

ADVANCED AUDIT AND ASSURANCE

CORPORATE LEVEL

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INTERNAL AUDITING – (PART 01)



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by

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INTERNAL AUDIT

Introduction and definition of Internal Audit

The role of the Internal Audit will vary according to the organisation's objectives but is likely to include review of Internal Control Systems, Risk Management, Legal Compliance and value for money.

"Internal auditing means an appraisal activity established within an entity as a service to the entity."

The difference between External Audit and Internal Audit

	External Auditor	Internal Auditor
Appointment and Removal	By Shareholders	By Management
Independence	High Independence, compared to Internal Audit	Lesser Independence, compared to External Audit
Reporting Line	To shareholders	To Management/Those Charge with Governance
Scope	Focusing on the Financial Statements	Expanded to a much wider scope
Time period	Financial Year	Can be vary according to the assignment

Objectives of internal audit

The role of the internal auditor has expanded in recent years as internal auditors seek to monitor all aspects (not just accounting) of organisations and add value to their employers. The work of the internal auditor is still prescribed by management, but it may cover the following broad areas.

1) Review of the accounting and internal control systems

The establishment of adequate accounting and internal control systems is a responsibility of management and the directors. Internal audit is often assigned specific responsibility for the following tasks.

- a) Reviewing the design of the systems
- b) Monitoring the effectiveness of the operation of the systems by risk assessment and detailed testing
- c) Recommending cost effective improvements

2) **Identification of significant business and financial risks**, monitoring the organisation's overall risk management policy to ensure it operates effectively, and monitoring the risk management strategies to ensure they continue to operate effectively.

3) **Special investigations into particular areas**, for example suspected fraud.

4) **Review of the economy, efficiency and effectiveness of operations**

- 5) **Review of compliance with laws**, regulations and other external requirements, with internal policies and directives, and with other requirements including appropriate authorisation of transactions.
- 6) **Examination of financial and operating information.**
This may include review of the means used to identify, measure, classify and report such information and specific enquiry into individual items including detailed testing of transactions, balances and procedures.
- 7) **Review of the implementation of corporate objectives.**
This includes review of the effectiveness of planning, the relevance of standards and policies, the organisation's corporate governance procedures and the operation of specific procedures such as communication of information.

Why business organizations are required Internal Audit Functions (Factors to be considered when the business organization required to have internal audit function)

1) Scale, diversity and complexity of the company's operations

The more complex the operations, the more that can go wrong. Also the greater the need for an independent internal audit department to look at the system as a whole, to see if risk management and internal controls are appropriately focused. Also, where there is close scrutiny of the company's operations by regulators with the power to remove the company's licence to operate, the case for internal audit is much stronger.

2) Problems with internal control systems-

Internal audit assessment would help to determine how serious these problems are and what can be done to resolve them.

3) Changes in key risks –

If the business is developing in new areas, an internal audit assessment of how effectively it is handling consequent changes in risk can be very significant.

4) Increased number of unexplained or unacceptable events

This applies not just to events that cause problems with the accounting records, but also problems that delay production or result in inferior quality goods or services. The costs of internal audit may need to be weighed against the possibilities of lost sales

5) Changes in/Complexity of organisational structure

A simplification of the organisational structure may often lead to reduction of the internal audit department.

6) Cost-benefit considerations

As with other controls, the costs of internal audit (salary, management time lost dealing with internal audit) should not outweigh the benefits. The benefits however may be difficult to quantify Eg: how do you quantify the errors that internal audit has prevented?

7) Number of employees-

Number of employees is generally used as a proxy for size. Investors would expect that the larger the company, the more formal the systems of internal control, including a separate internal audit department. A larger company may have complex reporting lines and it may have less shared culture between different locations.

Good Practices for Internal Control

- A) The Head of Internal Audit has clear access to the Chairman and Chief Executive Officer of the organization as well as to the Chairman of the Audit Committee.
- B) The Head of Internal Audit should report to a Senior Director
- C) The Internal Audit Department is Independent of Executive Management
- D) Internal Audit should have the access to all the required resources and information such as people, documents and ect.
- E) The aims of the Internal Audit should be agreed by the Board
- F) Internal Audit should be consulted if there are likely to be changes in the business and the control systems
- G) Internal Auditors do not have operational involvement in areas outside the internal audit scope
- H) The results of the Internal Audit Work are clearly communicated, and the recommendation should be acted by the Management

Internal Audit Charter/Terms of Reference

The Internal Audit Charter **"sets out the way in which Internal Audit will provide value to the business organization, the nature of the services it will provide and how it helps the organization to achieve its objectives."**

It also establishes

- A) The position of the Internal Audit within the organization
- B) The reporting lines of the Head of Internal Audit
- C) The authorization for the Internal Audit team to access to records, personnel and physical properties
- D) The scope of the internal audit activities

The Audit Charter will be drafted by the Head of Internal Audit. The draft charter will be then discussed in detail with both Senior Management and the Board to ensure it accurately reflects the agreed roles and expectations of the team. Once the Audit Charter is finalized, it will approve by the Board via Audit Committee.

Content of the Audit Charter

- ✚ **Mission:**
The overall purpose and function of internal audit within the organisation and how it will assist the organisation to achieve its objectives.
- ✚ **Objectives:**
To provide assurance on the adequacy and effectiveness of risk management processes in reducing risk exposures to acceptable levels. The charter should also refer to the provision and nature of consulting activities.
- ✚ **Role and scope of the work of internal audit.**
- ✚ **Independence:** an explanation of the way independence is established and maintained.
- ✚ **Access:** the charter should set out the requirement of internal audit to have unrestricted access to all activities across the organisation (access to records, personnel and physical property).
- ✚ **Reporting:** the charter should set out the internal audit reporting lines, for example, that it reports regularly to the audit committee.
- ✚ **Responsibilities of the head of internal audit as well as any relationship with other assurance providers.**
- ✚ **Planning:** the charter should briefly explain internal audit's approach to risk-based internal audit planning, the resource plan and budget, including arrangements for approval of the plans, reporting, monitoring progress and providing updates.
- ✚ **Quality:** a description of the arrangements for developing an on-going programme of quality assessment and continuous improvement.
- ✚ **Approval:** the charter should state that formal approval and endorsement should be obtained from the head of internal audit and audit committee.
- ✚ **Other considerations:** the Mission of Internal Audit, the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the Standards and the Definition of Internal Auditing should be recognised in the internal audit charter, the details of which should be discussed with senior management and board

What is Internal Audit

"A function of an entity that performs assurance and consulting activities, designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes"

The Preliminary Assessment of the Internal Auditor and Internal Audit Function

When planning the audit and when developing the Overall Audit Strategy, the external auditor should obtain a sufficient understanding of the internal audit functions of the business organisation. **When the external auditor expects to use the work of an Internal Auditor, the External Auditor has to perform a Primary Evaluation** with regard to the Internal Auditor and with regard to the Internal Audit Functions.

When performing the Primary Evaluation, following factors to be considered

- a) Organizational status of the internal audit function's and relevant policies and procedures support the objectivity of the internal auditors
- b) The level of Technical Competence of the internal audit function
- c) Whether the Internal Audit Function applies a systematic and disciplined approach

(If the External Auditor is not satisfied with the above three requirements, the Auditor shall not use the work of the Internal Auditor/Internal Audit Function)

Evaluation of the Internal Audit Function

When the external auditor decided to use the work of the Internal Auditor, the external auditor needs to discuss the planned scope of the audit with the internal auditor and to focus on the following factors

- a) Whether the internal audit function has been properly planned, performed, supervised, reviewed and documented.
- b) Whether the Internal Auditors obtained sufficient and appropriate evidence with regard to the tasks which they performed.
- c) Whether the Conclusions reached are appropriate with the circumstances and the reports prepared are consistent with the results of the work performed
- d) Whether the Management taken the required corrective actions/steps for the weakness and the issues highlighted by the Internal Auditors