Internal Audit as a Strategic Business Partner

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Lecture on Internal Audit
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History of Internal Auditing

As old as writing circa 8,500 BC

Earliest surviving records in Double entry system – 1397

Modern era of accounting – 1494

As early as the Middle ages, a form of Internal Auditing existed among manor houses of England

Earliest form of External Audit by an independent public accountant - 1720

Industrial revolution in England led to factory finance by stockholders

Organization of Chartered Accountants – Scotland – 1853

Establishment of AICPA in 1887

Formation of IIA in 1941

Formation of the ICAI in 1949
History of Internal Auditing

1987 : Treadway Commission (IIA, AICPA, AAA, IMA, FEI) report concluded that

- An Internal Audit function should exist in every public corporation
- There should be a corporate Audit committee composed of non-management directors

The Standards on Internal Auditing issued by The IIA have evolved and are the cornerstone of Risk Assessment
Early History of Auditing: INDIA

Vishnugupta Kautilya – better known as Chanakya first introduced the concept of auditing in his book - *Arthaniti*.

Birbal – A great auditor for Emperor Akbar. Gave him facts and solutions on several complex matters with desired evidence.
Need for Internal Audit

- Increased size & Complexity
- Enhanced compliance requirements
- Focus on Risk Management & Internal Controls
- Unconventional Business Model
- Intensive use of Information Technology
- Stringent norms mandated by regulators to protect investors
- Increasingly competitive environment
Corporate Governance

Corporate Governance Pyramid

Board of Directors

Direction

Execution
Sr Management
Managers
Process Owners

Oversight
Audit Committee
Internal Audit
External Audit
## Changing role of internal auditor

<table>
<thead>
<tr>
<th><strong>Old definition</strong></th>
<th><strong>New Definition</strong></th>
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<td>Internal auditing is an independent appraisal activity within the organization to check the accuracy and reliability of the organization's record, promote operational efficiency, encourage adherence to policies, systems and procedures and to safeguard the organization’s assets</td>
<td>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</td>
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Internal Audit Evolution

From Oversight to Insight to Foresight

Maturity

Oversight

Compliance & Control
- Regulatory Reporting
- Monitoring & Evaluation
- Policy Checking
- Fraud Detection

Insight

Business Insight
- Data Analysis
- Process improvements
- External Benchmarking
- KRI Monitoring
- BCP & DRP

Value Advisor
- Brand Protection
- Customer
- Cost Optimisation
- Fraud Prevention
- Data Governance
- IT Leveraging

Impact & Benefits

Foresight

From Oversight to Insight to Foresight

Oversight

Insight

Foresight

Impact & Benefits
What Changed the Role of Internal Auditor?

Catastrophes have been good for Internal Auditing Profession
New Regulatory/Governance Frameworks followed Big Scandals?

All major accounting scandals increased and tightened the Risk Management & Corporate Governance Norms. Increased norms / benchmarks increased responsibility on internal auditing.
Serving Two masters...

Senior Management

Internal Audit

Operations

Audit Committee

Independent Assurance

Consultative

Assurance
Summarizing the Paradigm shift

<table>
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<th>Traditional Role</th>
<th>Emerging Role</th>
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<tr>
<td>➢ Correctness of Financial statements</td>
<td>➢ Enhanced Focus on IT, Project Management ......</td>
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<tr>
<td>➢ Siloed approach towards Risk Management</td>
<td>➢ Integrated approach towards Risk Management</td>
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<tr>
<td>➢ Compliances</td>
<td>➢ Efficiency enhancement</td>
</tr>
<tr>
<td>➢ Watch dog</td>
<td>➢ Partners in Business</td>
</tr>
<tr>
<td>➢ Value preserver</td>
<td>➢ Value Creator</td>
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Facets of Business Partner Auditors

- System Development – Inventory (Industry - Generic) & Promo (Retail)
- Processes Based Audit – “P to P Cycle” & Cash Withdrawal from ATM
- Benchmarking
- Audit Committee – Corporate Governance Cycle & Enterprisewide Risk Management (ERM)
- Identifying Good Practices
- Worst Internal Audit Practices (What not to do)
System Development – Slow/non moving inventory

How is it normally reported?

- It is observed that there is a slow/non moving inventory of Rs. 532 lacs which needs to be liquidated.

A Strategic partner auditor did a root cause analysis and observed:

- Material being bought even though not moving (no system to indicate out movement when ordering)
- Material being bought even though in stock with high quantity (no system to indicate stock levels when ordering)
- Inflated stock values due to system error (this became part of IS audit)

How the issue got resolved?

- Auditor partnered with Business & IT to develop a Comprehensive System to address gaps
How is it reported?

- It is observed that the “Buy One Get One” promotion was not configured in the system

A Strategic partner auditor went further and reported

- The outcome was a manual bill with associated issues
- No control over pricing
- Analysed the impact on inventory
- Analysed the impact on replenishment
- Gave leads on possibility of frauds

How the issue got resolved

- Auditor partnered with business for complete overhaul of “Promotions” within company
Process Based Audits – “P to P Cycle”

How are these audits done?

- Each process separately – purchase, receiving, documentation & payment

A Strategic partner auditor will look at the following:

- Assess controls on purchase requisitions
- Vendor registration process
- Assess controls on placement of POs
- Money transfer process
- Documentation of exceptions

What is the outcome?

- Complete assurance (or gaps!!) to management on “Purchase to Pay Cycle”
In bank audit, how is cash withdrawal checked if done thru a bearer cheque?

Simple!!!!!

For withdrawals thru ATMs, the Strategic partner auditor needs answers for:

- Process for Issuance of card to customers

- ATM – Physical Security, log records, network security, how data is captured in the system, cash filling, accounting of ATM transactions in the books ……

- Process gets compounded in case of stand-alone ATMs

What is in it for us?

- Need for the auditor to be “live” to business process updates
Benchmarking as a Strategic Tool

In house auditors can benchmark processes within the company (especially between Group Companies)

- Differing payment terms to vendors, different purchasing rates, clubbing purchasing quantities for larger discounts, extended credit given, guest house sharing, …..
- Shared services concept

Outsourced auditors can benchmark processes between companies (excluding confidential information)
The Corporate Governance Cycle

Stakeholders

Corporate Governance Umbrella

Board of Directors

Senior Management

Enterprise Risk Management Process

Risk Owners

Assurance Activities

(Internal and External Auditors)

Key objective to protect and enhance stakeholder value
Internal Audit role in ERM

- Core internal audit roles in regard to ERM
  - Facilitating identification & evaluation of risks
  - Evaluating the management of key risks
  - Giving assurance that risks are correctly evaluated
  - Giving assurance on the risk management processes

- Legitimate internal audit roles with safeguards
  - Championing establishment of ERM
  - Developing & implementing the ERM framework
  - Co-ordinating ERM activities
  - Facilitating management in responding to risks
  - Coordinating reporting on risks
  - Setting the risk appetite
  - Imposing risk management processes
  - Taking decisions on risk responses
  - Implementing risk responses on management’s behalf
  - Accountability for risk management

- Roles internal audit should not undertake
  - Core internal audit roles in regard to ERM
  - Legitimate internal audit roles with safeguards
No matter what, an auditor must identify good practices

A C&F agent located at Wadi (outside Octroi limits of Nagpur)

- Warehouse design
- Household provisions
- Loan facilities
- 2nd bus timing
- Music at bays
- Employee speak
- Morning & Evening Walk by owner
- Spic & Span Wash Rooms ……

One of the many roles of Audit is to safeguard assets – physical assets, data & people
Worst Internal Audit Practices

- Not employing staff that believes in Internal Audit’s value
- Not letting Executive Management and the Audit Committee know how you add value
- Doing SALY and JELLY audits - “same as last year”
- Not issuing timely reports
- Issuing “snoozer” reports
- Using “fuzzy” math to validate quantified findings
- Issuing factually incorrect reports
- “Nit-picking”
- Not communicating during the engagement process
- Not knowing the business
- Re-auditing after external auditors and regulators
Worst Internal Audit Practices

- Not following up
- Not being available or responsive
- Not lending staff out for value-added projects
- Not being technically current. Must know industry issues, regulatory issues, ....
- Not doing special projects
- Not sharing audit tools, flow charts, ........
- Issuing reports that are negative by definition
- Not addressing current risks
Worst Internal Audit Practices

- Not attending business strategy meetings
- Not in-sourcing
- Having an inflexible annual plan
- Having too much turnover, too little experience or continuity
- Not recognizing all stakeholders
- Not recognizing best practices
- Not adding value
- Monitoring the wrong KPI’s
- Being a recluse. Talk, talk, talk to key stakeholders
- Not buying your last audit
If you had been a client, would you have paid for your last audit?

To conclude……..
Thank You