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Relevance of Internal Audit

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What is internal audit

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

Few pointers on Internal Audit

- An independent and objective assurance
- A consulting activity designed to add value and improve an organization's operations.
- Helps an organization accomplish its objectives by bringing a systematic, disciplined approach
- Evaluate and improve the effectiveness of risk management, control, and governance processes

Relevance of internal Audit

Relevance of internal audit

Background
As a CEO or CFO, one sets specific business goals such as increasing market share, rolling out new products and services, improving customer responsiveness, reducing costs, etc. Progress toward these business goals can be undermined by risks, such as changes in market preferences, inconsistent product quality or poorly trained customer service staff, etc. Management needs to consider and implement risk management measures so as to minimize the adverse impact the risks might have to achieving strategic business goals. Likewise, Audit Committees need to consider risk management relating to financial reporting. So, where does internal audit fit into this? Internal Auditors are trained professionals that have the expertise to assess risks and their potential impact on the business and evaluate controls that a company might have implemented to mitigate those risks. Risks can be of various types – business risk, financial reporting risk, compliance risk, information risk etc. These risks collectively impact all aspects of an enterprise’s operations and are hence called “enterprise risks.”

Relevance of internal audit

Background
Previously, internal auditors were concerned mainly with assessing and reporting on financial risks. With greater knowledge of risk management and introduction of the COSO framework, the domain of internal auditing has grown to encompass all areas of risk management i.e. “Enterprise Risk Management. Internal Audit can be managed internally by a company or outsourced to an experienced consulting firm. Both models have their advantages and disadvantages. Keeping the internal audit function in house brings the advantage of better utilizing company specific knowledge which internal auditors (being company employees) have of the companies’ business operations. In contrast, bringing in external firms as an outsourced internal audit service will enable the organization to get the benefits of that firm’s experience and expertise across industries as well as greater objectivity that an outside professional can bring to the Audit Committee.

Relevance of internal audit

Background
Management and the Audit Committee can seek the combined benefits of both models by creating a co-sourced internal audit function. Certain key business areas where the internal team has sufficient knowledge can be retained in house, and other areas where the in house staff might not have sufficient expertise (e.g. treasury specific risks and controls or information technology risks and controls) can be outsourced to consulting firms.

Relevance of internal audit

Key functions of internal audit
The internal audit function would help in the following: ▪ Identify risks and find better and cost-effective ways and processes to mitigate risks ▪ Partner with other divisions/ people to find more effective solutions ▪ Prevent any kind of problems that one may face from day-to-day operational activities ▪ Evaluate and improve the effectiveness of risk management, control, and governance processes ▪ Helps bring in leading practices and industry standards ▪ One can say that the essence of the internal audit function of tomorrow is on value creation apart from the generic requirement of value preservation

Relevance of internal audit

Key functions of internal audit	Internal Audit related services
Internal Audit: ▪ Identifies controls and control deficiencies; ▪ Identifies regulatory requirements and compliance therewith; ▪ Provides recommendations on internal control and governance improvements; ▪ Determines adherence with company policy and procedures; and ▪ Assists with channeling effective solutions for controls improvement.	▪ Performance audit ▪ Sox attestation and consulting ▪ Continuous auditing and Contiguous monitoring ▪ Quality assessment reviews ▪ Contract risk and compliance ▪ Regulatory and compliance reviews ▪ Capital project assurance ▪ Benchmarking exercises, etc.

Relevance of internal audit

Key reasons
▪ Recent events including global financial crises have emphasized the need for internal auditing within corporate governance structures
▪ Internal audit function is now made mandatory for a class of companies by most stock exchanges
▪ Regulatory bodies have time and again sighted in their guidelines and regulation the necessity of an internal audit function
▪ Stakeholders to most organizations – Donors, partners, shareholders – increasingly demand improved accountability and financial transparency in business activities and projects
▪ Furthermore, internal audit is considered good practice and advisable as part of the underlying control framework and financial management capacity of a project, particularly if it is complex/ decentralized in nature

Regulatory framework around internal audit in India

Regulatory framework around internal audit

Key points indicated by regulators over a period of time

Regulatory framework around internal audit is governed by the statutes set under the Act of the Parliament and directives issued by the different regulatory and self regulatory bodies from time to time

- Earlier the **Companies Act, 1956** required the Audit Committee of the Companies to ensure that the internal controls are operating effectively as per section 292A of the Act.
- The recently passed **Companies Act, 2013** has further prescribed classes of companies to appoint internal auditors mandatorily
- The **Securities and Exchange Board of India** (“SEBI”) has issued a circular in August 2008 mandating the internal audit of stock brokers and clearing members registered with the Stock Exchange
- **Insurance Regulatory and Development Authority** (“IRDA”) vide its circular dated August 4, 2009 has made internal audit of investment transactions mandatory on a quarterly basis

Regulatory framework around internal audit

Key points indicated by regulators over a period of time
Regulatory framework around internal audit is governed by the statutes set under the Act of the Parliament and directives issued by the different regulatory and self regulatory bodies from time to time ▪ The **Reserve Bank of India** regulating the Banks and NBFCs has been issuing directives around corporate governance, risk management and internal audit from time to time. It was one of the trendsetters in the country in mandating the requirements for a continuous auditing framework through directives issued as early as 1993 ▪ **The Institute of Chartered Accountants of India** (“ICAI”) , based on the 260th meeting held on June 2006, came out with a set of recommendatory standards specifically around Internal Audit. The objective was to give the members of the professional body a direction for ensuring high quality audit.

Regulatory framework around internal audit

Companies Act, 1856

- Section 292A of the Companies Act, 1956 contains provisions in relation to the Audit Committee
- Section 292A of the Companies Act, 1956 is the only section in the entire Act to draw a reference to Internal Audit
- Clause 5 states that the auditors, including the internal auditor and the director finance to attend and participate at the meetings of the audit committee without the right to vote
- Clause 6 states that the Audit Committee shall have discussions with the auditors periodically about the internal control systems, the scope of audit including the observations of the auditors and review of the half yearly financial statements before submission to the Board and also ensure compliance of internal control systems
- Clause 7 states that the Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary
- Clause 8 states that the recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.

Regulatory framework around internal audit

Companies Act, 2013 ***(recently passed)***

- **Section 138** of the Companies Act, 2013 contains the provisions in relation to appointment of Internal Auditors
  - The ***Clause 1*** of the section states that ‘Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company
  - The ***Clause 2*** of the section states that The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board
- **Section 177** of the Companies Act, 2013 contains provisions in relation to the Audit Committee
  - The ***Clause 5***, of this section states that Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company

Regulatory framework around internal audit

Securities and Exchange Board of India

- SEBI vide circular dated August 2008 came out with directives to stock exchanges requiring them to ensure mandatory internal audit for their stock brokers / clearing members on a half yearly basis
- Scope of the Internal Audit as mandated by SEBI includes the following:-
  - Existence, scope and efficiency of internal control system
  - Compliance with requirements of SEBI Act, SEBI notifications, Securities Contract and Regulation Act, KYC norms, exchange byelaws
  - Data Security with respect to operations of stock brokers/ clearing members
- The SEBI has provided a list of checks that have to made by the internal auditor as a part of the half yearly review and submit a report to SEBI

Insurance Regulatory and Development Authority

- Quarterly internal audit of investment transactions has been mandated by the IRDA as per the circular dated August 4, 2009

Regulatory framework around internal audit

Reserve bank of India

- The Reserve Bank of India was a pioneer in setting the practice of continuous auditing in execution in as early as 1993, vide its guidelines around concurrent audit for sensitive critical areas of the bank such as treasury, corporate banking, etc.
- The Reserve Bank of India has been coming out with subsequent guidelines since then with specific focus on risk management, governance and internal audit around the area of Banks and Non-Banking Financial Corporations (“NBFC”)
- The following guidelines exist in relation to Banks
    1. Concurrent Audit guidelines dated 1993
    2. Risk Based Internal Audit guidelines dated 2002
    3. Risk Management System in Banks dated 2003
    4. Information Systems Audit Guidelines dated 2004
- The following guidelines exist in relation to NBFCs
    1. Guidelines around Corporate Governance dated 2009

Benefits of internal audit

Benefits of internal audit

Some of the benefits of internal audit are

- **Focus on risk management, designing internal controls to manage risk**: Internal auditors can leverage their skills by directing their efforts in the risk areas, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources

- **Intensive use of information technology: Information technology (IT)** is invariably embedded in all spheres of activities of a modern business enterprise, from data processing to resource planning to online sales and e-commerce. Use of IT has, however, increased the threat of data theft, losses on account of systems failure, hacking/ espionage, etc. The use of IT also results in a need to comply with the cyber laws, etc.

Benefits of internal audit

Some of the benefits of internal audit are

- **Audit Committee support and interaction:** Internal audit serves as the eyes and ears of the board and audit committee, being an essential component in the system of checks and balances.

- **Aligning audit committee objectives with those of internal audit** helps to unify oversight and allocate limited resources in the most efficient and effective way. The internal audit function provides audit committees with relevant reports and ongoing updates. This function identifies new risks and is entrusted to conduct high-level reviews in a strategic manner. Audit committees have a great deal to gain by developing and empowering internal audit, and by working more closely with internal auditors to improve organizational oversight

Benefits of internal audit

Some of the benefits of internal audit are

- An effective internal audit activity is a **valuable resource for management**, the board or its equivalent and the audit committee due to its understanding of the organization and its culture, operations, and risk profile. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organizations internal control, risk management, and governance processes. Similarly an effective internal audit activity provides critical assurance to other stakeholders, such as regulators, employees, providers of finance and shareholders.

- Internal Audit is a control and functions by reviewing and assessing the adequacy and effectiveness of all controls.

Benefits of internal audit

Some of the benefits of internal audit are

- **Enhanced compliance requirements:** An increase in the geographical spread of businesses has led to crossing of political frontiers by businesses in a bid to tap global capital. This has highlighted the need for compliance with the laws of the home country as well as the laws of other jurisdictions as a critical factor for the ability of businesses abroad to prosper

- **Unconventional business models**: Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting. These businesses require the assurance that controls relating to these models and practices are adequate and operating effectively

Benefits of internal audit

Some of the benefits of internal audit are

- **Stringent norms mandated by regulators to protect investors:** Regulators, in their pursuit to protect the interests of the investors, are applying ever mounting pressure and stringent norms. Compliance with the latest regulations – being ethical conduct of business, enhanced corporate governance and financial reporting requirements – should be independently assessed by a competent internal audit function
- Internal audit **assists in linking of the risks to the objectives and strategies** of the business

Benefits of internal audit

Some of the benefits of internal audit are

- The internal audit function **provides assurance regarding governance and controls** to management and the audit committee.
- Internal Audit contributes to **improved management and control** as well as to organizational performance. Internal Audit is not an extension of the external audit function and focuses on all business risks.
- Internal audit **helps to find the root cause of problems** faced by various functions of the organization and helps **build preventive controls** within the environment
- Internal audit function **improves the quality and quantity of information**

Benefits of internal audit

Some of the benefits of internal audit are

- Internal audit feeds the management with a perennial **source of information for exercising effective control**. By measuring performance, evaluating results and recommending suggestions for remedial actions, internal audit may be instrumental for forcing events to conform to plans
- A **plan itself may be put to a critical study under an internal auditing programme** so as to find out its appropriateness and effectiveness in the organization. Particularly, policies and procedures are appraised to see their relevancy and continuation towards the attainment of enterprise objectives. Briefly, internal audit may be utilized as the keeper of managerial conscience in the organization

Benefits of internal audit

Some of the benefits of internal audit are

- An active internal audit function **demonstrates a thorough and resilient management** of an organization
- Internal audit **tests the control systems of an organization suggests ways to improve them** and monitors these improvements have been made.
- It **demonstrates to funders and stakeholders that the management of the organization have taken steps to control assets** and activities. It establishes management's responsibility for risk management and control
- Internal audit assists the people within the organization to a **better understanding of the purpose and effectiveness of risks and controls**

Benefits of internal audit

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Benefits of internal audit

Some of the benefits of internal audit are

- The introduction of an internal auditing programme **tones up the morale and working efforts** of all members of the organization. The risk of being exposed before the eyes of managers- induces persons to keep within the track and to avoid errors of omission or commission
- Internal audit **scrutinizes accounting and financial data to screen facts** from the heaps of figures and statistics. Thus accounting for management information can be made to prevail under a programme for internal audit
- Internal audit **improves communication and motivation** within the organization
- Internal audit also **helps in implementation of business objectives** by tracking of status on an ongoing basis

Benefits of internal audit

Some of the benefits of internal audit are

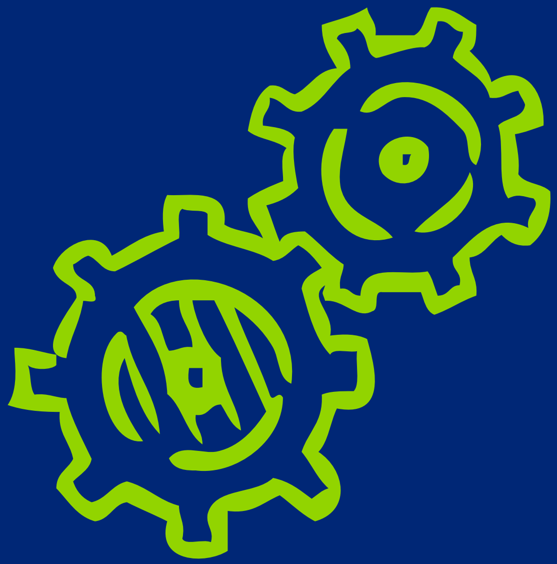
- **Increased size, complexity of business** and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations
- **An increasingly competitive environment**: Deregulation and globalization have lowered the political and other barriers for entry in the markets for goods and services. The free flow of capital, technology and know-how between countries, as well as strong infrastructure has helped in decreasing the costs of production and resulted in better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, resulting in stiffer competition. A well equipped internal audit function can assist businesses to identify opportunities for improved efficiency and effectiveness

Benefits of internal audit

Some of the benefits of internal audit are

- **Internal Audit – The third line of defense**: Internal auditors provide the senior management with comprehensive assurance based on the highest level of independence and objectivity within the organization. This high level of independence is not available in the second line of defense. Internal audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives.

Changing paradigm of internal audit



Changing paradigm of internal audit …1

- Challenges faced by internal audit
  - Increasing focus on value addition (pressure by management and audit committees)
  - Fraud prevention and detection
  - Increased corporate accountability
  - Regulatory pressures
  - Lack of skilled resources
  - Availability of technology solutions for auditing

- Traditional approach of once a year reviews considered insufficient

- New approach that provides a sustainable and cost-effective means to address current and future audit challenges is required.

Changing paradigm of internal audit …2

Characteristic	Old Paradigm	New Paradigm
Internal Audit Focus	Internal control / transactions	Business risk
Internal Audit Response	Reactive, after the fact, discontinuous, observers of strategic planning initiative	Proactive, real-time, continuous monitoring, participants in strategic plans
Risk Assessment	Risk factors	Scenario planning
Internal Audit Tests	Important controls	Important risks
Internal Audit Methods	Emphasis on the completeness of detail, controls testing	Emphasis on the significance of broad business risks covered
Internal Audit Recommendations	Internal control: Strengthened Cost-benefit Efficient/Effective	Risk management: Avoid/Diversify Risk Transfer/Share Risk Accept/Control Risk
Internal Audit Reports	Addressing financial controls	Addressing process risks
Internal Audit Role in the Organization	Independent appraisal function	Integrated risk management and corporate governance

Source: Risk Management: Changing the Internal Auditor's Paradigm, IIA

Internal audit's evolving role

- Results focused on adding value and improving efficiency
- Alignment of audit plans with key company initiatives and strategy
- Consultative projects (vs. compliance)
- Mindset of a business risk advisory partner who can team well with management
- Integration with Enterprise Risk Management (ERM) activities
- Brings uniquely skilled, specialized resources to complex business or technology issues
- Provides a flexible resource model to quickly adapt to changing organizational priorities

	Basic	Moderate	High Value
Competency	Financial	Financial and operational	Financial, operational, and strategic
Governance	No involvement	Limited involvement	Internal audit as advisor/ facilitator
Charter/role	Financial controls and compliance with policy/ procedures	Financial controls and operational effectiveness	Business controls and risk advisor
Risk focus	Financial and compliance	Financial, compliance, and operational	Enterprise risks (strategic, operational, financial, and compliance risk)
Methods	SOX controls and compliance checklists	Process and controls internal audit programs	Risk Intelligence frameworks
Reports	Financial and compliance issues	Process and operational improvements	Proactive risk and trends analysis and dynamic reporting
Style	Corporate police/reporter	Consultative	Trusted advisor
Perspective	Historic/reactive	Current	Proactive/future
Technology	Basic	Project management and administrative systems	Data analysis and continuous auditing/monitoring

IA Moving to Higher Maturity Levels

Risk focus	**Risk focus**
Rotational (Financial and Compliance)	Enterprise Risks
Governance	**Governance**
No involvement	IA as Advisor/Facilitator
Role	**Role**
Assurance on compliance with Policies/ Procedures	Enterprise Risk Advisory
Responsibility	**Responsibility**
External Assessment	Consultative Approach

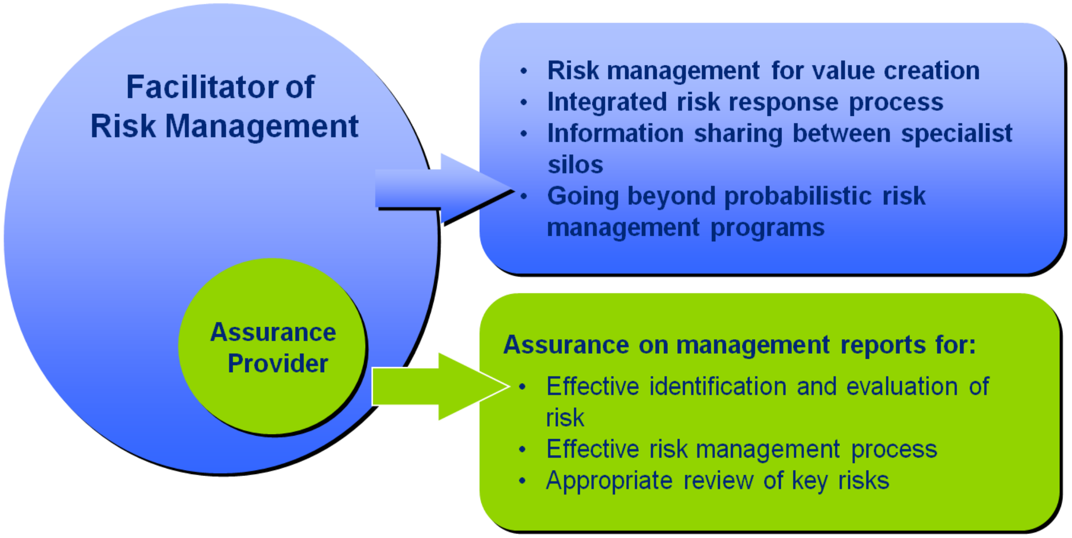
Conclusion

Conclusion

Concluding note
*Establishing a **professional internal audit function** should be **a governance requirement for all organizations**. This is not only important for larger and medium-sized organizations but also may be equally important for smaller entities, as they may face equally complex environments with a less formal, robust organizational structure to ensure the effectiveness of its governance and risk management processes.*

Shift from assurance provider to strategist and facilitator of risk management

Achieving strategic performance in these four areas enables internal audit to serve as more of a "strategist" — attending more to those tasks demanding strategic thinking and less to those that are purely transactional in nature



Focus Area	Description
Risk Focus	IA focuses on enterprise risks — strategic, operational, financial, and regulatory — and takes a proactive and forward-thinking focus. IA assists the organization in keeping its risk and reward picture in balance by taking a holistic approach to the management of risks across the enterprise
Flexibility	IA has the leadership, skills and experience to be proactive to changing business strategies and market conditions
Effectiveness	IA enhances the organization's governance, risk management, and controls processes
Efficiency	IA identifies opportunities in a collaborative and consultative manner before they become costs or issues. This includes timely reporting and forward-thinking and proactive solutions. IA also aligns and/or coordinates with other assessment and compliance related activities. IA leverages use of technology, including data analysis and continuous monitoring techniques

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