

Chapter - 4 Internal Audit

1. Meaning

The Institute of Internal Auditors (IIA) defines internal audit as follows:

“Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

The above definition leads us towards the following elements:

1. Internal audit is an independent activity.
2. It provides assurance and consulting services.
3. It helps the organization to achieve its objectives.
4. It enhances the effectiveness of processes related to internal control and risk management.
5. It is a systematic and disciplined approach

2. Basic Principles of Establishing Internal Audit

- 1 **High organizational status:** Whether internal audit is undertaken by an outside audit firm or by an internal audit department of the company itself, the organizational status of the internal auditor must be high. In an ideal situation, he should report to the highest authority of the company. He should have the liberty to directly communicate with the external auditor.
- 2 **Independence:** Internal auditor must have the full independence of work. There should not be any constraints or restrictions placed upon his work. Independence facilitates internal auditors to render the impartial and unbiased opinion essential to the proper conduct of audits.
- 3 **Technical competence:** The internal audit team should be professionally qualified and adequately trained. The number of staffs should appropriate.
- 4 **Due professional care:** The internal auditor should exercise due professional care in fulfilling his responsibilities. Examples of the exercise of due professional care by the internal auditor are the existence of adequate audit manuals, audit programmes and working papers.
- 5 **Reporting and follow-up:** The internal auditor should ensure that his findings with recommendations should reach to the appropriate authority of

the management. He should also ensure that proper follow up actions have been taken by the management based on his reports.

3. Objectives

The significance of internal audit is growing day by day. Historically, internal audit was mostly confine to ensure that the accounting and allied records have been properly maintained, the assets management system is in place in order to safeguard the assets and also to see whether standing policies and procedures are duly complied with. But with the passage of time, the objectives of internal audit have been significantly changed. Now cost benefit analysis, resources utilization and their proper deployment, effectiveness of management decisions etc. are also being reviewed by the internal auditor.

Briefly, the objects of internal audit may be described as follows:

1. **Evaluation of business control system:** Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other functional control.

2. **Compliance with standard policies and procedures:** Reporting to management about the compliance of standard policies and procedures is an important objective of internal audit.

For example, suppose company's standing policy is that any purchase order worth more than Rs. 4, 00,000/- cannot be awarded without asking quotation from at least three parties. If internal auditor found that this has not been strictly followed then he must report those cases to the management.

3. **Safeguarding and adequate utilization of business assets:** Internal audit has to ensure that all assets of the company are properly recorded. It has to verify assets utilization report and determine whether fixed targets have been achieved or not.

For example, suppose internal auditor found that valuable scrap are not being properly recorded in the books, he should include this observation in his audit report.

4. **Reliability of Management Information System (MIS):** Internal Audit ascertains the reliability of financial and operating reports prepared throughout the organization. The management relies on the reports of internal auditors as they provide an assurance as to validity of records and transactions of the enterprise.

5. **Suggesting improvements:** The ultimate objective of internal audit is to assist management in the effective discharge of their responsibilities by furnishing them with proper suggestions for improvements.

4. Evaluation of Internal Audit by Statutory Auditor

In spite of the various dissimilarities between two, there are ample scope of a gainful cooperation and coordination between external auditor and internal auditor. Due to his professional standing, the external auditor acquires a wide area of experiences, whereas internal auditor has an in-depth experience of the organization. If they work in tandem, the quality of audit will improve tremendously.

Unnecessary duplications of work can also be avoided by proper audit plan. The work load of external auditor can be reduced significantly as we know that inherent objectives and approaches of both the audit are same.

In order to determine, whether and to what extent the external auditor will depend and rely on the work of an internal auditor is given by SA 610, relying upon the work of an internal auditor, issued by the Institute of Chartered Accountants of India (ICAI). The important points of the standards are summarized below:

1. **Assessing the work of internal auditor:** The external auditor should assess the quality of work done by internal auditor before relying upon the work of the latter. He should essentially consider factors such as:

- (a) Competence
- (b) Independence and
- (c) Objectivity of the internal auditor while evaluating his work.

2. **Co-ordination:** It can be achieved by:

- (a) Meetings with internal auditor
- (b) Access to relevant audit reports and
- (c) Communication by the internal auditor of any significant information, which may affect his work.

3. **Relying upon specific internal audit work:** If as a result of his evaluation and appropriate interaction with internal auditor, the external auditor intends to rely upon specific internal audit work, he should take into account the factors such as:

- (a) Scope of internal auditor's work and adequacy of related audit programmes used by him;
- (b) Examine whether the work of assistants was properly supervised, reviewed and documented;
- (c) Examine whether sufficient and appropriate evidence was obtained.

Thus, the degree of reliance that is placed by the external auditor on such work is a matter of professional judgment. It may be noted that the report of the external

auditor is his sole responsibility and he cannot shove off this responsibility on internal auditor by relying upon his work.

4.2

1. Internal Check and Internal Audit

The main points of distinction between internal check and internal audit are as follows:

1. **Definition:** Internal check is an arrangement of jobs in such a manner that the work of each employee is checked by another and no employee is in charge of any work completely from beginning to end. Internal audit is a specific appraisal activity of operations, financial or otherwise and related records thereof.
2. **Purpose:** The main purpose of internal check is the prevention of errors and frauds. The main purpose of internal audit to find errors and frauds.
3. **Personnel:** As internal check is an inbuilt process of internal control no separate personnel are required for the job. Whereas for internal audit separate staffs are required to conduct the job.

4. **Timing:** Internal check is a continuous process. It begins the moment a transaction start and finishes after all aspects are recorded. Internal Audit is a post mortem appraisal system and starts after the completion of recording of transactions.

2. Relationship or differences between internal audit and statutory audit:-

Difference between two audits is explain below:

1. The extent of the work undertaken by the internal auditor is determined by the management whereas that of the external audit arises from the responsibilities placed on him by the statutes.
2. The internal audit approach is with a view to satisfy that the accounting system is efficient, so that the accounting information presented to the management is accurate and discloses material facts.
3. The internal responsibility is to management whereas the statutory audit is responsible directly to the shareholders. It follows from this that the internal auditor being an employee of the company does not have the same independence of status which is enjoyed by the external auditor. Even the maintaining of an independent approach is necessary for the internal auditor to be useful to the enterprise employing.