

* Introduction →

Internal Audit started with checking financial records, protecting assets and ensuring policy compliance.

as businesses grew, mgt found it hard to oversee everything.

Internal auditors were hired to monitor & report on different areas of business.

In large org., internal auditors became essential due to distance b/w mgt & daily operations.

Today, internal auditing covers more than finances & looks at all activities affecting efficiency!

It is now a crucial part of ensuring business success.

* Definition of Internal Audit →

- "Internal Auditing" is an independent activity that helps improve a company's operations.
- It focuses on assessing risk & improving areas like risk mgt, control & governance.
- Auditors ensure operations are efficient, financial info. is reliable, assets are protected and laws are followed.

"Professor Walter B. Meigs" → describes it as a continuous review of financial and operational activities by full time auditors.

- Based on risk assessment, internal auditors will check how well risks are managed in areas like operations, ethics, performance, ensuring good governance.
- Internal auditors help mgt and BOD by providing insights into co. v risks & controls.
- Audit gives assurance to regulators, employees, investors and about org's processes.

* Nature of Internal Audit →

- ① Management Tool: Audit checks internal control and reports to the Board.
- ② Continuous process: ongoing review of processes by ee & external experts.
- ③ Control system: Audit assesses other control systems in the organisation.
- ④ Risk mgt tool: Helps create and evaluate risk mgt, business continuity and security plans.

* HDFC'S Risk mgt →

HDFC Banks have a strong risk mgt system that helps it handle both financial & non-financial risks.

This system supports Bank in achieving its goals without taking excessive risks.

Effective policies, technology & governance have allowed the Bank to grow during uncertain times.

↓
Stress testing is used to manage current & future risks.

* Penalties of non-compliance u/s 450

if any co. / its officers breaks any rules (with no other penalty specified), they will be fined:

✓ ₹ 10,000 for 1st violation.

an addⁿ ₹ 1000 per day if violation continues, upto:

- ₹ 2 lakh for the company.
- ₹ 50,000 for officer / person in default.

* Case Study - M/s Indu Nissan Oxo Chemical Ind. Ltd →

Issue: The co. failed to appoint an internal auditor for 7 yrs violating Sec 138 of Co. Act, 2013.

Defence: The co. claimed it had been shut down since 1999 and was registered as sick co. with BIFR.

Proceedings: ROC issued a notice and gave the co. a chance for hearing, but the company did not respond / attend.

Outcome: ROC decided the co. & its directors were guilty of non-compliance and imposed a penalty of ₹ 1.4 l under Sec 454 of Co. Act, 2013.

* Role of Co as Internal Auditor →

Co as an internal auditor should:

- ① ensure compliance with accounting standards.
- ② oversee the audit of financial records.
- ③ manage timely compliance and report financial risks.
- ④ safeguard company meeting records.
- ⑤ advise on finances, tax & corporate issues.
- ⑥ prepare cost structures & measure business efficiency.
- ⑦ Design audit processes & reporting standards.

* Appointment of Internal Auditor →

- Sec 179 of Co. Act, 2013 : appointment of an internal auditor must be approved by way of BR at BM.
- Resolution for appointing internal auditor must be filed with ^{In MGT-14} ROC within 30 days from date of passing resolution.
- Pvt. co. are EXEMPT from filing this form.

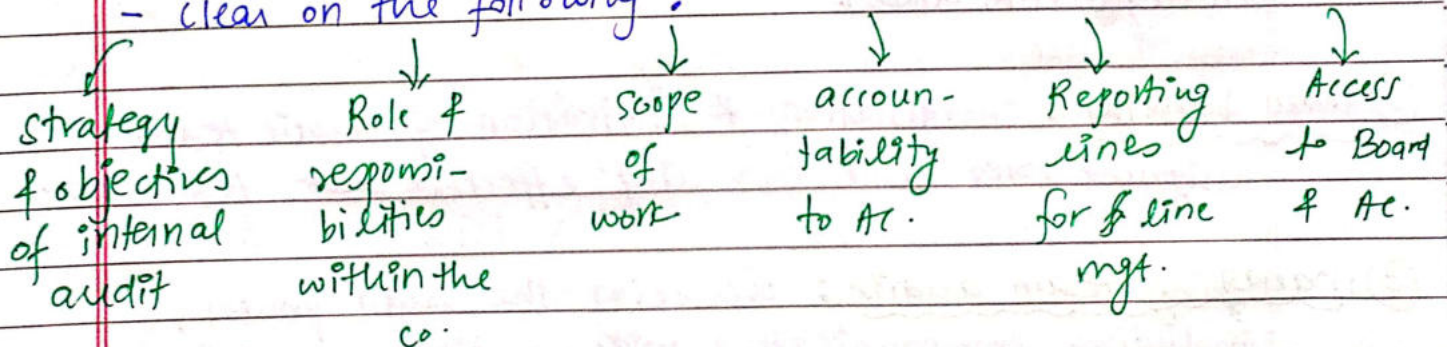
* Internal Audit Best practices →

- ① Bharti Airtel : Independent AC and strong internal assurance group.
- ② Cipla : Reviews non-financial performance and ensures auditor independence.
- ③ UNO Minda : Rotates internal auditors regularly.
- ④ ONGC videsh : Invites both $\left. \begin{matrix} \text{statutory} \\ \text{internal} \end{matrix} \right\}$ auditors in quarterly meetings!
- ⑤ Tata chemicals : Continuous internal audits by an external agency!

* Terms of reference for internal audit →

The terms of reference for internal audit should be :

- approved by Board, usually through the AC.
- communicated to functional heads within the org.
- clear on the following :



↓
unrestricted access to all info., people & records.

* General skills of Internal Auditor →

- ① Technical standards : knowledge of IAS [Indian accounting standards] and how to apply them in practice.
- ② Positive attitude & interpersonal skills : Ability to maintain an objective attitude & strong communication & interpersonal skills.
- ③ IT skills : Ability to work in IT-driven environment, understanding how technology is integrated into the org.
- ④ Interviewing skills : conducting detailed interviews to assess compliance with procedures and identify issues/ variances.
- ⑤ Audit documentation skill : compiling & organizing audit findings & evidence in clear & structured manner.
- ⑥ Reporting skills : writing objective audit reports with detail findings, their impact, causes & recommendations for improvement.

* Specific skills for internal auditors →

- ① Planning Audit engagements : Ability to plan audits based on risk assessment, anticipating key issues and focusing on high risk areas.
- ② Team building : coordination & motivation of audit team, assigning roles and ensuring effective ~~for~~ teamwork.
- ③ Managing team audits : overseeing the audit process, including communicating with auditees, setting expectations and selecting right team.

④ making professional presentations → presenting key audit findings to AC in clear, focused manner, highlighting critical issues.

⑤ knowledge mgt skills: managing critical skills / knowledge about org's operations, industry, external environment including:

collating (collecting), applying & updating knowledge.

understanding when knowledge is obsolete & needs refreshing.

Bench-
marking
skills.

determining how inf. flows within the audit ~~team~~ committee / team & how it impacts the audit.

* Addⁿ skills for internal auditor →

ability to think critically & analyze info.

strong data analysis skills for extracting & interpreting data

good understanding of business operations and needs.

ability to accurately trace & verify facts.

methodical & careful approach when dealing with people & processes.

~~set~~ Diligent, cautious nature

confidence in making independent decisions.

leadership qualities incl. reliability, punctuality & commitment of continuous learning.

* Objectives of internal audit →

- ① Provide assurance on org's risk mgt, internal control and governance framework.
- ② Review operational systems & risk mgt, Incl. fraud risks.
- ③ Check compliance with relevant statutory requirements.
- ④ assess the implementation of internal / external audit recommendations.
- ⑤ Evaluate the effectiveness of internal controls to ensure:

↓	↓	↓	↓	↓
operational	reliable	compliance	asset	goal
efficiency	financial reporting		safe-guarding	achievement.
- ⑥ Identify & determine risks areas within the org.
- ⑦ Establish & manage risk mgt framework
- ⑧ Identify potential threats and assess related risks.
- ⑨ Decide on risk responses, such as implementing controls.
- ⑩ monitor & coordinate risk mgt processes & outcomes
- ⑪ provide assurance on effectiveness of risk mgt activities.

* Hindustan Uniliver's internal audit vision is "zero ~~risk~~ surprise, Risk controlled org." The goal is to help mgt keep risks in check while adapting to a changing environment. HUL's approach includes:

- | | | |
|-------------|----------|-----------|
| ↓ | ↓ | ↓ |
| Risk based | process | proactive |
| transaction | reviews. | forensic |
| reviews. | | reviews |

* Scope of internal audit →

Internal auditing involves examining & evaluating an org.'s internal controls & performance quality. It focuses on:

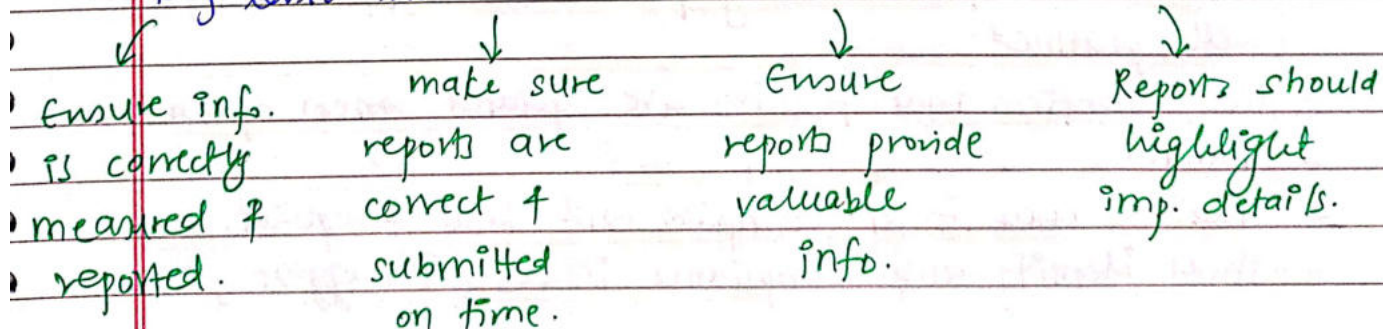
① Review of Internal controls:

- Auditors check if internal controls match org's structure.
- controls should be built into operations when cost-effective.
- For eg: in small businesses, credit control might be part of accounting & sales, instead of separate department
- Auditors evaluate whether controls are cost-effective & consistent over time & highlight any breakdowns.

United phosphorous Ltd v. DCIT → Court recognized that the co. had strong internal controls & auditor reviewed expn & reported any issues to mgt.

② Reliability & Integrity of financial & operating info →

- Internal auditors make sure that financial & operational data is accurate, timely & useful.
- key tasks include:



③ Economical & efficient use of Resources :

- Internal auditors check if resources are used efficiently and cost - effectively.
- They review standards for resource use to ensure they are clear & useful.
- They investigate why actual performance differs from set standards.
- They ensure variances are reported on time.
- They identify under-used resources like machines, space or idle staff.
- They check if staffing levels are appropriate.
- They ensure procedures are efficient and not slowing down operations.

④ Compliance with laws, policies, plans, procedures and regulations :

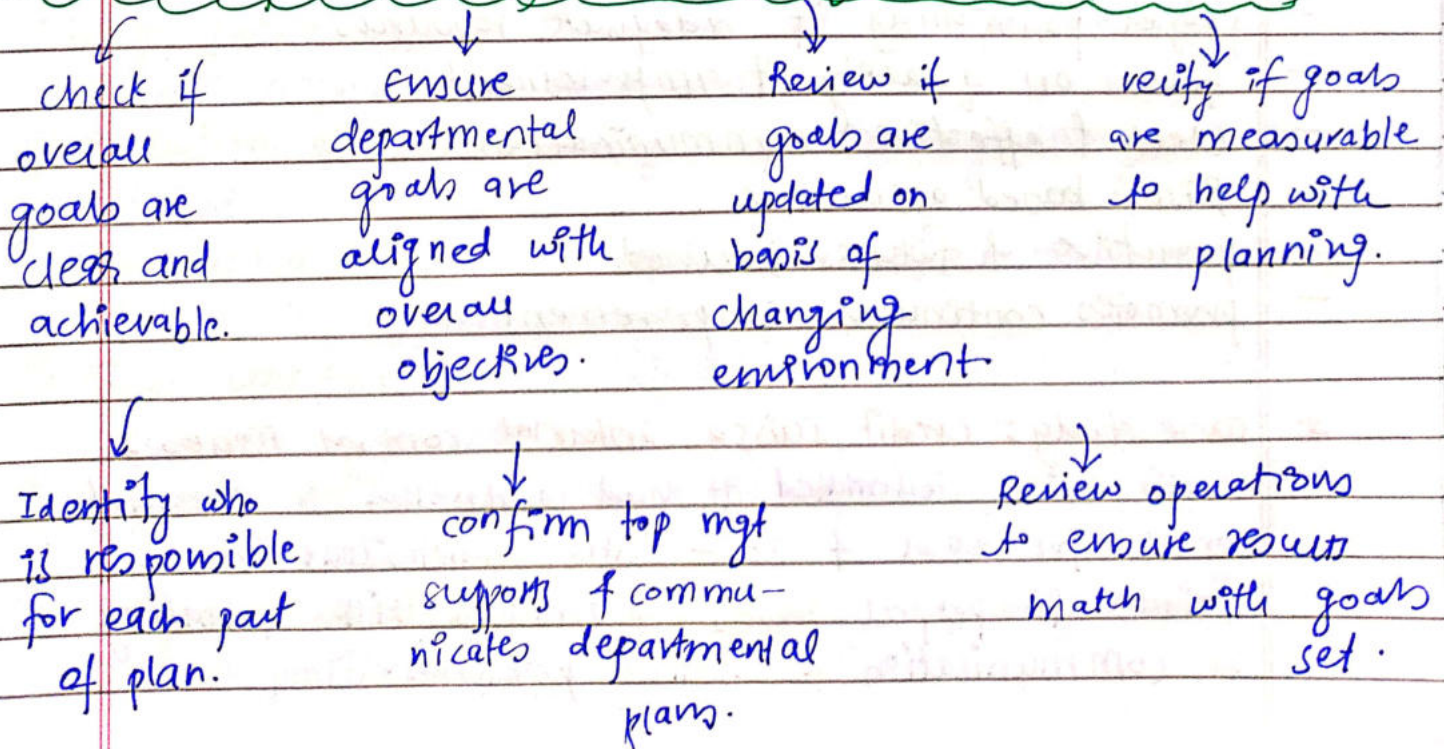
- Internal auditors check if businesses follow laws, policies & procedures.
- They ensure mgmt communicates policies to everyone.
- They review if accounting policies are accurate & well-planned.
- They confirm that policies are updated when operations change.
- Auditors check if co. complies with laws & regulations.
- They identify any compliance issues & suggest fixes.

Example : When applying for a loan : co. must provide certified T/o Statements, which auditors ensure are in compliance with the rules.

⑤ Review of organizational structure:

- Internal auditors check if the org's structure supports its goals & if responsibilities are clearly assigned.
- They ensure authority & responsibility are balanced & communicated at all levels.
- Auditors make sure there is no overlap of duties b/w Headquarter staff & operational staff.
- Each person should report to only one person. If dual responsibilities exist, primary one should be clear.
- Auditors should ensure that rules don't limit flexibility and info. flows freely!
- They also check if co. is preparing future leaders to avoid problems when senior staff retires.

⑥ Accomplishment of established goals for operations:



④ Review of custodianship & safeguarding of assets :

verify existence of assets and ensure they are fully accounted for.

Review control systems to safeguard assets from losses such as theft, fire & negligence.

Examine control over electronic data processing equipment & data storage.

Review adequacy of insurance coverage for various risks.

* Internal Audit Core Principles →

The core principles of internal auditing ensures it is effective and aligned with organization's goals. These principles include :

- Integrity & honesty
- Competence & professionalism
- Independence & objectivity.
- Alignment with organization's goals & risks.
- proper positioning & adequate resources
- focus on quality & improvement.
- Clear & effective communication.
- Risk-based assurance
- proactive & future-focused
- promotes continuous improvement.

* Case study: Credit Suisse Internal control issues :

Credit Suisse admitted it had weaknesses in internal control for 2021 & 2022. The main issue was a failure to properly assess & manage risks, leading to communication & control problems.

* Case study : Netflix & internal control failures →

- Michael Kail - Netflix's former VP of IT was sentenced to 30 months in 2021 for fraud. From 2011 to 2014 he approved IT contracts in exchange for kickbacks worth over \$500,000.
- While Netflix had policies to prevent conflict of interest, the lack of proper monitoring allowed Kail to exploit the system. This case shows that weak internal controls can lead to fraud & damage a co.'s reputation.
- It highlights the importance of strong, regularly reviewed internal controls to prevent misconduct.

* Recommended controls to prevent & detect fraud & educate to improve org's fraud awareness :

To prevent & detect fraud, org. can follow these key steps :

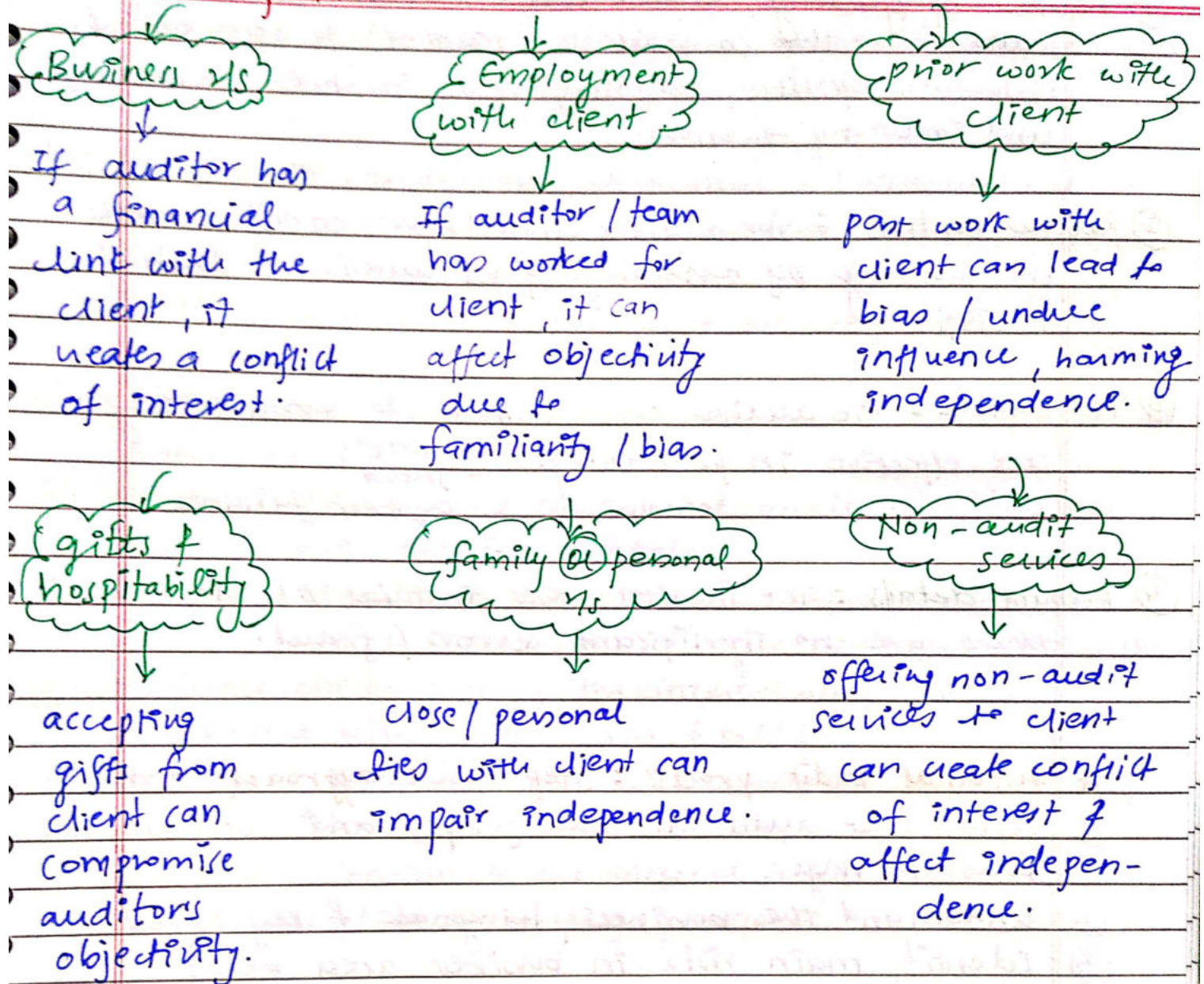
- ① Segregation of duties : Don't let one person handle both approvals & payments.
- ② Rotation of duties : Change key roles regularly to prevent fraud.
- ③ mandatory vacations : Require key staff to take time off to spot any hidden issues.
- ④ Treat employees well : fair treatment & rewards reduce the risk of fraud.
- ⑤ Regular audit : frequently audit high risk areas to catch fraud early.
- ⑥ Background checks : Screen employees, especially those in trust positions.

- ⑧ Whistleblower hotline: provide a safe, ~~secure~~ anonymous way for ee to report suspicious activity.
- ⑨ use technology: Employ software & data analysis to spot unusual behaviour.
- ⑩ fraud training: Train ee on how to recognize & report fraud.
- ⑪ code of conduct: set clear rules on ethical behaviour.
- ⑫ mgt oversight: Ensure mgt reviews key transactions & financials.
- ⑬ Accountability: hold ee accountable for their actions.
- ⑭ document retention: keep & securely store imp. records.
- ⑮ communicate policy changes: Inform all stakeholders of policy updates and confirm their understanding!

* Independence of internal auditor →

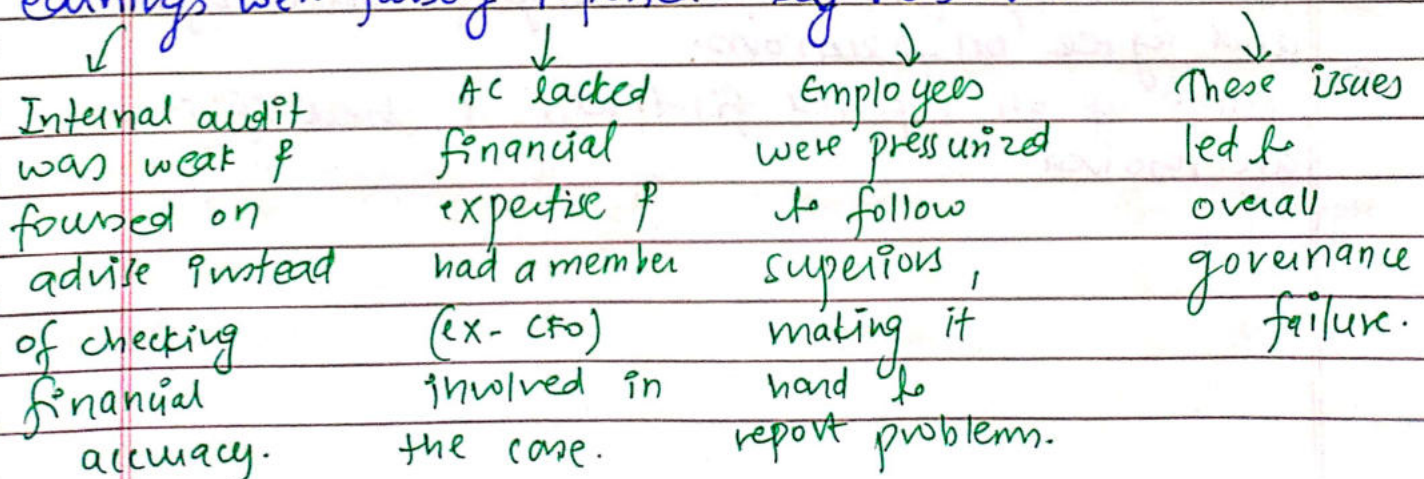
- Independence means internal auditors must work without bias (or) outside pressure.
- Objectivity means auditors must make decisions based on facts, not influenced by others.
- Internal auditors should report directly to BOD / AC, not to mgt to remain independent.
- If auditors report to lower mgt - their independence is compromised.
- External auditors are usually more independent than in-house auditors.
- Internal auditors must have enough freedom.

* factors that impair internal auditor independence →



* Toshiba Case Study →

In 2015, Toshiba's president resigned after \$1.2 Billion in earnings were falsely reported. Key reasons:



* Internal Audit Techniques →

- ① Review of operating environment → The auditor learns how the co. works by talking to co. ee & reviewing reports, assessing co.'s culture, leadership and industry trends.
- ② Review controls : The auditor checks how co.'s controls are working by reviewing past audits & talking to staff.
- ③ Test controls : The auditor tests controls to ensure they are effective in preventing $\left\{ \begin{array}{l} \text{errors} \\ \text{fraud} \\ \text{system failures.} \end{array} \right.$
- ④ Account details : The Auditor tests financial A/c to ensure there are no significant errors / fraud.

* Internal Audit process : step wise approach →

- ① Define what audit will cover (scope) and communicate this to mgt.
- ② understand the business, its goals & key objectives
- ③ Identify main risks in business area being audited.
- ④ Review controls are in place to manage those risks.
- ⑤ Test if key controls are working properly.
- ⑥ Share findings / issues / challenges with mgt and agree on solutions.
- ⑦ Follow up on reported findings & check if issues are resolved.

* Evaluation of internal audit by an Auditor →

- (a) **Organisation status**: check if internal audit is done in-house or by an external agency. Report this to top mgt.
- (b) **Scope of audit**: understand what areas internal audit covers & whether mgt act on its recommendations.
- (c) **Competence**: ensure internal auditors are properly ^{trained} & ^{qualified}.
- (d) **professional care**: confirm that internal audit is well planned, supervised & documented.
- (e) **Internal controls**: verify if internal audit monitors & improves the co.'s controls.
- (f) **financial & operational reviews**: ensure that internal audit tests financial transactions & checks operational activities.
- (g) **Compliance checks**: ensure the internal audit reviews compliance with laws, plans & policies.
- (h) **Risk mgt**: Assess if internal audit helps identify & manage risks.
- (i) **Governance**: confirm if the internal audit reviews the org's governance & accountability processes.

* **Report writing** → The internal audit report shares findings with mgt & leaders, highlighting non-compliance and areas of improvement. It ensures necessary actions are taken to improve compliance & performance.

* Objectives of Reporting →

communicate
key audit
results.

help mgt
address
issues.

enhance
controls &
performance

Track & report
progress on
actions.

* Internal audit Report → 4 steps →

- What's wrong? - state the findings
- Why it's wrong? - Explain the cause
- How to fix it? - offer solutions.
- What will be done? - Include auditee's response.

* Role of internal audit in control mechanism →

Internal control ensures reliable financial reporting, efficient operations, asset protection & legal compliance.

Co. Act, 2013: Defines internal control as policies to safeguard assets, prevent fraud, ensure accurate records and reliable financial info.

COSO: A process to achieve operational, reporting & compliance goals = internal control.

ICAEW: Internal control = A system to manage business smoothly, protect assets and ensure record accuracy!

* Objectives of internal control →

- ① Ensures transactions are authorized by mgmt.
- ② Ensures transactions are recorded accurately & on time, following proper accounting practices.
- ③ Safeguard assets from unauthorized access / misuse.
- ④ Ensure discrepancies b/w recorded & actual assets are identified & addressed regularly!

* Examine the { effectiveness } of Internal controls →

check if control is well-designed to prevent / detect fraud.

↓
ensure control is being used properly.

↓
controls may be manual / automated, depending on org's needs / technology.

* Worldcom Scam (USA) →

Background: Worldcom founded by Bernard Ebbers in 1983, grew rapidly through mergers. It went public in 1989 & became a major telecom player.

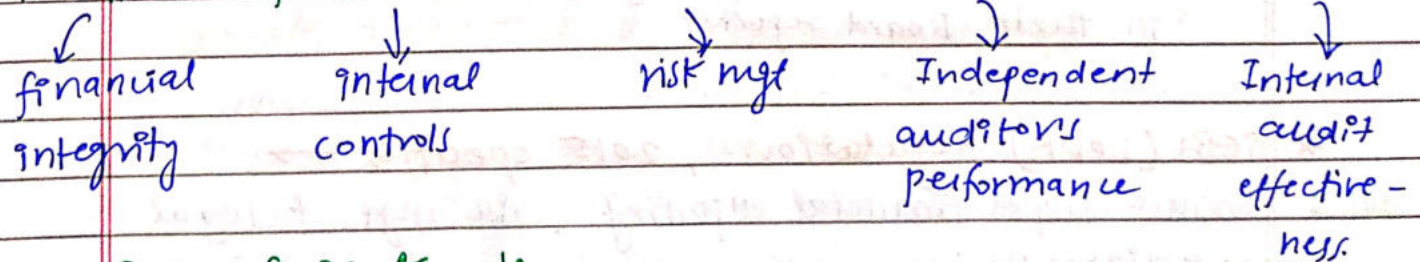
fraud: from 1999 to 2002, executives manipulated FS to hide losses & inflate profits.
\$3.85 billion in operating costs were falsely reported as long-term investments.
They had made false entries to inflate income.

Whistleblower Role: Internal auditor led an investigation after tips about accounting irregularities. Team found \$500 million unverified expn and \$2 billion in questionable entries. Senior officials admitted for inflating profits by \$3.8 billion.

outcome: SEC got involved, Board fired top executives and Worldcom filed for bankruptcy shortly after.

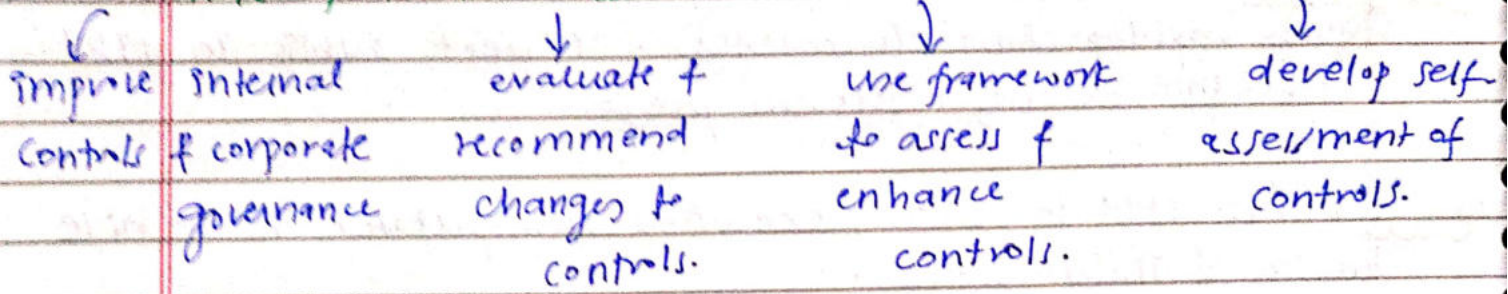
* Internal control mechanism →

The AC helps Board oversee:

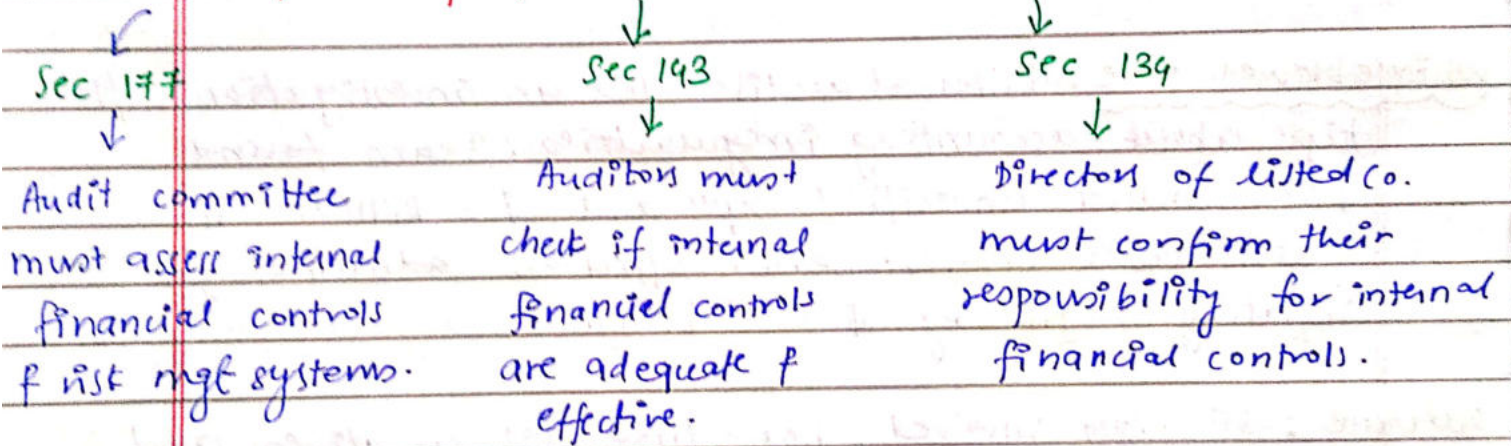


- BoD defines AC role.
- mgt is responsible for financial reporting, controls, compliance and risk mgt.
- Internal auditor evaluates & suggests improvements to internal control system but does not design / manage controls.

→ Role of internal auditor →



* Co. Act, 2013 specifies :



↓ Rule 8(5) (vii) ↓

All co. must report on adequacy of internal financial controls in their Board report.

* SEBI (LODR) Regulations, 2015 specifies →

BOD : Ensure proper financial reporting, risk mgt & legal compliance.

Audit committee : Evaluate internal controls, risk mgt and auditor's performance.

CEO / CFO certification : confirm responsibility for internal financial controls & assess their effectiveness.

* Risk mgt →

- Risk is a chance of something bad happening and risk mgt reduces potential losses.
- It involves identifying & responding to risks that could affect co.'s goals.
- Risk falls into 4 categories
 - strategic
 - operational
 - financial
 - legal.
- Internal auditors check how well risks are managed & advise on identifying new risks.

* Risk mgt practices →

- | | |
|--|---|
| <p>✓</p> <p>Happiest mind Technologies</p> <p>↓</p> <ul style="list-style-type: none"> - Regular audits to ensure ISO compliance - Risk registries are maintained & reviewed by Audit & compliance team. | <p>↓</p> <p>Reliance BP mobility.</p> <ul style="list-style-type: none"> - A system tracks risk with responsibility matrix. - Internal audit reports top risks to Ai. - Business leaders monitor & address risks weekly. |
|--|---|

* Corporate governance & Internal auditing →

- Corporate governance is how the Board manages & monitors the organisation to achieve its goals.
- Internal auditing is a key part of corporate governance, working with Board, mgt and external auditors.
- Internal auditors help Ai by:

↓

Reporting
control
issues

↓

sharing
insights
on
managers

↓

suggesting
meeting
topics.

↓

coordinating with
external auditors &
mgt.

* Satyam Computer service fraud →

Background: Satyam, founded in 1987 by Ramalinga Raju, was a leading outsourcing co. in India.

- In 2005, Satyam tried to invest \$ 1.6 billion in maytas properties, later revealed them to be a scheme to cover up fake assets.

Fraud details:

- Satyam inflated revenues, profits & bank balance to appear financially strong.
- Fake invoices were created and Bank statements were created to fake the financial situation.
- Raju admitted to manipulating A/c, including:

↓	↓	↓
fake cash & Bank balances.	Non-existent interest & understated liabilities	money misused to buy land through maytas.

Role of Auditors: Internal auditors: failed to detect fraud.

External Auditors: Did not verify key docs & missed the discrepancies in bank deposits.
(PwC)

Audit fees: small % of total income, raising concerns about audit's depth.

The verdict: Cg disbanded Satyam Board & appointed 10 new directors.

- In April '2015 Raju & nine (9) other directors were convicted of inflating revenues, falsifying accounts and fabricating invoices. They were sentenced to 7 yrs in prison of Hyderabad court.

Merger with Tech mahindra: In march 2012, Tech mahindra (part of Mahindra Group) completed its merger with Satyam forming 5th largest IT company in India, 4 years after acquiring Satyam.

* Olympus Corporation fraud →

Background: Olympus, founded in 1991, initially focused on microphones & thermometers.

- CEO Kikukawa led the company during the fraud.

Fraud discovery: Woodford, a long term employee, noticed irregularities in Olympus acquisitions, including overpaying for co. and covering up losses.

- Olympus paid \$600 million to AXAM Investment for advice on acquiring Gynus group - which raised suspicions.

Whistleblowing: Woodford confronted Kikukawa and was fired.

- Woodford hired PwC to investigate and found misstatements in Gynus transactions.

- Woodford reported the finding to
 - authorities
 - FBI
 - Japan's Regulators.

Revelation: In 2011, Olympus admitted to hiding \$1.5 billion in losses through inappropriate accounting.

Verdict: Kikukawa & others were sentenced to prison

- Olympus was fined \$7 million & Banks filed a lawsuit for addⁿ damages.

* Appraisal of mgt decisions.

mgt is responsible for setting up internal controls to manage risks & meet business goals. They are accountable to Board & AC.

Internal audit independently reviews & assesses effectiveness of internal control & risk mgt, providing assurance that risks are properly managed.

Importance of Internal Audit :

- ① Improves efficiency of business operations.
- ② provides independent evaluation to identify problems and suggest improvements.
- ③ ensures reliability of mgt info. for decision making.
- ④ validates effectiveness of internal control.
- ⑤ Ensures financial & operational data accuracy.
- ⑥ supports overall mgt processes
- ⑦ helps resolve conflicts & power issues.
- ⑧ Ensures compliance with Rules & procedures.
- ⑨ Aids in business growth through acquisitions & product launches.

The goal of appraisal of mgt decisions is to check if:

Decisions follow the right processes

Decisions align with co. goals.

Decisions are documented properly!

Steps in appraising mgt decisions:

- ① check if decisions are clearly defined.
- ② Ensure objectives are clear, measurable, aligned with co.'s strategy.
- ③ verify if, risks, time, alternatives and other factors were considered.

- ④ confirm all options were analyzed for $\left. \begin{array}{l} \text{value?} \\ \text{cost} \\ \text{risk} \end{array} \right\}$.
- ⑤ Ensure options were considered for major decisions.
- ⑥ Verify decisions were made after careful analysis.
- ⑦ Ensure efficient implementation of chosen option.
- ⑧ Ensure continuous review & monitoring of decisions.

* performance assessment →

Performance assessment of internal audit involves evaluating how well it meets mgmt's expectations and identifying areas of improvement. Key benchmarks include:

↓	↓	↓	↓
effectiveness in covering key audit areas.	feedback & timeliness of audit findings.	accuracy of audit results.	value of audit recommendations.

↓

contn of internal audit to business value.

* Keeping track of performance →

- To track internal audit performance, auditors should understand the business & support its goals. They must be part of corporate governance, offering independent advice & ensuring transparency!
- Auditor's role is to improve business performance, align with co.'s strategy and adapt to changing needs.

* Case law: Mindtree Ltd →

↓
mindtree
evaluates
auditors
annually.

↓
AC reviews &
gives feedback.

↓
CFO shares feedback
with the co's
auditors.