GUIDANCE NOTE

ON

INTERNAL AUDIT

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

(A Statutory Body under an Act of Parliament)

12, Sudder Street, Kolkata - 700 016

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ISSUED BY

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12, Sudder Street, Kolkata - 700 016

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FOREWORD

Internal auditing is a continuous process of appraisal of an organisation's operations and evaluation and monitoring of risk management, reporting, and control practices. It is an independent and objective oriented assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing in systematic and disciplined approach to evaluate and improve the effectiveness of the operations of an organization in totality.

I am sure that this publication can be used as 'authoritative guidance note' from the Institute to be followed by the Cost Accounting professionals and the Industry while discharging their duties effectively.

I would like to place on record the valuable guidance and support of the members of the Professional Development Committee of the Institute and in particular Shri Veeraraghvan lyengar, member of the Institute for his contribution in getting this Guidance Note. I would also place on record my sincere thanks to Shri B. M. Sharma, Chairman PD Committee and all my council colleagues for their valuable suggestions.

I sincerely hope that this Guidance Note will serve its purpose object of guiding the members in practice as well as in service.

Kunal Banerjee
President

January, 2009
Kolkata

PREFACE

The Guidance Note brought out by Professional Development Committee of ICWAI on Internal Audit is the first one in this series of Guidance Notes on Internal Audit. Internal auditing is a professional activity involved in helping organizations to achieve their stated objectives. It does this by utilizing a systematic methodology for analyzing business processes, procedures and activities with the goal of highlighting organizational problems and recommending solutions. The scope of internal auditing within an organization is broad and may involve topics such as the efficacy of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with laws and regulations.

This book provides a blueprint of the internal auditing process used by leading practitioners, describes concrete tools and techniques, prescribes a framework for effective implementation, and discusses the issues and challenges involved in introducing internal audit into a company's continuous improvement programme. The concepts, approaches and examples presented can be applied to all organizations regardless of size, business sector, product or services.

I would like to place on record efforts put in by Shri Veeraraghvan lyengar, member of the Institute in bringing out this Guidance Note by the Institute.

We are grateful to Shri Kunal Banerjee, President of ICWAI, Shri A.S. Durgaprasad, Vice-President of ICWAI, the members of

Central Council and the members of the Professional Development Committee in particular who have given their valuable guidance and support in bringing out this publication.

Brijmohan Sharma
Chairman
(Professional Development Committee)

Junuary, 2009
Pune

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PART-I

FRAME WORK FOR INTERNAL AUDIT GUIDELINES/STANDARDS:

PREFACE TO THE GUIDELINES…GLOBAL TO INDIAN CONTEXT.

While Clause 49 of the Listing agreement talks of compliance on internal controls and responsibility of Audit committee in the Indian Context we shall see how seriously the system evolved from a mere compliance in the MAOCARO (1975) and Cost Audit Report Rules 2001 to current scenario where internal audit has transformed into an assurance zone in the area of controls and risk assessment.

Shall we say it all started in the Americas?

The SEC rules are worth reviewing carefully. They "require a company's annual report to include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to

whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management.

Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting."

COSO PRINCIPLES OF INTERNAL CONTROL

"Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives."

"While internal control is a process, its effectiveness is a state or condition of the process at one or more points In time.''

Internal control systems operate at different levels of effectiveness. Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that:

- They understand the extent to which the entity's operations objectives are being achieved.
- Published financial statements are being prepared reliably.
- Applicable laws and regulations are being complied with.

"While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time."

"An internal control system, no matter how well conceived and operated, can provide only reasonable — not absolute— assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake.

COSO's internal control framework describes internal controls as consisting of five inter-related components. These are generally called "layers," and the controls within each must be included in management's assessment. The five layers are described by COSO as :

1. **Control Environment**

   "The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors."

2. **Risk Assessment**

   "Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory, and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change."

3. Control Activities

"Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties."

4. Information and Communication

"Pertinent information must be identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities, and conditions necessary to informed business decision-making and external reporting.

Effective communication also must occur in a broader sense, flowing down, across, and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream.

There also needs to be effective communication with external parties, such as customers, suppliers, regulators, and They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators, and shareholders."

5. Monitoring :

"Internal control systems need to be monitored — a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top.

EVOLUTION IN INDIAN CONTEXT

(i) MAOCARO(1975/1988)

4 (x) Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials, including components, plant and machinery, equipment and other assets, and for the sale of goods ;

(ii) Companies(audit report)order 2003:

4 (iv) Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods. Whether there is a continuing failure to correct major weaknesses in internal control;

Cost Audit Report Rules 2001

Format for cost audit report read with rule 2(c) and rule 4(h).

The scope and performance of internal audit of cost records, if any, and comment on its adequacy or otherwise.

Clause 49: Role of Audit Committee.

II. (E) REVIEW OF INFORMATION BY AUDIT COMMITTEE

The Audit Committee shall mandatorily review the following information :

1. Management discussion and analysis of financial condition

and results of operations;

2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

V. CEO/CFO Role :

They have indicated to the auditors and the Audit committee

(i) significant changes in internal control during the year;

(ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

(iii) instances of significant fraud of which they have become aware and the Involvement therein, if any, of the management or an employee having a significant role in the company's internal control system.

FRAMEWORK

Objective and Scope :

The Standard or guidance note issued under this framework shall have the object of enabling …the members with necessary information of methods and techniques to be adopted and the tools available for implementation. to ensure…that the management relies on the best practices in the business world in respect of controls and risk assessment, by providing methodology for quality assurance and see that the management enjoys value out of the internal audit report in the right time.

The scope of these standard or guidance will be global in application and will address the issues of controls, risk perception and quality assessment in an effort to continuously redress shortfalls and address process improvements and resultant value addition.

Topics under consideration and their scope of application

1. **Standards on Attributes arising out of compliance function...**
   a. Purpose authority and responsibility.
   b. Independence and objectivity
   c. Proficiency and due professional care.
   d. Quality assurance and Improvement Programme
2. **Performance standards**
   a. Managing Internal audit activity. Planning.. communication.. resource management.. policies... coordination.. reporting
   b. Nature of work..risk management.. control.. governance

c. Engagement planning.. consideration.. objectives.. scope.. resource allocation..work programme.

d. performing the engagement.. identifying... analysing... evaluating.. recording.

e. supervising the engagement

f. Communication results

g. Monitoring process

h. Resolution for management acceptance of risks

3. GTAG series of IIA for adoption...10 topics.

4. ERM specific role of Internal Audit.

5. System and issues concerning Internal audit.

Definition of Terms….to be taken up topic wise when such document is released.

Detailing on the subject matter….To describe in detail the subject matter and the objective use value.

Methods and techniques….to be employed for the specific topic selected.

Tools for implementation….where specific tools for measurement or subjective assessment is available the same need to be discussed here.

Case Study…Indian and global context

Guidelines for implementation.

Conclusion.

PART- II

INTERNAL AUDIT GUIDANCE DOCUMENT... A CMA's PERSPECTIVE

Definitions : OECD glossary.

Internal audit :

An independent appraisal function established within an organisation.

Internal control :

Internal control is the organisation, policies and procedures used to help ensure that government/other programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision making.

Internal audit is an independent and objective appraisal service within an organisation:

- Internal audit primarily provides an independent and objective opinion to the CFO/CEO on risk management, control and governance, by measuring and evaluating their effectiveness in achieving the organisation's agreed objectives. In addition, internal audit's findings and recommendations are beneficial to line management in the audited areas. Risk management, control and governance comprise the policies, procedures and operations established to ensure the achievement of objectives, the appropriate assessment of risk, the reliability of internal and external reporting and accountability processes, compliance with applicable laws and regulations, and compliance with the behavioural and ethical standards set for the organisation.

- Internal audit also provides an independent and objective consultancy service specifically to help line management improve the organisation's risk management, control and governance. The service applies the professional skills of internal audit through a systematic and disciplined evaluation of the policies, procedures and operations that management put in place to ensure the achievement of the organisation's objectives, and through recommendations for improvement. Such consultancy work contributes to the opinion which internal audit provides on risk management, control and governance.

Why This Guidance Note :

Internal Audit :

Internal Auditing 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 the effectiveness of risk management, control and governance processes. The effect of Internal Audit should be continual improvements and refinements to the internal control system as a contribution to proper, economic, efficient and effective use of resources.

INTERNAL AUDIT HAS TWO MAIN OBJECTIVES.

a) To ensure that internal control and risk management systems are continually being improved and optimised in response to an ever changing environment;

b) To provide reasonable assurance to the relevant the Audit Committee that significant risks in the organisation are being appropriately managed, with an emphasis on the role of internal controls.

CMAs are basically concerned with efficient management of resources, business sustenance and growth, by leveraging Value with Competition and process efficiency.

While Internal Audit has less to do with compliance mechanism in Indian context except some references in MAOCARO(CARO 2003—Section 4 Clause IV) and CARR-cost audit report rules{form of cost audit report section 3(h)} Clause 49 of the listing agreement SEBI.{(CEO/CFO certification…VI(d)}and recent amendment in Company law(2002)for Producer companies. It has become an important tool adopted by good business houses to re-engineer businesses and basically Internal Audit is more than just auditing transactions for accounting, it is all about processes, process efficiency, controls and risk management. These are the Parameters which become the skill-set of CMAs.. whether in service or practice.

Internal audit is an independent function in a business though often it could be executed by available staff internally, at times the function is outsourced to competent persons in public practice.

CMAs who are basically concerned with efficient utilization of resources and related cost are the best fit internal auditors of any business and hence this guidance Document.

Internal Audit can :

- *independently review and appraise the systems of control throughout the organisation (not just the financial controls);*
- *recommend improvements to internal controls;*
- *ascertain the extent of compliance with procedures, policies, regulations and legislation;*
- *provide reassurance to management that their policies are being carried out with adequate control of the associated risks;*
- *facilitate good practice in managing risks;*
- *save money by identifying waste and inefficiency, and by facilitating the spread of good practice;*
- *avoid duplication of effort by an effective partnership with the other review agencies;*
- *by its activities help to ensure that assets and interests are safeguarded from fraud, deter fraudsters and possibly identify fraud.*

CONTROL AND RISK ASSESSMENT

Assessment of enterprise risks :

The underlying premise of enterprise risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to erode or enhance value. Enterprise risk management enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value. Value is maximized when management sets strategy and objectives to strike an optimal balance between growth and return goals and related risks, and efficiently and effectively deploys resources in pursuit of the entity's objectives. Enterprise risk management encompasses:

Aligning risk appetite and strategy **:**

Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.

Enhancing risk response decisions **:**

Enterprise risk management provides the rigor to identify and select among alternative risk responses – risk avoidance, reduction, sharing, and acceptance.

Reducing operational surprises and losses **:**

Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.

Identifying and managing multiple and cross-enterprise risks – Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.

Seizing opportunities :

By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.

Improving deployment of capital :

Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

These capabilities inherent in enterprise risk management help management achieve the entity's performance and profitability targets and prevent loss of resources. Enterprise risk management helps ensure effective reporting and compliance with laws and regulations, and helps avoid damage to the entity's reputation and associated consequences. In sum, enterprise risk management helps an entity get to where it wants to go and avoid pitfalls and surprises along the way.

Events – Risks and Opportunities

Events can have negative impact, positive impact, or both. Events with a negative impact represent risks, which can prevent value creation or erode existing value. Events with positive impact may offset negative impacts or represent opportunities. Opportunities are the possibility that an event will occur and positively affect the achievement of objectives, supporting value creation or preservation. Management channels opportunities back to its strategy or objective-setting processes, formulating plans to seize the opportunities.

Enterprise Risk Management Defined

Enterprise risk management deals with risks and opportunities affecting value creation or preservation, defined as follows:

Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

The definition reflects certain fundamental concepts. Enterprise risk management is:

A process, ongoing and flowing through an entity

Effected by people at every level of an organization

Applied in strategy setting

Applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk

Designed to identify potential events that, if they occur, will affect the entity and to manage risk within its risk appetite Able to provide reasonable assurance to an entity's management and board of directors

Geared to achievement of objectives in one or more separate but overlapping categories.

This definition is purposefully broad. It captures key concepts fundamental to how companies and other organizations manage risk, providing a basis for application across organizations, industries, and sectors. It focuses directly on achievement of objectives established by a particular entity and provides a basis for defining enterprise risk management effectiveness.

***Strategic* –** high-level goals, aligned with and supporting its mission

***Operations* –** effective and efficient use of its resources

***Reporting* –** reliability of reporting

***Compliance* –** compliance with applicable laws and regulations.

Enterprise risk management consists of eight interrelated components. These are derived from the way management runs an enterprise and are integrated with the management process. These components are :

Internal Environment – The internal environment encompasses the tone of an organization, and sets the basis for how risk is viewed and addressed by an entity's people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.

Objective Setting – Objectives must exist before management can identify potential events affecting their achievement. Enterprise risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.

Event Identification – Internal and external events affecting achievement of an entity's objectives must be identified, distinguishing between risks and opportunities.

Opportunities are channeled back to management's strategy or objective-setting processes.

Risk Assessment – Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.

Risk Response – Management selects risk responses – avoiding, accepting, reducing, or sharing risk – developing a set of actions to align risks with the entity's risk tolerances and risk appetite.

Control Activities – Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.

Information and Communication – Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.

Monitoring – The entirety of enterprise risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

Enterprise risk management is not strictly a serial process, where one component affects only the next. It is a multidirectional, iterative process in which almost any component can and does influence another.

Internal control is an integral part of enterprise risk management. This enterprise risk management framework encompasses internal control, forming a more robust conceptualization and tool for management. Internal control is defined and described in *Internal Control – Integrated Framework*. Because that framework has stood the test of time and is the basis for existing rules, regulations, and laws that document remains in place as the definition of and framework for internal control. While only portions of the text of *Internal Control – Integrated Framework* are reproduced in this framework, the entirety of that framework is incorporated by reference into this one.

INTERNAL CONTROL

Internal control has been defined by the Committee of Sponsoring Organisations of the Treadway Commission (COSO)-USA in *Internal Control – Integrated Framework,* as:

'A process, effected by an entity's board of directors, management and other personnel(people), designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations; (basic operational objectives, performance goals and safeguarding resources)*
- *Reliability of financial reporting*
- *Compliance with applicable laws and regulations.'*

Internal control is a management tool used to provide reasonable assurance that the organisation's objectives are being achieved efficiently. Internal control covers the whole system of controls, policies and procedures established by management to meet their targets and objectives.

The potential scope of Internal Audit is the whole system of internal control established by a organisation. This may include controls over all the organisation's activities, not just controls over financial accounting and reporting. Internal Audit should review all significant operational and management controls, including policies and procedures for the management of risk. However, Internal Audit should concentrate its efforts on the high risk areas and the most important internal controls.

Internal Audit work should go beyond the accounts to check that officials and others entrusted with resources are:

a) complying with applicable laws and regulations

b) achieving the objectives and desired services or benefits established by the organisation.

Internal Audit should be sufficiently independent from line management to ensure that Internal Audit's professional judgements and recommendations are objective and impartial. To be effective, Internal Audit needs to have adequate authority and report at a sufficiently senior level within the organisation. Internal Audit should also report to an Audit Committee and have a direct reporting line to the CFO/ CEO.

It is generally considered that Internal Audit should not report to a line manager if Internal Audit regularly reviews systems that this manager is directly responsible for.

For the individual Internal Auditor, objectivity is essential to ensure an attitude of mind characterised by integrity, steadfastness and an impartial approach to work. Objectivity may be impaired through familiarity both with systems and non-audit staff. This may occur if Internal Audit staff are involved with the same work assignments and ministerial officers for several years.

Internal Audit should take its authority and terms of reference from the Audit Committee and CFO/CEO to whom the Head of Internal Audit should report and have the right of direct access.

Internal Audit's terms of reference (or charter) should clearly outline the nature, objectives, responsibilities and scope of Internal Audit. Internal Audit's terms of reference should be approved by the Audit Committee subject to applicable legislation.

The written terms of reference for Internal Audit should clearly:

a) establish Internal Audit's position within the organisation

b) establish Internal Audit's right of access to all records (both electronic or otherwise), assets, personnel and premises, and its authority to obtain such information and explanations, as it considers necessary to fulfil its responsibilities

c) define the scope of Internal Auditing activities.

Objectivity is an independent attitude of mind that Internal Auditors should maintain when performing Internal Audit work. It is important that Internal Auditors always retain a critical edge in undertaking their work. Internal Auditors need to be sceptical in discussions with CFO/CEO and to obtain an adequate level of proof from Audit testing.

Objectivity requires Internal Auditors to carry out Audits in such a way that the quality of their work or their honest belief in the results of that work is not compromised.

Internal Auditors should not be placed in situations in which they feel unable to make objective professional judgements.

Internal Auditors should not be placed in situations in which they feel unable to make objective and impartial professional judgements. If any of the situations referred to below arise, Internal Auditors should inform their Head of Internal Audit so that alternative arrangements for the Internal Audit assignment may be made:

(a) Internal Auditors, notwithstanding their employment by the organisation, should be free from any conflict of interest arising either from professional or personal relationships or from pecuniary or other interests in an organisation or activity that is

subject to Audit.

(b) *Internal Auditors should be free from undue influences, which either restrict or modify the scope or conduct of his work or over-rule or significantly affect judgement as to the content of the Internal Audit report.*

(c) *Internal Auditors should not allow their objectivity to be impaired when Auditing an activity for which they have had authority or responsibility in the past.*

(d) *Internal Audit should be consulted about significant proposed changes to the internal control system or the implementation of new systems. Internal Audit may make recommendations on the standards of control to be applied without prejudicing Internal Audit's objectivity in reviewing those systems at a later date.*

(e) *Internal Auditors should not normally undertake non-Audit duties, but if they do, exceptionally, they should ensure that management understands that they are not then functioning as Internal Auditors.*

International best practice suggests that Audit Committees should be established. Audit Committees are generally considered to improve the independence of Internal Audit. Members of an Audit Committee, especially the chair, should be chosen so that they are sufficiently independent from the senior managers of the public sector organisation and so they are suitably experienced. An Audit Committee may deal with more than one organisation.

The role an Audit Committee with regard to Internal Audit is that it should:

- *approve Internal Audit's strategic and operational plans and review performance against them*
- *discuss with Internal Audit its findings and the responses of management to its major recommendations; and, periodically, its views on the overall quality of internal control*
- *consider the objectives and scope of any additional (non-audit work) work undertaken by the Internal Auditors to ensure there are no conflicts of interest and that independence is not compromised*
- *review the adequacy of the Internal Audit function, its adherence to professional standards, particularly independence, standing, scope, resourcing, its liaison with the Auditor- General and other review agencies and its reporting arrangements*
- *meet regularly two or three times a year and meet with the Internal Auditors at their request as they deem necessary*
- *be involved in the process of appointment or dismissal of the Head of Internal Audit*
- *periodically review the Internal Audit terms of reference.*

INTERNAL AUDIT INDEPENDENCE

Internal Auditors should be objective, and, as far as possible, operationally independent of the management of the public sector organisation.

Internal Audit independence should permit it to provide impartial and unbiased judgements that are essential for its proper function. Internal Audit independence should also ensure that the Head of Internal Audit can report without 'fear or favour' to all levels within the organisation. Internal Audit independence can be ensured through status and objectivity.

It is the responsibility of the CFO and the Audit Committee to ensure that conflicts of interest do not arise and that Internal Audit's objectivity and independence are not compromised. If the independence or objectivity of Internal Audit is impaired, in fact or appearance, the details of the impairment should be disclosed to the CFO and the Audit Committee.

STATUS

The Head of Internal Audit should be responsible to an individual with sufficient authority to promote Internal Audit independence and to ensure the broadest Internal Audit coverage, adequate consideration of Internal Audit reports and appropriate action on Internal Audit recommendations. Internal Audit needs the support of top management officials so that they can gain the co-operation of officers and perform their work without interference. Internal Audit should have a direct reporting line to the CFO/CEO and the Audit Committee.

The Head Internal Auditor should report to the CFO/CEO and an Audit Committee.

TERMS OF REFERENCE

Internal Audit should have written terms of reference (or charter) that are agreed by the CFO/CEO and the Audit Committee. These should clearly outline the nature, objectives, responsibilities and scope of Internal Audit. The Head of Internal Audit should actively seek to develop and obtain approval of such terms of reference. The terms of reference should be reviewed and revised, if necessary, at least every three years.

The terms of reference for Internal Audit should include the requirement for Internal Audit to have the access, to all personnel, records, assets and property that Internal Audit considers necessary for it to undertake its work effectively.

The position of Internal Audit should be categorised specifically as a *Staff* function as opposed to all *Line Functions*. Internal Auditors should not supervise or manage other sections or activities. If Internal Auditors perform non-audit work they are not functioning as Internal Auditors. Performance of such activities is presumed to impair Internal Audit objectivity. Therefore, the Internal Auditor should not undertake executive functions outside their divisional activities.

The position of Internal Audit within the organisation should be high enough to ensure that there is no impairment of Internal Audit scope.

The term objectivity includes the requirement on the part of Internal Auditors to have an independent mental attitude to the performance of their work. Objectivity should ensure that Internal Auditors have an honest belief in their work product and that no significant quality compromises are made.

Internal Auditors should not be placed in any situation where they feel unable to make objective professional judgements. Objectivity may be impaired through familiarity, with both systems and officers. This may be created by Internal Audit staff being involved with work assignments for too long a period of time. In order to maintain maximum awareness and motivation amongst Internal Audit staff, work assignments should be rotated on a planned basis. Transfers of Internal Audit staff between public sector organisations are to be recommended, every few years, where possible.

Internal Audit assignments should be undertaken in such a way that there is no potential or actual conflict of interest. Internal Audit staff should not undertake Audits of systems if they worked in this area in the last year. Internal Audit staff should declare any conflict of interest that may arise.

Recommending standards of control for new systems or reviewing procedures before they are implemented is part of Internal Audit work. However, designing, installing and operating systems is not an Internal Audit function. Performing such work is presumed to impair Internal Audit objectivity.

The Head of Internal Audit should effectively manage Internal Audit to ensure it adds value to the public sector organisation and to ensure that:

(a) Internal Audit work fulfils its terms of reference

(b) Resources for Internal Audit are used efficiently and effectively

(c) Internal Audit staff undergo suitable professional development

(d) Internal Audit work conforms to approved standards

(e) The morale of Internal Audit staff is developed and maintained.

The Head of Internal Audit should submit periodic activity reports to the Accounting Officer and the Audit Committee. These reports should compare:

(a) actual performance with goals and Internal Audit plans

(b) actual expenditures with financial budgets.

The Head of Internal Audit should explain major variances (positive or negative) together with action taken to address these.

The Head of Internal Audit should ensure that Internal Audit staff are provided with a suitable Audit Manual including written policies and procedures to guide them with their work. This guidance should also include programmes for particular Internal Audit assignments. The Internal Audit programmes should specify reporting lines at each level of management.

The Head of Internal Audit should ensure that the work of all levels of Internal Audit staff is effectively supervised from planning to conclusion. This supervision should include:

(a) provision of suitable instructions and guidance at the outset of an Internal Audit assignment and approving the Audit programme

(b) seeing that the approved Audit programme is carried out unless deviations are both justified and authorised

(c) ensuring that Internal Audit staff understand the work to be undertaken and obtain and document sufficient relevant and reliable audit evidence

(d) determining that Internal Audit objectives are being met.

MANAGEMENT REVIEW

All Internal Audit working papers and reports should be reviewed by Internal Audit managers before the reports are released. This review should include:

(a) determining that Audit working papers adequately support the Audit findings, conclusions and report

(b) making sure that Audit reports are accurate, objective, clear, concise, constructive and timely.

Internal Audit working papers should show clear evidence of this management review.

QUALITY ASSURANCE APPRAISALS

There should be periodical reviews of Internal Audit performance to ensure that its performance and value to the management of the organisation is maximized and to ensure compliance with appropriate standards and guidance.

The Head of Internal Audit should establish and maintain a quality assurance programme to evaluate the operations of Internal Audit. This programme should provide reasonable assurance that Internal Audit work conforms to relevant standards and these *Internal Auditing Guidelines*. It should also ensure that Internal Audit adds value by improving internal control. This quality programme should include:

(a) supervision

(b) internal review

(c) external review.

Internal reviews should be performed periodically by senior Internal

Audit staff to appraise the quality of the Internal Audit work that is undertaken in all organisations.

On completion of such reviews, formal written reports should be issued to the relevant CFO/CEO and the Audit Committee. These reports should express an opinion on Internal Audit's compliance and, where necessary, should include recommendations for improvement.

PROFESSIONAL PROFICIENCY

In carrying out their duties Internal Auditors should exercise due professional care, that is competence based on appropriate experience, training, ability, integrity and objectivity.

Due professional care is defined as carrying out Internal Audit work with competence and diligence. Due care does not mean infallibility. Consequently Internal Auditors cannot provide absolute assurance that non-compliance or irregularities do not exist.

However, it will be incumbent upon the Internal Auditor to consider the effect of significant weaknesses in the systems under review and evaluate the possibility of material irregularity or non-compliance with the legislation and regulations when undertaking Internal Audit. Professional care requires the use of Audit skills and judgements based on appropriate experience, training, ability, integrity and objectivity. The level of professional care to be exercised should be appropriate to the objective and complexity of the Internal Audit work being performed.

In order to demonstrate due professional care, Internal Auditors should be able to show that their work has been performed in the manner which meets the criteria set or specific departmental policies.

Internal Audits should be performed by, or supervised and controlled by, Audit staff who have the technical skills, experience and perspective which will enable them to comply with these Guidelines. This is necessary to maintain Internal Audit's credibility as a dependable instrument of management.

The Head of Internal Audit should therefore ensure that Audit staff have the capacity to meet the responsibilities identified by the terms of reference agreed with the Audit Committee and the CFO/CEO.

The Head of Audit should ensure that all Internal Audit staff are reminded of their ethical responsibilities and also ensure that their declarations of interest are reviewed, and where appropriate, updated at least once a year.

Internal Auditors should not accept any gift or inducement from an officer, worker, supplier or other third party. Information acquired by Auditors in the course of their work should not be used for unauthorised purposes or for personal benefit or gain.

Internal Auditors should only accept hospitality when this is consistent with the public sector organisation's documented arrangements.

The most important source of information for Internal Auditors is the staff working within the area subject to Audit. These officers know how the system actually operates and should have a reasonable idea of how practical any improvements may be. Thus interviewing skills are essential for all Internal Auditors. Internal Auditors need to be able to understand what may be a complex system. Internal Auditors also need to be able to critically assess each stage of the process. Why is its performed? Could it be undertaken more efficiently?

Staff who operate the system will know what they do, but not necessarily why they do it.

They may also try and explain the system in the most positive light. The skill of Internal Auditors is to enable all the staff they interview to open up and describe what they actually do (not just what they think they should do) and to identify any aspects they think could be improved.

Understanding why each step taken is more difficult. Staff may just do it "because we've always done it that way" or even worse "because the Auditors told us to"!

An experienced Internal Auditor will ensure that the staff they talk to are relaxed and so describe the system, its bad points as well as the good points. They will also challenge the staff to ensure that they describe what actually happens and through discussion ascertain whether any improvements are possible and practical.

RELATIONSHIPS

Management and staff at all levels should have confidence in the integrity, independence and capacity of Internal Audit. This should be reflected and maintained in good working relationships between Internal Auditors and the staff in the sections that they review.

The Head of Internal Audit should seek to foster and maintain constructive working relationships with stock verifiers, fraud investigators, inspectors and any other review staff.

Consultations between Internal Audit and review staff should lead to effective coordination and minimise duplication of work.

Internal Audit should not improperly disclose any information obtained during the course of their work. Permission should be provided by senior management before any information is passed outside the organisation. Internal Audit will, quite properly, reveal to appropriate responsible parties all material facts they have established which, if not so revealed, may prevent the uncovering of unlawful acts or could distort Audit reports.

The passing of this information should be treated as confidential and legally privileged. That is the Internal Auditor will be exempt from any legal liability from the passing of such information.

It is important for Internal Audit to market the services it can provide to managers. This could include producing leaflets and making presentations to CFO/CEOs and other senior officers on the services, assistance and role that Internal Audit can play.

The relationship between Internal Audit and the Audit Committee needs to take account of their differing roles and responsibilities. Internal Audit is an independent appraisal function within the organisation and Internal Auditors are direct employees and at times a external practitioner.

The aim should be to achieve mutual recognition and respect, leading to a joint improvement in performance and the avoidance of unnecessary overlapping of work. It should be possible for the Statutory Auditor and the Head of Internal Audit to rely on each other's work, subject to limits determined by their different responsibilities, respective strengths and special abilities.

Consultations should be held and consideration given to whether any work of either Auditor is adequate for the purpose of the other.

The Head of Internal Audit should seek, where appropriate, co-ordination of the plans of Internal Audit with those of the Statutory Audit and the programme of, for example, stock verifiers. This co-operation should promote the most effective total audit coverage and should avoid duplication of work. The Statutory Auditor will have to decide if they can place reliance on the work of Internal Audit and so reduce the amount of work undertaken by their own staff.

The Head of Internal Audit should meet with Statutory Auditor to:

- *discuss work plans for Internal Audit and the Statutory Audit.*
- *agree and review the performance of the work relied on*
- *evaluate the relationships with the Statutory Audit and report as required to the CFO/CEO and Audit Committee on this relationship*
- *agree access to each other's audit programmes and working papers*
- *exchange audit reports and management letters*
- *enhance understanding of each other's audit techniques and methods*
- *discuss any other matters of mutual interest.*

INTERNAL AUDIT PLANNING

Internal Audit work should be planned at all levels of operation in order to establish priorities, achieve objectives and ensure the efficient and effective use of Audit resources.

Planning should be based on Internal Audit's terms of reference and allow for coverage of all significant systems, operations, staff and sites within the public sector organisation.

Internal Audit plans should be based on a comprehensive understanding of the organisation and the way in which it operates. High-risk systems or transactions and any known problem areas should be clearly identified. The emphasis of the Internal Audit plan should be directed towards these systems.

Internal Audit plans should be developed in consultation with senior staff and the relevant CFO/CEO. The appropriate Audit Committee should then approve the Internal Audit plans.

Internal Audit planning should include the following steps:

- *Identify all auditable activities within the agreed scope of Internal Audit*
- *Carry out a risk assessment on these activities in conjunction with management, identifying categories such as high, medium, low*
- *Prepare an audit needs assessment based on the risk assessment.*
- *Develop an overall strategic plan from the audit needs assessment to cover these risks, over, say, a three-year period*
- *Bring to the CFO/CEO and/or the audit Committee's attention*

any mismatch between Audit needs and actual Audit resources • identify systems to be covered in the first year of the strategic plan and prepare an annual Internal Audit plan

- *Discuss the strategic and annual plans with appropriate senior managers, CFO/CEO and the Audit committee and amend as necessary*
- *Present the plans to the CFO/CEO and/or the Audit Committee for approval.*

Internal Audit plans should be amended as necessary to take account of changing circumstances. The CFO/CEO and the Audit Committee should formally approve all significant changes to the Internal Auditor.

APPROACHES TO INTERNAL AUDIT

There are several different approaches to Internal Audit. International best practice suggests that systems audit is the most effective way that Internal Audit can add value to an organisation. However, it is considered necessary for Internal Audit to complement systems audit with a pre-audit approach. If a pre-audit approach is adopted the Head of Internal Audit, the Audit Committee and the CFO/CEO should discuss the extent that this is necessary. They should also consider suitable means of reducing the proportion of time that Internal Auditors spend on pre-audit work.

The systems approach to Internal Audit seeks to assess and improve the effectiveness of the organisation's internal control system.

The prime purpose of a systems Audit should be to evaluate the extent to which the system may be relied upon to ensure that the objectives of the system are met.

Where internal controls are not adequate and reliable Internal Audit should make practical recommendations to ensure that these controls are improved.

Internal Audit evidence should be adequate to meet the objectives of Audit assignments.

Internal Auditors should be satisfied with the nature, adequacy and relevance of Audit evidence before placing reliance on that evidence. Information should be collected analysed and documented by the use of appropriate Audit techniques.

The production of Audit evidence should be supervised and reviewed by the Head of Internal Audit. To meet an acceptable standard the *evidence should be sufficiently adequate and convincing to the extent that a prudent, informed person would be able to appreciate how the Auditor's conclusions were reached.*

Internal Audit may also complement its systems approach with other techniques, for example:

- *Performance auditing*
- *Control self assessment*
- *Advice and assistance on control issues*
- *Helping with risk management.*

Conclusions are the Internal Auditor's evaluations of the effects of the findings on the particular system reviewed. They should:

- *Put the findings in perspective based on the overall implications and significance of the weaknesses identified*
- *Identify the extent to which the system's control objectives are being achieved and the degree to which the internal control systems should ensure that the goals and objectives of the organisation are accomplished efficiently.*

Management should be required to respond in writing to each Internal Audit report.

Management and Internal Audit should agree officer responsibility and target dates for implementation of agreed recommendations. The responsibility for final editing of Audit reports should remain with the Head of Internal Audit who should always retain the right to issue reports without further editing.

Follow-up activity is the process by which Internal Audit confirms *that agreed recommendations have been implemented by line managers. Internal Audit should periodically follow up Audit reports to review and test the implementation of agreed Internal Audit recommendations.*

The Head of the Internal Audit should submit to the CFO/CEO and Audit Committee, at agreed intervals, a report of Internal Audit activity and results. The report should compare actual Internal Audit activity against the annual Internal Audit plan and should clearly indicate the extent to which the total Internal Audit needs of the public sector organisation have been met.

In the annual Internal Audit report the Head of the Internal Audit should give a formal opinion to the CFO/CEO and Audit Committee on the extent to which reliance can be placed on the organisation's internal control system. The attention of the CFO/CEO and Audit Committee should be drawn to any major Internal Audit findings where action appears to be necessary but has not been undertaken.

References

1. *Enterprise Risk Management... Integrated Framework... Executive summary by Committee on sponsoring organization of Treadway Commission.*

2. *Internal Audit finding its way...Public Financial Management...World Bank Institute.*

3. *Internal Audit Guidelines..*

Eastern and Southern Africa Association of "Accountants General"

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INSTITUTE PUBLICATIONS

A. GUIDELINES/GUIDANCE NOTES ON

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A Source Book for Tax Audit	100
Anti-dumping, Countervailing and Safeguard Duties under WTO Relevance for Cost & Management Accountants	200
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Guidance Note on Valuation Audit under Central Excise Law (Revised Edition 2006)	100
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Guidance Notes	
Cost of Production for Captive Consumption	200
Internal Audit	200

B. RESEARCH PUBLICATIONS

An Analysis of the Cost Behaviour with respect to Indian Industry	150
Corporate Capital Structure and Cost of Capital	50
Corporate Governance and Management Audit	250
Economic Value Added: A tool for Business Planning	400
Farm Management Accounting and Control	70
Financial Asset Replacement	10
Glossary of Management Accounting Terms	100
Human Resource Accounting	
Inflation Accounting as a Tool to Fight Inflation	35
Management Accountant and The Computer	
Management and Accounting for Research And Development- The Indian Praxis	125
Management Information Report for Operating Managers	150
Mutual Funds in India	200
Profit Planning	60
Research Bulletin (Biannual each issue)	100

C. INDUSTRY-WISE PUBLICATIONS

Cost Accounting Records Rules And Cost Audit (Report) Rules:

Cycle Industry (Revised, 1999)	100
Cement Industry (Revised,2004)	150
Automobile Battery Industry	50
Tyre and Tube Industry	50
Tractor Industry	50
Motor Vehicles Industry(Revised,1999)	100
Room Air-Conditioners Industry	50
Refrigerator Industry	50
Electric Fan Industry	50
Aluminium Industry	50
Vanaspati Industry	50
Industrial Alcohol (Revised, 1999)	100
Sugar Industry(Revised,1999)	100
Paper Industry	50
Textile Industry(Revised Ed.2001)	150
Soda Ash Industry	50
Jute Industry	50
Rayon Industry(Revised Ed.2001)	150
Dry Cell Battery Industry	50
Power Driven Pump Industry	50
Electric cables and conductors Industry	50
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Steel Tubes & Pipes Industry	50
Formulation Industry	50
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Nylon industry(Revised Ed.2001)	150
Infant Milk Food Industry	50
Caustic Soda (Revised,2004)	150
Dyes (Revised,2004)	150
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D. COST ACCOUNTING STANDARDS(CAS)

Classification of Cost (CAS-1)	30
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