

# A STUDY OF INTERNAL AUDIT PRACTISED IN MODERN BUSINESS ENTERPRISES

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## ABSTRACT:

In India, appointment of internal auditor has been made mandatory for listed and certain other classes of companies by the Companies Act 2009. This is an inflexion point for the internal audit as the new provision gives an opportunity to internal auditors to claim their rightful position in companies by strengthening their relationship with the audit committee of the board of directors (Board). However, achieving recognition as a valuable function also requires providing services that are needed by the Board to enable it to play an effective role in corporate governance. Contemporary internal audit serves both the management and the Board. This paper examines the scope of internal audit.

Internal audit is a dynamic profession involved in helping organisations achieve their objectives. It is concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation.

Now there is more pressure than ever on executive management and internal auditors to mitigate corporate fraud and misconduct. Job security can be at risk for internal audit directors when they don't develop an antifraud action plan and fail to address stakeholders' expectations. Management can be liable for two types of misconduct – failing to have sufficient internal controls and the offense itself. The increased concern for fraud prevention is easily understood in light of the billions at stake due to fraud. Companies have changed their management of fraud from a compliance driven approach to proactive prevention.

**Key Words:** audit committee, corporate governance, internal audit, management audit, and social audit.

## INTRODUCTION

Nowadays businesses operate in the fast, competitive and ever-changing environment. Their success is based on the ability to adapt to the environmental changes, to fulfill organizational objectives and to manage risks as the business landscape evolves every day.

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**REVIEW OF LITERATURE**

**(Colbert and Alderman, 1995):** In planning and executing audit tasks, internal auditors would consider the appropriate audit approach based on the effectiveness and efficiency of the approach in accomplishing the task at hand. There are generally three types of audits which internal auditors perform and they are compliance, operational, and financial audits. The objective of these audit types is to support the auditee's assertions.

**(Verschoor, 2006):** A risk-driven approach on the other hand, involves assessing, during the annual audit planning stage, the risks inherent in each audit area. Specific audit procedures would only be established after considering the risks involved. The goal of the audit planning process is to customised a dynamic, risk based and defensible audit plan that addresses all the needs of the organisation.

**(Colbert & Alderman, 1995):** The fact that risk-driven approach helps internal auditors to focus their efforts on areas which are relatively more risky, it is hence regarded as more effective in meeting the objectives, and also efficient as it focuses on areas which are riskier as compared to the procedures-driven approach.

**(Rivenbark, 2000):** By identifying, assessing, and monitoring a company's risk, internal auditing helps to ensure that adequate resources are deployed and focused on priorities (Kunkel, 2004). In short, risk based auditing focuses on assessing the goals, risks and controls that are infused in the organization's success.

**(Kanter et al., 1990):** While risk assessment is an essential part of the audit planning process, internal audit departments are finding their resources are limited with the scope of audit and the associated risk exposures ever increasing in the challenging environment.

**(Alderman & Tabor, 1989):** By adopting a risk-driven approach where the audit engagement objectives, auditee's assertions and risks are considered, the internal auditor can assure that appropriate focus and resources are given to risky areas and that audits can be performed in the most efficient and effective manner.

**(Walz, 1991):** At the individual audit unit level in a risk based model, auditing procedures should be designed to achieve the objective that the controls in place are adequate. The internal auditor should understand the control and its environment; evaluating the adequacy of controls and test these controls are functioning as designed and effective.

**(McNamee & McNamee ,1995):** The scope and function of internal audit have increased in response to changes in the business environment over the decades, shifting the focus of their audit work from financial statement and accounting functions to compliance audit, assessing the internal control and operating processes, and in recent years, adding risk management to their existing role. The internal auditing function has evolved along with changes in the business environment.

(COSO, 1992, pp 9): A process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: Effectiveness and efficiency of operations; Reliability of financial reporting and compliance with applicable laws and regulations. (Bearsley, Chen, Nunez and Wright, 2006): The internal and external pressures and other risk drivers have also increased the complexity of risk which the traditional risk management is no longer appropriate to identify, assess and respond to.

**Bailey et al. (2003)** edited a monograph published by the IIA Research Foundation on research opportunities in internal auditing. There were two key objectives of this monograph. It was intended, first, to inspire academic research on topics of relevance to internal auditing and, second, to bridge the gap between academics and practitioners raises a series of research questions related to a specific topic in internal auditing and we refer to these where relevant.

**Cohen et al. (2004)** provide an extensive review of research on corporate governance and its impact on financial reporting quality. The authors introduce the notion of a corporate governance mosaic, comprising interactions among the board of directors and the audit committee, management, external audit and internal audit.

**Brown (2009):** There is also a challenge in building consensus for an expanded and more strategic role for internal audit," said Brown.

### OBJECTIVE OF THE STUDY:

To trace the origins of the internal audit and offer suggestions in improving the internal audit mechanism practised in business enterprises.

### THE ORIGIN OF AUDITING

According to Walter W. BIGG (1972), the origin of auditing had its origin in the necessity for the institution of some system of check upon persons whose business it was to record the receipt and disbursement of money on behalf of others. In the early stages of civilization the methods of account were so crude, and the number of transactions to be recorded so small, that each individual was no doubt able to check for himself all his transactions, but as soon as the ancient States and Empire acquired any coherent organizations, systems of check were applied to their public accounts, as evidenced by exact records; the ancient Egyptians, the Greek and the Romans, all utilized systems of check and counter-check as between the various financial officials.

It was not until the fifteenth century that the great impetus given to trade and commerce generally by the Renaissance in Italy led to the evolution of a system of accounts which was capable of recording completely all kinds of mercantile transactions, and the principles of double entry were first published in 1494 at Venice by Luca Pacioli.

The increase in volume of trading operations, necessitating the use of more capital than was the disposal of the average trader, induced him to combine in partnership with others for the purpose of obtaining the requisite funds, and this tendency was a potent factor in the evolution of a more perfect system of accounts.

In the same way, no doubt, it had a material effect on the practice of auditing, but the audit of business accounts did not become common until the Nineteenth century. The enormous increase in trade in that period, which was fostered by the discovery of steam power and by mechanical inventions generally, led to the formation of numerous joint stock companies, and other corporate undertakings, involving the use of large sums of capital under the management of a few individuals. Under these conditions the advantages to be obtained from utilizing the services of auditors became apparent to the commercial public generally, and a great increase in the practice of auditing resulted; at the present day it forms the most important part of a professional accountant's practice.

## HISTORICAL DEVELOPMENT

According to Howard F. Stettler (1977), internal auditing appeared on the business scene much later than auditing by public accountants. The principle factor in its emergence was the extended span of control faced by management in concerns employing thousands of people and conducting operations from widespread locations.

Other advantages also resulted from an internal approach to the problem: internal auditors tended to become better acquainted with the procedures and problems of the company, and the auditing activity could be carried on continuously, rather than once a year when outside auditing services were utilized.

**Meaning of Auditing:** According to Jach C. Roberston (1976), Auditing may be defined in several ways depending upon what purpose is to be served. Four definitions are given below, beginning with the most general one produced by a committee of the American Accounting Association. The latter three definitions exhibit three different purposes served by independent auditors, and governmental auditors.

### Meaning of Internal Audit

Internal auditing 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.

### ICAI's Proposed Revised Definition Of Internal Audit

“Internal audit provides independent assurance on effectiveness of internal controls, risk management processes and contributes to enhancing governance for achieving organizational objectives.”

### **Explanations to above Proposed Revised Definition**

- i) Independence: Internal audit should be an independent function, achieved through the position, organization structure and reporting of the internal auditor.
- ii) Internal controls and risk management: are an integral part of management function and business operations. An internal auditor is expected to evaluate the design and operating effectiveness of internal controls and risk management processes (including reporting processes) as designed and implemented by the management.
- iii) Governance: is a set of relationships between the company and its various stakeholders and provides the structure through which the company's objectives are set, and the constant performance monitoring required to help attain them.
- iv) Organizational objectives incorporate the interests of all stakeholders and includes compliance with internal policies and procedures and laws and regulations.
- v) Advisory role: At certain times, in addition to providing assurance, the internal auditor may adopt an advisory role to help an organization achieve its objectives, provided this does not compromise the independence of the internal auditor.

### **INTERNAL AUDITORS**

These are employees within an organization whose primary responsibility is to determine whether organizational policies and procedures are being carried out correctly and to safeguard organizational assets as well as assessing the efficiency of internal control system.

### **INTERNAL CONTROL SYSTEM**

According to ISA 315 internal control system is the process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entities objective with regard to financial reporting, effectiveness and efficiency of operations and compliance with a appropriate laws and regulations.

### **AUDIT COMMITTEE**

This is a committee consisting primarily of non-executive Directors, which is able to view a company's affairs in a detached and independent way and liaise effectiveness between the main board of directors and the external auditors.

### **AUDITING PROCEDURES:**

AICPA (1963) defines auditing procedures as the acts performed by the auditor in the course of attaining the objectives of the examination of financial statements.

**AUDIT PLAN:**

A description and schedule of audits to be performed over a certain period of time (typically three years); includes areas to be audited, type and scope of work, and high-level objectives.

**AUDIT PROGRAM:**

Policies and procedures that govern the audit process.

**SCOPE OF INTERNAL AUDITING**

1) Facilitate the integrity and reliability of the financial statements by ensuring that:

- The financial statements have been prepared in compliance with IAS and IFRS.
- Safeguarding the company's assets by ensuring that proper records are maintained to proof their existence and periodic physical count to ensure the assets are in existence and their conditions are okay.
- Ensure compliance with the relevant laws and regulations and in the event of breaches the financial statements should disclose such.

2) Review the operational effectiveness and efficiency and ensure economic utilization of resources, targets of the economy are achieved and managers display efficiency in discharging their duties.

3) Review the accounting system in use and the related internal control system to ensure their design and effectiveness are suitable, monitor their operations and recommend improvements thereto.

4) Assist in the governance process. Governance process is the way the board of directors manage the affairs of the company. Internal audit contributes by doing the following:

- Ensure adherence to the code of conduct and promote the ethical culture.
- Assist the Board Of Directors to discharge their duties ethically by informing them of the weaknesses and recommendations of the strategies employed.
- Ensure the recommendations of the external auditors are implemented within the prescribed/reasonable time.

Internal auditors are secretaries to the audit committees and acts as a link person between external auditors and audit committees.

**QUALITIES OF AN EFFECTIVE INTERNAL AUDIT DEPARTMENT**

The institute of internal Audits practice standard (1980) includes five categories of guidance that takes into consideration financial and operational auditing, independence, professional proficiency, scope of work, performance of audit and management of their internal auditing department.

1. **Independence:** This is an essential element to the effectiveness of the internal auditing function and requires internal auditor to be independent of all the activities that they may be required to audit.

2. **Competent personnel:** The proper functioning of any system depends on the competence and integrity of those operating it. The staff employed should therefore be competent and experienced in their

files. If need be, staff should be continuously updated through in house and /or off the job training.

3. **Professional proficiency:** internal audits should therefore be performed with proficiency and due professional care.

4. **Scope of work:** The scope of work of the internal audit department should encompass the examination and evaluation of the adequacy and effectiveness of the organizations system of internal control and the quality of performance in carrying out assigned responsibilities.

5. **Programmes for review:** The internal audit department should have comprehensive Programmes so as to ensure that no major aspect of operations is overlooked. The department should avoid being involved in activities not falling within their audit to function as this may prevent it from following their normal programme closely. Collect, analyze, interpret and document information to support audit results.

6. **Report:** Proper reports should be written after every audit and communicated periodically to all interested parties within the organization. Recommendations made on such reports should be clear and achievable.

## SUGGESTIONS:

- The firms are advised to ensure more involvement of all personnel by taking them into confidence in key business matters and policy decisions and also accord a free hand to divisional managers.
- It is also suggested for the companies to make the verification and cross checking documentary evidences in a more elaborated manner.
- Business enterprises are advised to streamline the frequency of periodic reports to be made by the employees cutting across all divisions to bring in uniformity in the firm in reporting practices.
- The firms are advised to undertake a more nuanced approach for accounting for the stock and inventory by harmonizing the systems in place for various activities associated with stock such as 'sourcing'.
- The companies are advised to adopt a flexible approach and take corrective measures to ensure that the internal audit process does not hamper the regular working of employees in carrying out their assigned jobs. So that there is no concession and deviation in the regular business activities of the organization.
- It is suggested to bring in uniformity in the system of accounts maintenance by full adoption of Computer Application Based models in place of manual book keeping as it will help in avoiding accounting errors.
- Companies can initiate steps to reduce employee turnover by retaining of experienced staff. It can also be seen that employees with matriculation and less as education are trained to handle monetary transaction efficiently.

**CONCLUSION:**

Internal Audit plays a pivotal role in the successful running of any business entity. Not only business enterprises but also any organization relies upon internal check and internal audit mechanisms for efficiently carrying out business activities. Internal Audit is responsible for many functions such as:

- Matching receipts, payments and cash / bank balances.
- Stock maintenance and inventory management
- Assets Quality control
- Tax and legal compliance
- Quality assurance and production management
- Stress Assets control and management
- Wage administration and payroll management
- Prevention of frauds and inadvertent errors
- Proper book keeping and assistant to external auditors etc

**WEBSITES:**

[www.icaai.org](http://www.icaai.org)

[www.qcsl.co.uk](http://www.qcsl.co.uk)

[www.taxguru.in](http://www.taxguru.in)

[www.iiaindia.org](http://www.iiaindia.org)

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