



# **Internal Audit - Module 1**

***(ADVANCED CERTIFICATE COURSE IN INTERNAL AUDIT)***

**ACIA**

May 28, 2022

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# Agenda- Introduction to Internal Audit

- ◆ **Module 1- PART 2**
- ◆ Internal Audit of Cost Records
- ◆ Role of Internal Auditor as a Management Member
- ◆ Role of Cost Accountant as an Internal Auditor
- ◆ Guidance Notes on Internal Audit
- ◆ **Case Studies**

# Part A = IAAS 11

- ◆ **IAAS 11 – INTERNAL AUDIT OF COST RECORDS**
- ◆ This standard explains the significance of including internal audit of cost records in the internal audit charter and the role of Chief Internal Auditor to provide assurance to the Audit Committee and Board on the effectiveness of cost accounting system, cost flow process, control mechanism, and reporting framework
- ◆ **Requirements**
- ◆ 1.1 ***The scope, functions, and activities of internal audit as embedded in the internal audit charter approved by the Audit Committee/Board must include internal audit of cost accounting records of the entity, besides audit of financial records, operations, internal financial controls, legal & regulatory compliance, risk management, governance process, etc.***
- ◆ **Assist the external Cost auditors**
- ◆ **Processes /functions**
- ◆ A. Procure to Pay
- ◆ b. Order to Cash
- ◆ c. Inventory
- ◆ d. Fixed Assets
- ◆ e. Investments and Borrowings

- ◆ MCA , Government of India has notified The Companies (Cost Records and Audit) Rules, 2014. Form CRA-3 prescribes Form of the Cost Audit Report.
- ◆ The certificate from the cost Auditor includes clause (v) which reads as under
- ◆ “(v) In my/our opinion, the company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.”
- ◆ **Companies (Cost Records and Audit) Rules 2014 provides that**
- ◆ (a) The cost records shall be maintained on regular basis;
- ◆ (b) The cost records should be maintained for units and branches; and
- ◆ (c) It should facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.
- ◆ requirement under law is = records should enable preparation of cost statements for all its products & services on monthly or quarterly or half-yearly or annual basis.
- ◆ Audit requirements of reporting to Government are annual wherein the cost auditor is required to certify whether the company has adequate system of internal audit of cost records which is commensurate to its nature and size of its business
- ◆ Responsibility of the Internal Cost Auditor to check adherence to the Principles laid down in CRA-1, CAS and GACAP.

- ◆ The internal audit must provide assurance to the Audit Committee and Board relating to reliability of financial management and reporting, efficiency of operations, internal control systems, processes and governance, effectiveness of cost accounting system, cost flow process, cost reporting framework, and compliance with various laws and regulations.
- ◆ 1.3 The internal auditor must use :
  - ◆ the product & service unit-wise,
  - ◆ SKU-wise,
  - ◆ business vertical-wise, and
  - ◆ customer group-wise cost data to evaluate efficiency, productivity, & effectiveness of a plant, department, function, technology, process, product, activity, machine, material, customer, market, etc. with the objectives to review & design business strategy for enhanced value creation and sustainability.
- ◆ 1.4 The internal audit of the cost records must assure the management that the cost information, which is the basis of their evaluation of performance, risk management and control, is reliable and reported timely.

- ◆ 1.5 The work of internal audit function relating to cost analytics and performance optics may be used by the external auditors after evaluating the following:
- ◆ (a) The extent to which organizational status and relevant policies and procedures of the internal audit function support the objectivity of the internal auditors;
- ◆ (b) The level of competence of the internal audit function;
- ◆ (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control;
- ◆ (d) Whether the work of the internal audit function had been properly planned, performed, supervised, reviewed, and documented;
- ◆ (e) Whether sufficient appropriate evidence had been obtained to enable the internal audit function to draw reasonable conclusions; and
- ◆ (f) Whether conclusions reached are appropriate in the circumstances and the reports prepared by the internal audit function are consistent with the results of the work performed.

# Application Guidance: IAAS 11

- ◆ The chief internal auditor must have:
- ◆ adequate understanding and knowledge of the entity,
- ◆ its size, nature of activities,
- ◆ business processes, major inputs & outputs,
- ◆ key personnel,
- ◆ regulatory set-up,
- ◆ applicable cost and financial reporting framework,
- ◆ internal control systems,
- ◆ risk management policy,
- ◆ IT architecture, etc.
- ◆ 1.7 The purpose of maintaining robust cost accounting system, cost data analysis & reporting, and performance analysis is to determine whether the entity is performing well and to identify areas, activities, processes, products, services, etc. that requires improvement
- ◆ The cost performance data aims to discover various drivers of costs and profitability and their impact on the performance variables with the objective of helping the entity to improve margins and profitability; to optimize resource allocation and utilization thereof; to optimize the product and services portfolio; to monitor performance of the entity in various areas; and to know whether the management is meeting its set goals & objectives.



# Regulations

- ◆ Section 148 of Companies Act, 2013 provides for prescribed class of companies to maintain cost records and audit of these records. As part of these provisions, Central Government notified the Companies (Cost Records and Audit) Rules, 2014.
- ◆ These Rules require the cost auditor to certify whether or not, based on his opinion -
- ◆ *the company has adequate system of internal audit of cost records which to his opinion is commensurate to its nature and size of its business.*
- ◆ *Therefore, the internal audit scope must include audit of cost records of the entity, irrespective of its inclusion/ exclusion from the requirements under Companies Act, 2013*



# Coverage of records & data- IAAS 11

- ◆ The cost accounting requires 3-dimensional data viz. quantity, rate & value, compared to the financial accounting that largely require one dimensional data viz. values only.
- ◆ Further, the cost accounting system also requires distinct identification of products/services, product lines, cost centers, etc.
- ◆ Hence, cost records are different from the financial records, though some books and records are common to both.
- ◆ Therefore, internal audit of cost records would require not only the audit of common books of account and records, but also the specific books and records covering the following areas:
  1. Capacity Determination;
  2. Production Records;
  3. Sales Records;
  4. Materials Cost
  5. Employee Cost;
  6. Utilities;
  7. Direct Expenses;
  8. Repairs and Maintenance;
  9. Overheads - Production Overheads, Administrative Overheads , Selling & Distribution OH

# Cost heads

- ◆ Transportation Cost;
- ◆ Royalty and Technical Know-how;
- ◆ Research and Development Expenses;
- ◆ Quality Control Expenses
- ◆ Pollution Control Expenses;
- ◆ Service Department Expenses; Packing Expenses;
- ◆ Interest and Finance Costs;
- ◆ Fixed Assets and Depreciation;
- ◆ Work-in-Progress and Finished Stock;
- ◆ Records of Physical Verification;
- ◆ Captive Consumption; By-Products and Joint Products;
- ◆ Adjustment of Cost Variances;
- ◆ Reconciliation of Cost and Financial Accounts;
- ◆ Related Party Transactions;
- ◆ Expenses or Incentives on Exports; and Cost Statements

# Part B = Role of IA as Management Member

## ◆ Profile Summary :

1. to supervise extensive Internal audits / IT audits on SAP/ JDE/ Oracle/ Peoplesoft etc software to authenticate the system, process controls & workflows , Fraud Risk Assessment & need based investigative audits.
2. setting up a comprehensive Risk Based Internal Audit program & execute audits
3. conduct Risk assessment study of all the business verticals & coordinate & facilitate Risk Mitigation initiatives across the organization
4. issuance of reports to the management after full buy in of the process owners & business CEO's and present the audit findings and the Risk Mitigation plans in the quarterly Board Audit Committee of independent directors
5. ensures implementation of agreed audit action plans
6. responsible for drafting & change management of Standard Operating procedure document & Delegation of Power Document across all business verticals,
7. Drive process reengineering initiatives from the intelligence gathered in the audit & risk management study & Crisis Management

# Major Area covered & supervised in Internal Audit:

- ◆ - Procurement audit
- ◆ - Production Audit
- ◆ - Accounts Payable , Accounts receivable
- ◆ - HR & Admin audit
- ◆ - Direct taxes & Direct tax Review
- ◆ - Sub-contractors audit
- ◆ - Related party transaction
- ◆ - Working capital audit
- ◆ - Review of budget Vs Actual expenditure and variance analysis.
- ◆ - Margin Analysis – Bidding estimates Vs Actual expenditure
- ◆ - Optimum utilization of Own P&M and Hired equipment
- ◆ - Inventory Audit
- ◆ - Scrap generation & disposal
- ◆ - Process Audit & Risk Assessment
- ◆ - Risk register updating
- ◆ - Treasury audit

# ICAI Guidance Note on Internal Audit

- ◆ Issued in 2009
- ◆ **INTERNAL AUDIT**
- ◆ **PART I –FRAMEWORK**
  - GLOBAL TO INDIAN CONTEXT
  - COSO PRINCIPLES OF INTERNAL CONTROL
  - EVOLUTION IN INDIAN CONTEXT
  - FRAMEWORK
- ◆ **INTERNAL AUDIT**
- ◆ **PART II – GUIDANCE DOCUMENT**
  - DEFINITIONS
  - OBJECTIVES OF INTERNAL AUDIT
  - CONTROL & RISK ASSESSMENT
  - INTERNAL CONTROL
  - INTERNAL AUDIT INDEPENDENCE
  - MANAGEMENT REVIEW
  - INTERNAL AUDIT PLANNING
- ◆ APPROACHES TO INTERNAL AUDIT

# GN on IA – Extracts ( ICAI)

## ◆ 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.*
- ◆ 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 = 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 & Audit Committee.
- ◆ The Head Internal Auditor should report to the CFO/CEO and an Audit Committee



# GN on IA – Extracts : 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 3 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.
- ◆ IA **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.

# GN on IA – Extracts

- ◆ 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.

# GN on IA – Extracts

- ◆ The Head of Internal Audit should effectively manage Internal Audit to ensure it adds value to the organisation and to ensure that:
  - ❑ Internal Audit work fulfils its terms of reference
  - ❑ Resources for Internal Audit are used efficiently and effectively
  - ❑ Internal Audit staff undergo suitable professional development
  - ❑ Internal Audit work conforms to approved standards
  - ❑ 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:
  - ❑ actual performance with goals and Internal Audit plans
  - ❑ 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.

# GN on IA – Extracts

- ◆ 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:
  - ◆ *provision of suitable instructions and guidance at the outset of an Internal Audit assignment and approving the Audit programme*
  - ◆ *seeing that the approved Audit programme is carried out unless deviations are both justified and authorised*
  - ◆ *ensuring that Internal Audit staff understand the work to be undertaken and obtain and document sufficient relevant and reliable audit evidence*
  - ◆ *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:
  1. *determining that Audit working papers adequately support the Audit findings, conclusions and report*
  2. *making sure that Audit reports are accurate, objective, clear, concise, constructive and timely.*
  3. *Internal Audit working papers should show clear evidence of this management review.*

# GN on IA – Extracts - QAIP

## ◆ 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:
  - ❖ supervision
  - ❖ internal review
  - ❖ external review.
  - ❖ 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.*
- ◆ *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.*

# GN on IA – Extracts : Interacting with staff & interview skills

- ◆ 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 it 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 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 “because the Management told us to”!
- ◆ 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 may also evaluate through discussion whether any improvements are possible



# GN on IA – Extracts

## ◆ 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.

## CMA as a internal auditor

Basically, CMA can do entire Internal Audit

- ▶ A CMA having thorough knowledge of each and every aspect of Product cost and Service cost can certainly play a vital role in adding value :
  - Validation of costs – procurement of materials and services
  - By identifying and reporting non value adding activities
  - Validation of product pricing strategies and components of cost
  - Validation of sales mix w.r.t margin analysis
  - By identifying the areas where tax benefit can BE availed etc.

# ACIA Exam – oriented MCQ

- ◆ 1. Internal Audit is?
- ◆ A. An Art
- ◆ B. A Science \_
- ◆ C. Profession
- ◆ D. All of these
- ◆ ans - D
- ◆ 2. When the Internal auditor suspects that fraud may be present, he / she should:
- ◆ A.. terminate his involvement with sufficient notice given to the client.
- ◆ B. issue an adverse opinion.
- ◆ C. obtain additional evidence to determine whether material fraud has occurred and modus operandi .
- ◆ D. suggest management to suppress the matter
- ◆ Ans - C

◆ 3. Internal Audit is required under which of the regulators in India ?

◆ A. SEBI

◆ B. MCA

◆ C. RBI

◆ D. All the above

◆ Ans - D



◆ 4. The internal audit of a Company is conducted -

A As required under the Companies Act, under section 138

B. at the instruction of MCA

◆ C. at the direction of CAG

D. none of the above

◆ Ans - A

- ◆ 5. Fraudulent financial reporting may be accomplished through the manipulation of:
  - ◆ A. assets.
  - ◆ B. revenues.
  - ◆ C. liabilities.
  - ◆ D. all of the above
- ◆ Ans - D
- ◆
- ◆ 6. Which party has the primary responsibility to formulate and oversee an organization's financial reporting and internal control processes?
  - ◆ A. The CEO
  - ◆ B. The Board and Audit committee
  - ◆ C. The CFO
  - ◆ D. The internal auditor
- ◆ Ans - B

◆ 7. Payment to vendors who are not on approved list is a

◆ A. Management red flag

◆ B. Red flag in purchase

◆ C. Red flag in payroll

◆ D. Red flag in Accounts Receivables

◆ ans – B

◆ 8. Which of the following is excluded in the scope of Internal audit ?

◆ A. Business transactions

◆ B. Compliance with laws

◆ C. financial statement audit

◆ D. review of internal controls

◆ Ans - C

- ◆ 9. Weak internal controls in an organization will affect which of the following elements of fraud?
  - ◆ A. Motive
  - ◆ B. Opportunity
  - ◆ C. Rationalization
  - ◆ D. None of the above
- ◆ ans - B
  
- ◆ 10. The “5 Threats” for auditors, excludes -
  - ◆ A. Self review
  - ◆ B. Self interest
  - ◆ C. Related party
  - ◆ D. Familiarity
- ◆ Ans - C