to raise further funds. Auditors are planning to use these red-flags as a major defence to insulate them from the ongoing crisis...”* unquote.

The audit system always relies on facts and evidence. Reports and emails are effective mediums in engaging with clients’ management. The standard long form ‘word’ report is perhaps giving way to ‘online reporting’, ‘flash reports’, ‘alerts’, email notification and web-based platforms that ensure timely information to stakeholders.

### **Reengineering the Internal Audit Profession**

The advent of digitalisation, technological solutions, cloud computing and information revolution has necessitated audit functionaries to “unlearn/re-learn” the audit procedures and stay updated on the required “subject domain” knowledge. This would enable them to remain on “top of matters” in understanding the dynamism of business conditions, operational challenges, the technological advances and regulatory changes as applicable to the audited entity. Being technologically savvy would further enable the audit functionaries to comprehend aberrations from established procedures, isolate exceptions,

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slice and dice the process deviations, carry out an “impact analysis” and excel in reporting skills. The audit functionary must be required to be adept with use of audit tools, big data analytics, competitive business intelligence, cost leadership and risk advisory services. The transformation of the function from the traditional post mortem exercise to a real time operator is inevitable. The internal auditor must follow a simplistic approach in presenting issues written in a lucid manner without technical jargons.

**The advent of digitalisation, technological solutions, cloud computing and information revolution has necessitated audit functionaries to “unlearn and relearn” the audit procedures and stay updated on the required “subject domain” knowledge.**

Traditionally, the “checks and balances” were in-built in processes by segregating the activities such as gate controls, stores, production, dispatch, payroll and there were essential cross checks akin to ‘system-brakes,’ through a maker-check concept suited to manual interventions. The digital environment has brought new concepts of tracking transactions in terms of activities within the marketing, sales, operations, manufacturing, mining, service, trading, projects, finance, etc. using relational data base analysis. Another important factor that requires reengineering the internal audit function is the impact of digitalisation of processes, that has brought redundancy in existing activities/tasks that hitherto involved manual interventions. The



use of robotics in posting entries in automated systems, is a threat that challenges the age-old method of conducting internal audits.

Internal audit functions in most corporate entities often tend to be top heavy with the Chief Audit Executive being a monolithic leader and legally designated signatory to the internal audit reports. Considering the role of an Internal auditor requires an extra ordinary skill in being a trusted confidante and exercising independence in reporting aberrations to the Audit Committees, a federal audit structure with an officially designated “internal auditor” for any business entity would suit the requirement of large businesses. Such decisions on appointing a full-time internal auditor would depend on the maturity level of business process, the control environment and scale of business operations of the entity. Outsourcing of audit resources is another option especially where an entity has large network of operations spread across a wider geographical area.

In conclusion, the responsibility of the internal auditor is unquestionable in terms of building a resilient organisation. This ensures a right balance between business and control objectives. This is achieved by an objective assessment of the control environment backed by a robust audit methodology, within a defined framework.

**The responsibility of the internal auditor is unquestionable in terms of building a resilient organisation that ensures a right balance between business and control objectives. This is achieved by an objective assessment of the control environment back by robust audit methodologies, within a defined framework.**

The internal audit function delivers on this fiduciary responsibility as an independent assessing body that provides a proactive service to the Management, the Directors and the Stakeholders through reporting to the Audit Committee of the significant audit findings thereby enabling them to form an informed opinion on the affairs of the company. ■