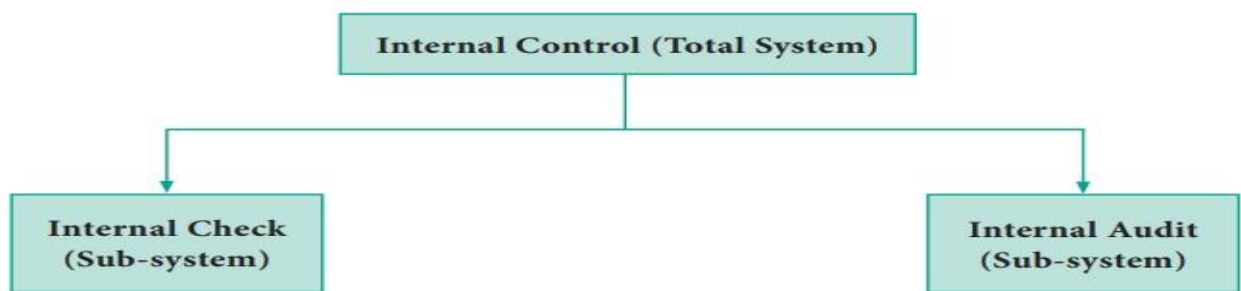


Class: B.Com (Hons) Semester III

Subject : BCH 3.1 AUDITING AND CORPORATE GOVERNANCE

2. Topic: Internal Audit



Internal audit is a sub system of the total control system set up by the management of an organization. An independent audit team within the organization, that keeps a constant check on the accounting and finance practices. This is quite different from a statutory audit.

As per the name, an internal audit occurs within an organization. So an independent auditor or team of auditors, who are actually employees of the organization, will review the financing, accounting and operating activities of the organization. It is actually a part of the internal control system of the company.

2.1: Definition of Internal Audit

Internal audit is defined as an unbiased, rational resources and consulting function, developed by the management to keep a check on the activities of the organization. It involves regular critical analysis of the functions of the organization, for the purpose of recommending improvements. It is aimed at assisting the members of the organization in discharging their responsibilities in an effective manner.

2.2: Requirement to conduct an internal audit:

For most organizations, the appointment of an internal auditor is completely mandatory. However, according to Rule 13 of the Companies (Accounts) Rules 2014 the following classes of companies are required by law to carry an internal audit:

- Every company listed on the stock market
- Every unlisted public company that has:
 - Paid up capital exceeding 50 crores in the previous year
 - Turnover greater than 200 crores in the previous year
 - If at any point in the previous year if outstanding loans and liabilities exceeded 100 crores
 - Outstanding deposits exceeds 25 crores in the previous year

➤ And every private company that:

- Has a turnover of more than 200 crores in the previous year
- If at any point in the previous year if outstanding loans and liabilities exceeded 100 crores

2.3: Objectives of Internal Audit

1. Proper Control:

One of the main objectives of an internal audit is to keep stringent control over all the activities of an organization. The management needs assurance of the authenticity of the financial records and the efficiency of the operations of the firm. An internal audit helps establish both.

2. Perfect Accounting System

An internal audit keeps a very close check on the accounting system of an organization. It checks everything from the vouchers, to the authority of transactions to mathematical accuracy. All entries are verified against documents and other proof. Chances of mistakes or frauds are greatly reduced.

3. Review of Business

The purpose of an internal audit is to keep a check on the financial and operational aspects of a business. So as the current financial year is ongoing, internal audit can point out the mistakes, weak points, and strengths of the business. This will allow an ongoing review, instead of waiting till the year-end.

4. Asset Protection

In the process of internal audit, there is always a valuation and verification of an asset. There is also a physical verification of the ownership and possession of the asset. And in case of special transactions like sale, purchase or revaluation of the asset, the authorization of this is also audited in an internal audit. So the assets enjoy complete protection.

5. Keeps a Check on Errors

In a financial audit, the auditor will be able to determine if any mistakes were made in the financial records. But this only happens at the end of the financial year. And the mistakes are corrected thereafter. But in case of an internal audit, the mistakes are spotted as soon as they are made, and corrected immediately.

6. Detection of Fraud

In case the company has an internal audit in place, the detection of fraud becomes much easier. This is because there is a year-round check on the employees.

In fact, an employee is less likely to attempt fraud in the presence of an internal auditor. He will not have any time gap between the occurrence of fraud and its detection to cover it up. This will dissuade employees from committing fraud.

2.4: Internal audit execution:

A typical internal audit assignment involves the following steps:

1. Establishing and communicating the scope and objectives of the audit to appropriate members of management.
2. Developing an understanding of the business area under review – this includes objectives, measurements & key transaction types and involves interviews and a review of documents – flowcharts and narratives may be created, if necessary.
3. Describing the key risks facing the business activities within the scope of the audit.
4. Identifying management practices in the five components of control used to ensure that each key risk is properly controlled and monitored. An internal audit checklist^[13] can be

a helpful tool to identify common risks and desired controls in the specific process or specific industry being audited.

5. Developing and executing a risk-based sampling and testing approach to determine whether the most important management controls are operating as intended.
6. Reporting issues and challenges identified and negotiating action plans with the management to address these problems.
7. Following-up on reported findings at appropriate intervals. Internal audit departments maintain a follow-up database for this purpose.

Audit assignment length varies based on the complexity of the activity being audited and internal audit resources available.

2.5: Internal audit reports:

Internal auditors typically issue reports at the end of each audit that summarize their findings, recommendations, and any responses or action plans from management. An audit report may have an executive summary—a body that includes the specific issues or findings identified and related recommendations or action plans, and appendix information such as detailed graphs and charts or process information. Each audit finding within the body of the report may contain five elements, sometimes called the "**5 C's**":

1. Condition: What is the particular problem identified?

2. Criteria: What is the standard that was not met? The standard may be a company policy or other benchmark.
3. Cause: Why did the problem occur?
4. Consequence: What is the risk/negative outcome (or opportunity foregone) because of the finding?
5. Corrective action: What should management do about the finding? What have they agreed to do and by when?

The recommendations in an internal audit report are designed to help the organization achieve effective and efficient governance, risk and control processes associated with operations objectives, financial and management reporting objectives; and legal/regulatory compliance objectives.

Audit findings and recommendations may also relate to particular assertions about transactions, such as whether the transactions audited were valid or authorized, completely processed, accurately valued, processed in the correct time period, and properly disclosed in financial or operational reporting, among other elements.

Under the IIA standards, a critical component of the audit process is the preparation of a balanced report that provides executives and the board with the opportunity to evaluate and weigh the issues being reported in the proper context and perspective. In providing perspective,

analysis and workable recommendations for business improvements in critical areas, auditors help the organization meet its objectives.

2.6: Quality of internal audit report:

- **Clarity** – The language used should be simple and straightforward.
- **Accuracy** – The information contained in the report should be accurate.
- **Brevity** – The report should be concise.
- **Timeliness** – The report should be released promptly immediately after the audit is concluded, within a month.