

# **SECTION - C**

**INTERNAL CONTROL, INTERNAL AUDIT,  
OPERATIONAL AUDIT AND OTHER RELATED ISSUES**



# Internal Control and Internal Audit

14

**This Module includes:**

- 14.1 Internal Control-Concept**
- 14.2 Internal Control and the Auditor**
- 14.3 Internal Auditing – Evolution of the Profession**

# Internal Control and Internal Audit

## **SLOB Mapped against the Module**

To obtain a detail understanding of the scope and structure of internal control to conduct an evaluation of the same to identify the root causes of inadequacies and thereby recommend appropriate corrective actions. (CMLO 3a, c)

## **Module Learning Objectives:**

Internal control is a system that comprises of control environment and procedure, which help the organisation in achieving business objectives. On the other hand, internal audit is an activity performed by professionals to ensure that internal control system implemented in the organisation are effective. After studying this module, the students will be able to –

- ✦ Reinforce key elements related to internal audit, its scope and function within the organisation
- ✦ Distinguish the types of internal audit assignments related to operational, compliance or process internal audit
- ✦ Develop engagement process based on considerations, objectives, scope and risk-based internal audit engagements
- ✦ Identify reportable items, report formulation, and methods of communication

**I**nternal Control can be defined as the whole system of controls, financial or otherwise, established by the entity's management; which includes Internal Check, Internal Audit and other forms of control.

Internal control is a system that comprises of control environment and procedure, which help the organisation in achieving business objectives. On the other hand, internal audit is an activity performed by professionals to ensure that internal control system implemented in the organisation are effective.

Control is one of the most prominent human need, that is present in almost every human activity. So, in business too, control have a great role to play in ensuring best possible use of resources and escalate profits. Most of the business activities are performed by computers, individuals and other equipment, which requires periodic examination, to make sure that losses and wastes do not occur.

Internal control and internal audit help business firms to keep an eye on the regular activities. These are commonly used interchangeably, but they hold different meanings.

Internal Control can be understood as a system developed, implemented and maintained by the entity's management, in order to ensure the achievement of objectives concerning:

- ⦿ Effectiveness and efficiency of operations.
- ⦿ Protection of assets.
- ⦿ Prevention and detection of frauds and errors.
- ⦿ Accuracy and completeness of financial reporting.
- ⦿ Adherence to relevant laws.

It comprises of five elements, which are interconnected to each other and apply to all firms, but their implementation depends on the size of the firm. The elements are control environment, risk assessment, control activities, information and communication and monitoring.

### **Objectives of Internal Control**

- ⦿ Examining whether the transactions are executed as per the management's authorization/policies set out.
- ⦿ Accounting period, to which it belongs.
- ⦿ Ascertaining assets are protected from unauthorized access and use.
- ⦿ Comparing recorded assets with the existing ones, at various time intervals and taking actions in case of differences observed.
- ⦿ To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

### Internal Control Review Methods

The most important part of the internal control system is its review, for which the auditor can use any of the methods:

- ⦿ Narrative Records.
- ⦿ Checklist.
- ⦿ Questionnaire and
- ⦿ Flowchart.

### Definition of Internal Audit

It is an independent, objective assurance and consulting activity designed to **add value and improve an organisation's operations**. It helps an organisation accomplish its objectives by bringing a **systematic, disciplined approach to evaluate and improve effectiveness of risk management, control and governance process**.

### Internal Audit Process

The task of reviewing controls and its effectiveness carried out by the internal auditor, who is appointed by the company's management/Board of Directors. For listed entities, the Internal Audit Head is appointed by the Audit Committee and supposed to report to Audit Committee. He/she furnishes reports to the management with recommendation post review/appraisal; for management feedback and initiating necessary actions against the recommendation.

### Objectives of Internal Audit

- ⦿ To check the accuracy and authenticity of the accounting records, which are reported to those charged with governance.
- ⦿ To identify whether the standard accounting practices, which are deemed to be pursued by the entity, are complied with or not.
- ⦿ To ensure early detection of fraud, errors and prevention of fraud.
- ⦿ To examine that transactions are recorded after due approval by appropriate authority.
- ⦿ To verify that the liabilities are incurred only for business causes and not for any other purpose.
- ⦿ To review the activities of the internal control system, so as to report management regarding deviations and non-compliances.

### Key Differences Between Internal Control and Internal Audit

The difference between internal control and internal audit can be drawn clearly on the following grounds:

1. Internal Control refers to the methods and procedures implemented by the entity's management to control the operations, so as to help the organisation in achieving the desired goals. On the contrary, Internal Audit reviews the existence and effectiveness of controls. The Internal auditing program purposed to review its financial and operational activities; the gaps, if any; and suggest corrective actions to mitigate the same.

2. While internal control is combination of 'Internal Check' and 'Internal Audit' system designed, implemented and maintained in an organisation. Internal Audit function is designed by those charged with governance, to keep a check on the activities of the entity.
3. In the internal control system, checking is performed simultaneously, while carrying out work. On the contrary, in internal audit system work is checked after it is performed.
4. The basic objective of the internal control system is to ensure compliance with management policies. In contrast, internal audit aims at detection of fraud.

The scope of internal control is wider than that of internal audit, as the former includes the latter.

# Internal Control-Concept

## 14.1

**I**nternal Controls are systematic and procedural steps adopted by an organisation to mitigate risks, primarily in the areas of financial accounting and reporting, operational processing and compliance with laws and regulations.

Internal Controls (ICs) are essentially risk mitigation steps taken to strengthen the organisation's systems and processes, as well as help to prevent and detect errors and irregularities. The actual steps of mitigation (e.g., review, approval, physical count, segregation of duty, etc.) are referred to as 'Control Activities'.

When ICs mitigate the risk of financial exposure, they are also referred to as Internal Financial Controls (IFCs) and when they mitigate operational risks, they are also referred to as Operational Controls (OCs). ICs generally operate with human intervention (Manual Controls), but in an automated environment, system controls are deployed to secure the systems and called IT General Controls (such as access controls) or check transaction processing at an application level and called Application Controls (such as sequential numbering of invoices, etc.).

Internal Controls can be broad-based covering the whole entity (i.e., Code of Conduct), or focused to a specific process or area (such as Order processing or Payroll, etc.). In the former case they are generally referred to as "Entity Level Controls (ELCs)" as part of the "Control Environment". In the case of later, they are also referred to as "Process Level Controls (PLCs)".

"Internal Controls Framework" is a pre-defined benchmark Internal Control System, based on suitable criteria, which can be used by management or auditors to assess the design, adequacy and operating effectiveness of the overall internal control system.

### **Responsibilities for Internal Control**

As per Companies Act, 2013, in a limited company, the board of directors are responsible for ensuring that appropriate internal controls are in place. Their accountability is to the shareholders, as the directors act as their agents. In turn, the directors may consider it prudent to establish a dedicated internal control function. The point at which this decision is taken will depend on the extent to which the benefits of function will outweigh the cost.

The directors must pay due attention to the control environment. If internal controls are to be effective, it is necessary to create an appropriate culture and embed a commitment to robust controls throughout the organisation.

### **Internal Control Procedures**

- ⦿ Physical controls over assets.
- ⦿ Authorization and approvals
- ⦿ Segregation of Duties.
- ⦿ Management design of the Controls.
- ⦿ Effective operational controls.

## Internal Audit

Internal audit carries out assessment of internal controls and as such is a management responsibility to ensure compliance and conformity of internal controls to pre-determined standards.

Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.

As per SIA (Standards on Internal Audit) 210 issued by ICAI, the Internal Audit Function is the responsibility of the Chief Internal Auditor or the designated person. He performs a number of activities to achieve the objectives as outlined in Terms of Engagement. A few of the critical activities are as follows:

- ⦿ Define the overall plan, scope and methodology of the Internal Audit Function on a periodic basis.
- ⦿ Oversee and monitor various audit assignments, their proper planning, execution, reporting of findings and recommend action plan to mitigate risk/concerns w.r.t observation/s and subsequent closure of reported observations.
- ⦿ Plan, engage and review the performance, training and development of professional staff, talent and other resources to achieve its objectives.
- ⦿ Identify, source, engage and manage external experts and technical solutions, if required.
- ⦿ Communicate and engage with all key stakeholders regarding progress and achievement of objectives.
- ⦿ Develop and maintain a quality evaluation and improvement program.

## Responsibility of Internal Auditor

The Internal Auditor shall ensure that the entity has designed, implemented and maintains effective and efficient Internal Controls. The audit procedures shall be sufficient to allow the Internal Auditor to check the design, proper implementation and operating effectiveness of the Internal Controls.

Any shortcoming shall result in recommendations for improvement and suggestions on how to make the Internal Controls more efficient and effective in line with the objectives.

Where the Internal Auditor is required to provide an independent opinion over the presence, design, implementation and/or operating effectiveness over Internal Controls, this shall be consistent with the requirements of SIA 110, “Nature of Assurance”, especially with regard to the need to have a clear understanding of the Internal Controls Framework which shall form the basis of the assurance.

## Key Risks

The Internal Auditor shall review and reports on internal controls in relation to key risks affecting the organisation. The objective should be to test the extent to which the controls will manage the risk if it crystallizes. The conclusions of these reports should enable management to reconsider the controls and modify or redesign them if appropriate.

## Compliance

Organizations have to implement performance standards in relation to compliance. This may be to satisfy the demands of external regulators, or to operate to pre-determined internal standards. Internal audit should review operations for compliance with such standards. In this respect, the work of internal auditors has broadened, as organisations increasingly pursue compliance not only with industry standards for products and service provision, but also with criteria relevant to environmental standards.

### 14.1.1 Objectives of Internal Audit

The overall purpose of an internal audit is to create a roadmap to improve business success. Throughout the process, an auditor examines, reviews, and tests the efficiency of operations in the day-to-day activities of an organisation.

The auditor evaluates findings to provide management with appraisals regarding the quality of internal controls, recommendations for improvement, and advice on how to fine-tune operating style to advance achievement of objectives within the business.

The key piece of a successful audit is to properly evaluate and test the specific internal controls of an organisation.

#### The COSO Framework as an Audit Tool

COSO's Internal Control-Integrated Framework defines Five Components of Internal Control:

- ⦿ Control Environment.
- ⦿ Risk Assessment.
- ⦿ Control Activities.
- ⦿ Information and Communication, and
- ⦿ Monitoring.

Although the main focus of an internal audit is on the reliability of financial reporting, the audit will encompass the entire internal control system.

#### Control Environment

The foundation of an effective internal control system relies on the support of everyone within the organisation. COSO refers to the concept of "tone at the top," which explains that the adoption of internal controls begins with an entity's board of directors, trustees, or management. An auditor wants to understand management philosophy regarding the importance, acceptance, and adherence to the internal control system.

A few examples of Internal Control environment:

Is everyone in the Organization aware of the policies and procedures of the entity?

Are ethical values encouraged, exemplified, and rewarded by management?

Do staff have a solid understanding of and receive training on how to perform control activities associated with their individual responsibilities?

#### Risk Assessment

As an internal auditor, risk management is one of the primary responsibilities. By nature of the process, one of the internal control audit objectives is to conduct a Risk Assessment.

#### Control Activities

Internal control review objectives are defined by the specific control activities adopted within an organisation. Control activities are the basis of an auditor's evaluation and testing of controls.

#### Information and Communication

Information systems provide reporting in all areas of operations, including financial, operational, and compliance. To correctly perform its function, the audit staff monitors the quality of communications and information systems within the organisation.

## Monitoring

Ongoing monitoring of internal controls is a management function with many monitoring activities built into the daily operations of an organisation. Some internal controls are classified as monitoring activities. Additional and periodic monitoring occurs in the form of an internal audit.

### Understanding Internal Control review Objectives

Any organisation in operation has risks. Risks need controls. Controls need to be evaluated, improved, redefined, or discarded. To complete a comprehensive internal control audit, auditors test control activities against specific control objectives.

**Definition of internal control objective:** A control objective is the reason a control activity is put into action. More specifically, a control objective is a series of actions and statements describing how a control activity is designed to avoid or reduce risk to an acceptable level.

### Three Categories for Control Objectives

Control objectives are generally classified into three categories:

- ⦿ Operational.
- ⦿ Reporting.
- ⦿ Compliance.

### Operational Objectives

Objectives revolving around effective and efficient business operations. Examples of control activities designed to meet operational objectives:

- ⦿ Business performance reviews.
- ⦿ Physical safeguards and security over assets.
- ⦿ Education, training, coaching.
- ⦿ Review and approval.
- ⦿ Segregation of duties.

### Reporting Objectives

Objectives pertaining to reliable, transparent, and timely reporting of both financial (internal and external) and non-financial transactions.

Examples of control activities designed to meet reporting objectives:

- ⦿ Authorization.
- ⦿ Review and Approval.
- ⦿ Verification.
- ⦿ Reconciliation.
- ⦿ Password Protections
- ⦿ Segregation of Duties.
- ⦿ Performance Reviews.

### Compliance Objectives

Objective relating to following and abiding by state and federal laws and industry regulations. Examples of control activities designed to meet compliance objectives:

- ⦿ Verification (information is correctly captured).
- ⦿ Performance reviews.
- ⦿ Education and training.
- ⦿ Policies and procedures manuals.

### Internal Control Audit Objectives

Audit objectives are designed to verify that the preferred outcome of a control activity is achieved. This is completed by judging the control procedure against a set of predefined criteria. These are commonly referred to as audit objectives.

Transaction-related audit objectives include:

- ⦿ Occurrence/Existence.
- ⦿ Completeness.
- ⦿ Accuracy.
- ⦿ Classification.
- ⦿ Cut-off/Timing.
- ⦿ Reporting and Summarization.

To better understand the process, let's look at an example of applying internal control audit objectives to evaluate internal control over financial reporting.

**Control objective:** Verify that a misstatement was prevented or detected by a specific control activity

**Control activity:** Management authorization of expenditures

### Application of Internal Control Audit Objectives

- ⦿ Occurrence: management authorizes all expenditures.
- ⦿ Completeness: Authorizations are recorded in appropriate fashion.
- ⦿ Accuracy: Authorizations are stated in correct amounts throughout financial statements.
- ⦿ Classification: Authorized expenditures are classified according to established guidelines.
- ⦿ Timing: Authorizations are dated and recorded on correct dates.
- ⦿ Reporting and summarization: Authorizations are documented in appropriate reports and include a summary of each transaction.

Internal control audit objectives not only serve to find potential problems, but to discover opportunities for improvement and help implement necessary changes.

### 14.1.2 Scope of Internal Control

It is clear from above that internal control is an essential pre-requisite for efficient and effective management of any organisation and is therefore, a fundamental ingredient for the successful operation of the business in modern days. In fact, an effective internal control system is a critical success factor for any organisation in the long term. They are indispensable tools for the ever-increasing risks, exposures, and threats to accounting systems, data, and assets. It embraces the whole system of controls – financial, operational or otherwise, established by the management in the functioning of a business including internal check, internal audit and other forms of control. In fact, internal control has now been recognized as fundamental and indispensable to modern auditing. Thus internal control has its all-embracing nature and is concerned with the controls operative in every area of corporate activity as well as with the way in which individual controls interrelate.

The scope of internal control, according to the aforesaid definitions, extends well beyond accounting control. Thus, the latest definition of internal control encompasses operational controls like quality control, work standards, budgetary control, periodic reporting, policy appraisals, quantitative control, etc., as all parts of the internal control system. In an independent financial audit or the statutory audit, the auditor is concerned mainly with the financial and accounting controls. However, in an operational audit (as part of internal controls), the auditor reviews all the controls including operational functions. The internal controls can be broadly classified into following four main categories: financial & accounting controls, administrative controls, operational controls and compliance controls.

- (i) **Administrative Control:** Administrative controls include all types of managerial controls related to the decision-making process. An example of administrative controls is the maintenance of records giving details of customers contacted by the salesmen.
- (ii) **Operational Control:** This is exercised through “management accounting” techniques viz. budgetary control, standard costing etc.
- (iii) **Financial and Accounting Control:** This control refers primarily the management plans, objectives and procedures that are concerned with the safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information.
- (iv) **Compliance Control:** These controls aim at ensuring compliance with applicable laws and regulations.

These Controls also help to ensure compliance with laws regarding the system and intellectual property.

### 14.1.3 Structure of Internal Control

There is no uniform or identical in its approach of internal control in all the organisations. It often varies in concept and applications, having regard to the following:

- (a) Type of business.
- (b) Magnitude of the business.
- (c) Infrastructure available in the organisation.
- (d) Potentiality of the human resources and their outlook.

Therefore, while designing an internal control system, the following factors must be considered to ensure greater chances of successful internal control system.

## **Factors to be considered while designing an Internal Control System to ensure greater chances of successful internal control system**

### **1. Segregation of Duties**

It is very necessary for successful internal control system that no one person handles the complete transaction.

Similarly, the people responsible for authorising these transactions or reconciling of the records should also be different.

### **2. Rotation of Duties**

It is also sometimes more desirable to rotate the duties of various officers and staff in an attempt to ensure that a fraud or error, if any, may not remain undetected for a very long time.

### **3. Competence and Integrity of People**

The controls to be successful and effective, necessitate the need for competent people to enforce such controls.

### **4. Appropriate Levels of Authority**

Controls to be effective, require the authority to be granted on a need to have basis only.

### **5. Accountability**

Mere presence of these controls may have no meaning or

May give a false sense of security

Unless strict action is taken every time, a discrepancy is noticed.

### **6. Adequate Resources**

It is very necessary that minimum resources to enforce the controls must always be present to enable the controls to be successful and effective.

### **7. Supervision and periodical updation**

It is very necessary for the controls to be adequately supervised and periodically updated in line with changing environment to be effective and successful

## **Types of Control**

### **1. Preventive Control**

We have heard many times that prevention is better than cure.

### **2. Detective Control**

Detective internal control detect an error or fraud after it has occurred.

Examples of detective controls are internal audits, reconciliation, financial reporting, financial statements and physical verification.

### **3. Input Controls**

Input controls in the context of internal control means the procedure and systems to ensure completeness, accuracy, existence, validity of the data entered in the financial and non financial records.

### Benefits of Internal Control

1. Early Warning System  
Problems are easier to fix when you catch them early.
2. Prevent Fraud  
With multiple checks and fraud, fraud is much more difficult.
3. Avoid External Audit Findings and Regulatory Fines  
It is always best to find and fix a problem before an external entity discovers it.

### Internal Control Review Methods

The most important part of the internal control system is its review, for which the auditor can use any of the following methods

1. Narrative Records
2. Checklist
3. Questionnaire and
4. Flowchart

### Responsibility for Internal Control

As per

1. Clause XIV of the Companies (Auditor's Report) Order, 2020 (CARO 2020)
2. Rule 18 (3) of LODR 2015 and
3. Sub-Section (5) of Section 177 of the Companies Act, 2013

Review of Internal Controls are mandatorily required to be done by Audit Committee who in turn brief the Board of Directors about the same.

So ultimate responsibility for ensuring that appropriate internal controls are in place lies with the Board of Directors.

#### 14.1.4 Evaluation of Internal Control

The guiding factor for audit operations by the auditor depends to a great extent on the soundness or otherwise of the internal controls in the business. Due to the limitation of time, an auditor can spend limited time only on a company's audit. Therefore, he has to decide the extent of in-depth audit of many areas, particularly the checking and verification of routine aspects of financial transactions. Clause – XIV of the Companies (Auditor's Report) Order, 2020 (CARO 2020) requires that the auditor's report on the account of a company to which this Order applies shall inter-alia include a statement as to whether there is an adequate internal control system commensurate with the size of the company and the nature of its business, whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

As per section 177 of the Companies Act, 2013, the Board of directors of every listed company and the following classes of companies, as prescribed under Rule 6 of Companies (Meetings of Board and its powers) Rules, 2014 shall constitute an Audit Committee:

- (i) All public companies with a paid up capital of ₹10 Crores or more;
- (ii) All public companies having turnover of ₹100 Crores or more;

- (iii) All public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding ₹50 Crores or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Sub-section (5) of section 177 of the Companies Act, 2013 provides that the 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.

Sub-section (6) of section 177 of the Companies Act, 2013 provides that the Audit Committee shall have powers to investigate any activity within its terms of reference, to seek information from any employee, to obtain outside legal or other professional advice, to secure attendance of outsiders with relevant expertise, if it considers necessary.

The roles of the Audit Committee are:

- (i) Evaluation of internal financial controls and risk management systems;
- (ii) Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;
- (iii) Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;
- (iv) Discussion with internal auditors of any significant findings and follow up there on;
- (v) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board
- (vi) Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

The Audit Committee shall mandatorily review the Internal audit reports relating to internal control weaknesses; and the appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

The evaluation of internal controls including internal accounting controls gives an opportunity to the auditor to a clearer insight into the operational systems and an overall view of the organisational workings to spot weaknesses in the systems and procedures both in respect of financial and operational areas of the business. The audit process effectively evaluates the auditee's existing internal controls through the use of questionnaires and flow charts. The internal control questionnaire is a list of systematically and logically prepared questions designed to find out and evaluate the effectiveness of internal control systems regarding various aspects and accounting transactions of an organisation. The questionnaires are to be comprehensive in nature to ensure that all aspects and accounting transactions are covered which are to be replied by the officials of the department or division concerned. The criteria for replies against each question are "yes", "no", "not applicable", "explanatory notes" and "comments". Normally the affirmative answers suggest satisfactory internal controls while negative answers suggest weaknesses of internal controls.

# Internal Control and the Auditor

## 14.2

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) had recently issued the “COSO report”, which was jointly sponsored by the Institute of Internal Auditors (IIA), the American Institute of CPAs, the Financial Executives Institute, the American Accounting Association, and the Institute of Management to provide a common, widely accepted definition of internal control and provide a framework of internal control which can be used as a benchmark for assessing its effectiveness. The COSO report defines internal control as follows:

- ⦿ A process, effected by an entity’s board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:
  - Effectiveness and efficiency of operations.
  - Reliability of financial information.
  - Compliance with applicable laws and regulations.

The COSO study identifies five interrelated components of internal control:

- (a) The control environment;
- (b) Risk assessment;
- (c) Control activities;
- (d) Information and communication;
- (e) Monitoring.

The underlying foundation of internal control, termed as ‘the control environment’ is dependent on the people in an organisation. including their competence, attributes and their ethical values. The management must assess the anticipated risks (risk assessment) and devise mechanisms (control activities) to manage those risks to achieve its goals and objectives. Information and communication among people are vital links in the effective control system. Lastly, monitoring of internal controls is an ongoing process like managerial reviews or periodic reviews like internal self-assessment or an audit. The internal audit function is a part of internal control i.e as part of the monitoring process.

Control compels events to conform to plans. Internal control is an essential part of control mechanism within an organisation, which functions for the success of an organisation by way of implementation of organisational objectives, policies, plans and philosophy. To assess the effectiveness of internal control measures, it is essential to measure the extent of accomplishment of objectives through appraisal, review and evaluation of the related factors.

The importance of role of an internal auditor in the context of internal control cannot be exaggerated.

- (a) The purpose of the review of the systems of internal control is to ascertain whether the system established provides reasonable assurance that the organisation's objectives and goals will be met efficiently and economically.
- (b) The purpose of the review for effectiveness of the system of internal control is to ascertain whether the system is functioning as intended.
- (c) The purpose of the review for quality of performance is to ascertain whether the organisation's objectives and goals have been achieved.
- (d) The primary objectives of internal control are to ensure:
  - (i) reliability and integrity of information.
  - (ii) compliance with policies, plans, procedures, laws and regulations.
  - (iii) the safeguarding of assets.
  - (iv) the economical and efficient use of resources.
  - (v) the accomplishment of established objectives and goals.

At times, the internal auditor is to go beyond the ambit of control measures determined by appraising and assessing the extent of implementation of the management control systems, ensuring as well as assuring the management control systems are as effective as these are expected to be and thereby converting hopes and aspirations of the organisation into reality and accomplishments. Internal auditing, as has been seen, can therefore reveal a sound internal control system but nevertheless the support of the management is a must.

# Internal Auditing – Evolution of the Profession

## 14.3

Chanakya (350-283 BC) was an advisor and Prime Minister of first Maurya emperor Chandragupta (340 – 293 BC) in his Book ‘Arthashastra’ mentioned about maintenance of Accounts, periodicity of Accounting, verification, certification and various avenues of fraud (40 types of embezzlement – Chanakya Chalisha) of Government Fund /Exchequer. He cited an example that it is very difficult to ascertain ‘how much water the fishes are consuming from a pond full of water’. The origin of internal audit goes back to thousands of years. There are records available, which show that the Greeks, Romans, and Egyptians were conducting audits before the birth of Christ. Interestingly, the scope of all these early audits was in many ways similar to that of modern internal audits. The audit in Government during the modern time dates back to the year 1789, when the first U.S. Congress approved an ‘Act’ that included a provision for the appointment of a secretary of the treasury, a comptroller, and an auditor. The auditor’s job was to receive all public accounts, examine them, and certify the balances.

In the modern era, railroad companies in USA are often credited for being the first to introduce internal audit during the latter part of the nineteenth century. These railroad companies had traveling auditors to visit the railroads’ ticket agents and determine that all the accounting for all monies was properly handled. Krupp Company in Germany had employed some type of internal audit staff at least as early as 1875, since there is an audit manual dated January 17, 1875, which inter-alia includes the following provisions:

The auditors are to determine whether laws, contracts, policies and procedures have been properly observed and if all business transactions were conducted in accordance with established policies and with success. In this connection, the auditors are to make suggestions for the improvement of existing facilities and procedures, criticisms of contracts with suggestions for improvement, etc. The growth of large corporate houses during the early part of the twentieth century necessitated the need for extended span of control by the managements employing thousands of employees with manufacturing plants at many locations and sales & marketing all around the world. The traditional form of audit by the public accountant was not very effective in these companies because of huge distances between different locations besides being proving very costly also as it necessitated lot of traveling.

Therefore, a need was felt for internal auditors at all the locations mainly for protection of assets. The objectives of internal audit during this period have been explained as under:

Protection of company assets and detection of fraud were the principal objectives. Consequently, the auditors concentrated most of their attention on examinations of financial records and on the verification of assets that were most easily misappropriated. A popular idea among management people a generation ago was that the main purpose of an auditing program was to serve as a psychological deterrent against wrongdoing by other employees.

However, this role of internal auditor has undergone a vast change during the second half of twenty first century. Earlier, internal auditing was essentially to check the records after those had been created to ensure accuracy. These internal auditors were also concerned with the possibility of fraud.

The emergence of war economy during 1940s is attributed credit for the initial expansion in scope of internal audit. With huge back-log of orders, managements became more concerned with production scheduling, shortages of materials and labourers, and compliance with regulations. Most of these contracts were on cost plus basis. Therefore, cost reporting also became more important. As a result, internal auditors began directing their efforts towards other areas also, which were till then outside the purview of internal audit.

The fast technological leaps and global expansion are also responsible for the fast changing and ever-expanding role of internal auditors. With emergence of very powerful and cheap computers, accounting has become mechanized and computerized. These are subject to automatic checking procedures. Thus, there may no longer be the need to check each and every transaction. Therefore, the modern concept is that internal auditors are an arm of the management and are just as concerned with waste and inefficiency as with fraud.

Arthur H. Kent's published an article, "Audits of Operations," in March 1948 describing the expanded scope of audit. Kent made frequent mention of an operations audit in that article. However, by the 1970s, the paradigm shift in the role of internal auditors from financial perspective only to wide operational perspective had become profound and permanent. The modern work of the internal auditor had become more of auditing for efficiency and effectiveness than financial propriety. Thus, the main objective of the Internal Audit function has shifted from fraud detection to assisting managements in making decisions. This has also ensured that the internal auditor was now an important integral part of the management team.

Section 301 (Public Company Audit Committee) of the Sarbanes-Oxley Act passed by the U.S. Congress in the year 2002 requires an audit committee in all the listed companies. Section 404 (Management Assessment of Internal Controls) of the said Act requires an annual report on management of the internal controls and their effectiveness. The law requires annual reports to contain an assessment of the effectiveness of internal control over financial reporting. In addition, it also requires the adoption of standards for independent auditors to attest to management's report on internal control. Separately, the act requires a company's CEO and CFO to certify quarterly and annual reports. These developments will ensure the necessity for the adequate and effective internal audit department in all the listed companies to assist management with these requirements. Similar provisions are already in place under the Indian Companies Act, 2013.

The role of internal audit is to provide independent assurance that an organisation's risk management, governance, and internal control processes are operating effectively. Internal audit is conducted objectively and designed to improve and mature an organisation's business practices.

Internal auditing provides insight into an organisation's culture, policies, procedures, and aids board and management oversight by verifying internal controls such as operating effectiveness, risk mitigation controls, and compliance with any relevant laws or regulations.

### **Necessity of Internal Audit**

The necessity of internal audit is as follows:

1. Internal Audit assists management to improve internal controls by identifying weaknesses in systems. and provides an opportunity to correct those weaknesses. Internal auditors deal with issues that are important to the continued existence and prosperity of any organisation.
2. It helps to detect errors and frauds and provides suggestions to rectify the same and to pre-empt possibility of recurrence.
3. It steps in time to detects the misuse of resources, in time which helps to reduce infructuous unnecessary expenses.
4. It helps in improving the processes and workflow. It also works as a morale check.

5. The Internal Audit checks the books of accounts, detects errors and frauds and helps in its correction which makes the act of External/Statutory Auditor can rely on the internal audit reports and reduce the audit time easier.
6. The vigil by Internal Audit team and timely intervention, keeps operating staff on their toes for keeping Books updated.
7. Independent review of operations/business.

## Sum Up

Internal control is the process, effected by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- ⊙ Reliability of financial reporting,
- ⊙ Effectiveness and efficiency of operations, and
- ⊙ Compliance with applicable laws and regulations.

## Types of Internal Controls

1. **Detective:** Designed to detect errors or irregularities that may have occurred.
2. **Corrective:** Designed to correct errors or irregularities that have been detected.
3. **Preventive:** Designed to keep errors or irregularities from occurring in the first place.

## Limitations of Internal Controls

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

**Judgment:** The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.

1. Bypassing laid down control parameters by changing the process flow makes the earlier one redundant and for setting a new one entire process flow to be re-examined for suitability.
2. Overriding attitude to make the control ineffective.

**Breakdowns:** Even well-designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.

**Management Override:** High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

3. **Collusion:** Control systems can be circumvented by collusion among employees for fraudulent activities.
4. Cost of controls should not exceed the benefits accruable from exercising control, e.g one external Agency is appointed to verify daily cash at a retail outlet, where daily turnover is ₹1000/-.
5. Multiple controls at the same point of time makes process slower, e.g despite existence of maker-checker control for release of Purchase Orders (PO), the same are placed for manual sign-off before release.

**Authorization:** The objective is to ensure that all transactions are approved by the person authorized to do so.

**Completeness:** The objective is to ensure that no valid transactions have been omitted from the accounting records.

**Accuracy:** The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.

**Validity:** The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.

**Physical Safeguards & Security:** The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.

**Error handling:** The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported /escalated to the appropriate level of management.

**Segregation of Duties:** The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.

A well-designed process with appropriate internal controls should meet most, if not all of these control objectives.

### Major Components:

Control environment: Factors that set the tone of the organisation, influencing the control consciousness of its people. The seven factors are (ICHAMPBO):

- ⦿ I - Integrity and ethical values,
- ⦿ C - Commitment to competence,
- ⦿ H - Human resource policies and practices,
- ⦿ A - Assignment of authority and responsibility,
- ⦿ M - Management's philosophy and operating style,
- ⦿ B - Board of Director's or Audit Committee participation, and
- ⦿ O - Organizational structure.

**Risk Assessment:** Risks that may affect an entity's ability to properly record, process, summarize and report financial data:

- ⦿ Changes in the Operating Environment (e.g., Increased Competition)
- ⦿ New Personnel
- ⦿ New Information Systems
- ⦿ Rapid Growth
- ⦿ New Technology
- ⦿ New Lines, Products, or Activities
- ⦿ Corporate Restructuring
- ⦿ Foreign Operations
- ⦿ Accounting Pronouncements

**Control Activities:** Various policies and procedures that help ensure those necessary actions are taken to address risks affecting achievement of entity's objectives (PIPS):

- ⊙ P - Performance reviews (review of actual against budgets, forecasts)
- ⊙ I - Information processing (checks for accuracy, completeness, authorization)
- ⊙ P - Physical controls (physical security)
- ⊙ S - Segregation of duties

**Information and communication:** Methods and records established to record, process, summarize, and report transactions and to maintain accountability of related assets and liabilities. Must accomplish:

- ⊙ Identify and record all valid transactions.
- ⊙ Describe on a timely basis.
- ⊙ Measure the value properly.
- ⊙ Record in the proper time period.
- ⊙ Properly present and disclose.
- ⊙ Communicate responsibilities to employees.

**Monitoring:** Assessment of the quality of internal control performance over time.

#### **What can happen when Internal Controls are weak or non-existent?**

These arguments represent pitfalls to unsuspecting management. Each argument is in itself a problem that needs to be resolved.

1. Compensating controls can be implemented in situations where one person has to do all of the business- related transactions for a department.
2. If implementing a recommended control seems too expensive, be sure to consider the cost of a fraud that could occur because of the missing control. Fraud is always expensive and the prevention of fraud is worth the cost.
3. Finally consider the issue of trust. Most employees are trustworthy and responsible, which is an important factor in employee relations and departmental operations. However, it is also the responsibility of administrators to remain objective. Experience shows that it is often the most trusted employees who are involved in committing frauds.

## Exercise

### A. Theoretical Questions

#### ⊙ Multiple Choice Questions

- Several checks & controls exercised in a business to ensure its efficient working is known as:
  - Internal check.
  - Internal control.
  - Internal audit.
  - Interim check.
- The work of one clerk is automatically checked by another clerk is called:
  - Internal control.
  - Internal check.
  - Internal audit.
  - None of the above.
- Internal controls and internal checks are:
  - One and the same.
  - Different.
  - Internal control includes internal checks.
  - None of the above.
- Which of the following statements is not true about a continuous audit?
  - It is conducted at regular intervals.
  - It may be carried out on daily basis.
  - It is needed when the organisation has a good internal control system.
  - It is expensive.
- In comparison to the independent auditor an internal auditor is more likely to be concerned with:
  - Cost accountancy system
  - Internal control system
  - Legal compliance
  - Accounting system

6. Verification is \_\_\_\_\_.
- (a) The art of recording the business transaction.
  - (b) An examination of the books of accounts.
  - (c) The act of establishing the accuracy of entries in the books of accounts.
  - (d) None of the above.
7. The main objectives of investigation is \_\_\_\_\_.
- (a) To discover errors and frauds.
  - (b) To prevent errors and frauds.
  - (c) To verify statements.
  - (d) All the above.
8. The company's auditor is expected to give \_\_\_\_\_.
- (a) His expert opinion about the accounts.
  - (b) A factual position about the accounts.
  - (c) A critical review of the accounts.
  - (d) Financial assistance.
9. Which of the following is not likely to be a fraud risk factor relating to management characteristics?
- (a) Tax evasion.
  - (b) Failure to correct known weakness in internal control system.
  - (c) Adoption of conservative accounting principles.
  - (d) High management turnover.
10. The primary purpose of establishing quality control policies and procedures for deciding on client evaluation to \_\_\_\_\_.
- (a) Ensure adherence to generally accepted auditing standards.
  - (b) Acceptance or retention of clients whose management does not lack integrity.
  - (c) Ensure audit fees is charged according to the type of audit work assigned.
  - (d) Medical policies.

⊙ **Essay Type Questions**

1. Explain the steps to prepare for and perform an internal audit.
2. The utility of the audit programme can be retained and enhanced only by keeping the programme and also the client’s operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed”. Discuss stating clearly the advantages of an audit programme.
3. “The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting”. Explain.
4. “The audit engagement team should hold discussions to gain a better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference”. Explain.
5. “An internal control system consists of the policies and procedures companies use to protect assets, ensure reliable accounting, promote efficient operations, and urge adherence to company policies”. Explain.

**Answer:**

**Multiple Choice Questions**

1.	(a) Internal check.
2.	(b) Internal check.
3.	(c) Internal control includes internal checks.
4.	(c) It is needed when the organisation has a good internal control system.
5.	(b) Internal control system
6.	(c) The act of establishing the accuracy of entries in the books of accounts.
7.	(d) All the above.
8.	(a) His expert opinion about the accounts.
9.	(c) Adoption of conservative accounting principles.
10.	(b) Acceptance or retention of clients whose management does not lack integrity.