

# Diploma in Financial Management & Accountability

- A joint initiative of TISS & FMSF

## Course Material



Audit

Paper - VII

Module - IV

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<b>UNIT- 8</b> <b>BEST PRACTICES - INTERNAL AUDIT</b>
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**8.1. INTRODUCTION**

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilization of all available resources, within the legal, socio, economic and environmental constraints. To achieve optimum utilization of resources, management should determine the goals and objectives of the concern, quantify them to the extent possible, develop major policies and plans, implement them and exercise control over such implementation.

Many modern enterprises have become huge and sophisticated this has resulted in decentralization of their activities and consequently the top management is remotely concerned with the day-to-day activities of the concern. In this context internal auditing has acquired a great deal of significance.

**8.2. NATURE AND SCOPE OF INTERNAL AUDIT**

Internal Audit has seen many changes from the days when its basic purpose was to check arithmetical accuracy or to ensure that the accounting and allied records have been properly maintained or vouching of payments or to ensure that the assets of the enterprise have been properly safeguarded and that the policies and procedures laid down by the management have been complied with.

Though the underlying philosophy remains intact, its modern concept and innovative approach have lent added importance to its role and responsibilities. According to contemporary internal auditing, it is expected to provide an assurance to the top management about the integrity, objectivity and credibility of financial statements and other corporate activities.

Internal auditing, therefore, is not merely an examination of financial records, but is a tool of management control which measures and evaluates the effectiveness of all other controls.

The modern concept suggests that the scope of internal auditing may be extended to the task of reviewing whether the resource utilization of the enterprise is efficient and economical. This would necessitate a review of all operations of the enterprise as also an evaluation of the effectiveness of the management. This is because of various factors as also discussed in the preceding paragraphs such as increasing complexities of management, decentralization, sophistication, incidence of number of laws etc. All these have resulted in vastness and complexity in financial transaction and decentralization of activities and functions. This has led to remoteness of top management of an enterprise from its day -to- day activities. The management therefore looks for some one who on their behalf can look after the various activities and functions are being carried out in a satisfactory manner and in consonance with management objectives and policies.

This function exactly befits the role of modern internal auditor.

### **8.3. DEFINITION - INTERNAL AUDIT**

The definition of Internal Audit given in the statement of responsibilities of internal Auditors, Issued by the Institute of Internal Auditors Inc.U.S.A(IIA), reads as under:

“Internal Audit is an independent and 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 process.” IIA further states that internal audit activities are performed by persons within or outside the organization.

The Institute of Chartered Accountants of India (ICAI) has defined this term in a more explicit manner as given below:

Internal Audit is an independent appraisal activity, within an enterprise whether by the Staff of the enterprise or by a firm of accountants appointed for that purpose for the review of accounting, financial and other operations and controls as a basis

for service to management .It involves a specified application of the techniques of auditing”

From the above definitions it is evident that modern internal auditing is a control function and is not confined only to review of financial transactions, It at the same time covers the following:

- **Independent, Objective Activity:** This implies that internal auditors should not participate in any activity that may impair or be presumed to impair their unbiased assessment.
- **Performed by Persons within or outside the Organization:** IIA recognizes that as the scope of internal audit services expands, it would become increasingly difficult to maintain the diverse range of relevant skills within the organization at reasonable cost.
- **Assurance and Consulting:** Earlier definitions of internal auditing considered it primarily to be an 'assurance' activity only. Now, both 'assurance' and 'consulting' are considered to be a part of internal auditing. As earlier, the term 'assurance' implies that internal auditor should provide an assessment of the reliability and relevance of data, compliance with laws, regulations, policies and procedures, and efficiency and effectiveness of operations. Thus, the new definition continues to include all traditional internal audit areas like financial audit, compliance audit, operational audit, etc. The term 'consulting' refers to the use of problem-solving methodologies to make direct improvements. The new definition thus looks at internal auditing as a combination of consultative and assurance services in the areas of control, risk management and governance.
- **Adding Value:** The definition emphasizes that all types of internal audits add value. For example, compliance audits add value by keeping the management/those incharge of governance informed about the effectiveness of control structure. Internal audit should strive to add value more directly through efficiency audits and consulting in the areas of control, risk management and governance.
- **Organizational Objectives:** The definition aligns internal audit with the organization's critical success factors and core processes. This implies that

internal auditors should view problems and solutions from the broader perspective of the entire organization and not from the narrow perspective of a single functional area.

- **Systematic and Disciplined Approach:** It is emphasized that internal audit should be driven by a systematic and disciplined approach based on strict adherence to well-defined professional standards.
- **Risk Management, Control and Governance Processes:** The definition lays down the boundaries of internal auditing as those including risk management and control, and 'corporate governance.

#### 8.4. SCOPE OF MODERN INTERNAL AUDITING

In its International Standards for the Professional Practice of Internal Auditing, IIA states that "Internal audit activity should evaluate and contribute to the improvement of risk management, control and governance processes using a systematic and disciplined approach"

These can be summed up as below:

**8.4.1. Review of internal control system and procedures:** Internal Control system is formulated and installed by the management for the smooth and economic conduct of the activities. The internal auditor should determine whether the internal control system is in consonance with the organizational structure as far as possible , control should be in-built in the operating functions, if they are to cost effective. He should also determine the adequacy and effectiveness of the internal controls.

Also each control should be reviewed and analyzed in terms of its cost and benefits. It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal control for a specific portion of intended reliance would need special attention.

**8.4.2. Review of Compliance with Policies, plans, procedures and regulations:** Internal auditors should review the systems established to ensure compliances with those policies, plans, procedures, laws, contracts and regulations which could have a significant impact on operations and reports and should determine whether the organization has complied with them or not. The Internal auditor:

- Should examine whether the management has a system by which its policies, plans and procedures are communicated to all concerned,
- The information given to each person should be appropriated to his responsibility and authority
- The information should be in adequate detail to enable him to programme and conduct his own work within the framework of the relevant policies and in accordance with the prescribed procedures in order to achieve that part of the enterprise plan with which he is concerned
- Should examine whether management formulates the major accounting policies after due regard to their effect on the financial statements both present and future
- should also examine the system of periodical review of existing policies particularly when there is change in the method and nature of the organization.
- By combining the results of his review of the adequacy of the system with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former.
- Existence of effective system is important since non- compliance may entail serious legal consequences. Moreover, the cost of compliance with legal and regulatory requirements can be optimized through proper systems.

**8.4.3. Review of custodianship and safeguarding of assets:** The objective of the management is to ensure that the assets are reasonably protected against loss and that they are properly managed and accounted for. In this context the internal auditor should review the control systems to ensure that the assets are fully accounted for. The system of safeguarding assets should be evaluated to assess the risk of losses from theft, fire, improper

activities and exposure to elements of nature. The internal auditor should also verify the existence of assets.

**8.4.4. Review of accomplishment of goals and objectives:** The success of management can be judged by the extent of achievement of goals and objectives of the organization. The entire organization should work towards the attainment of its objectives and goals, and the internal auditor serves as a medium to review the overall objectives and to find out whether the same are attainable or not.

**8.4.5. Review the utilization of resources:** Management is interested in ascertaining the efficiency and economy with which the resources of an organization have been managed and used. Resources are generally tangible like the cash, internal or brought out services etc. Tangible resources are depleted through use and in this case management is interested in knowing whether the use is optimal. On the other hand, intangible resources like goodwill are not depleted through use may be lost due to management or enhanced by good management.

The internal auditor should check whether proper operating standards and norms have been established for measuring economic and efficient use of the resources.

As a part of evaluating resources utilization, identifying the facilities which are under- utilized is an important function of the internal auditor. Such instances may consist of under- utilized machines, unoccupied storage space, huge cash or bank balances, idle man power etc. He may also identify under-staffing and overstaffing in various areas as these prevent optimum use of resources.

**8.4.6. Review of reliability and relevance of information:** The Internal auditor should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information. This involves an examination to ascertain whether:

- financial and operating records and reports contain accurate reliable, timely, complete and useful information; and
- Controls over record- keeping and reporting are adequate and effective.

**8.4.7. Effectiveness and efficiency of operations:** Internal auditors should appraise the economy and efficiency with which resources are employed. In its international Standards for the professional practice of Internal Auditing IIA has therefore, stated that the role of the internal auditor in this regard should be to determine whether-

- Operating standards have been established by the management for measuring economy and efficiency (it is not the responsibility of the internal Auditors to set these standards);
- established operating standards are understood and being met;
- deviation from operating standards are identified, analyzed and communicated to those responsible for corrective action; and
- corrective action has been taken.

**8.4.8. Review of the Organization Structure:** The internal auditor should conduct an appraisal of the organization structure to ascertain whether it is in harmony with the objectives of the organization and whether the assignment of responsibilities is in consonance therewith. For this purpose he should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the group pattern. The internal auditor should examine the organizational chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the other. He should see whether the lines of authority and responsibility are clearly defined and communicated to all the organizational levels. He should examine whether there is unity of command i.e., whether each person reports only to one superior. Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed.

One way of reducing organizational rigidity without sacrificing control is to have a quick and free flow of information within the organization.



Finally he should evaluate the process of managerial development in the organization. This is a vital aspect in the fast growing organizations. Unless executives are properly groomed to take over positions of responsibilities when senior people retire, there is bound to be organizational chaos.

**8.4.9. Governance:** The internal audit should evaluate and make recommendations for improving the governance process for achieving the following objectives.

- a) Promoting appropriate ethics and values within the organization.
- b) Ensuring effective organizational performance management and accountability.
- c) Effectively communicating risk and control information to appropriate areas of the organization
- d) Effectively coordinating the activities of and communicating information among the board, external and internal auditors, and management.

It can thus be seen that the modern concept of internal auditing covers not only the traditional functions dealing with a review of custodianship and safeguarding of assets, compliance with policies and reliability of accounting information, but it also emphasizes new areas like reviewing the economical and efficient use of resources and organizational performance. Finally, it evaluates the entire governance process and makes recommendations for its improvement.

## **8.5. NEED FOR INTERNAL AUDITING**

The need for internal audit arises primarily due to the fact that in the recent years, organizations have grown enormously in size and operations. Many of them employ large number of persons and conduct their functions and activities from various locations. It has, therefore, become necessary for the management of such organizations to have a team of specialists to review the procedures and activities of various units and report cases of non- compliance, inefficiency and lack of control, so that necessary corrective action can be taken. The task cannot be left

to the statutory auditors whose main objective is to report whether or not the financial statements reflect a true and fair view of the working results and financial position of an organization.

Internal auditing has, therefore become a specialized service requiring not only expertise in accounting but also in organizational behavior and in functional areas of management.

#### **8.6. WORKING ENVIRONMENT - INDEPENDENCE OF THE INTERNAL AUDITORS**

Management is primarily responsible for the attainment of objective s and optimal use of the resources by establishing sound practices and control system. The nature and scope of operations and the status of and internal auditor differ from one organization to another, according to the needs and perceptions of the different managements.

The internal audit, on the other hand, based on the results of his examinations and investigations can assist management by bringing to their attention weaknesses, wasteful expenditure and by offering constructive suggestions to secure improvements.

However, if an internal audit has to perform his duties effectively, he should be independent of activities that he audits. This can be achieved only if he is given the requisite organizational status and if he possessed the desired degree of objectivity.

The professional standards are IIA, issued by the Institute of Internal Auditors Inc.U.S.A(IIA), require the following in this regard.

#### **8.7. INDIVIDUAL OBJECTIVITY**

Internal auditors should have an impartial, unbiased attitude and avoid conflict of interest. The following steps would be useful in this regard.

- a) The internal audit staff should be assigned to various audit jobs that all potential and actual conflicts of interests and bias are avoided.

- b) It should be obligatory for the staff to inform the chief executive if any conflict of interest or any bias is possible in an audit situation.
- c) Assignments of internal auditors should be rotated periodically whenever it is practical to do so.
- d) Internal auditors should not generally be asked to assume operating responsibilities.

This is because having assumed authority or responsibility for any function, an internal auditor cannot review the performance in that area objectively. Even designing, installing and operating the systems are not internal audit functions and they are likely to impair audit of objectivity. The internal auditor can review the procedures before they are implemented, or recommend the standards of control for systems.

IIA has stated that the objectivity is presumed to be impaired if an internal auditor provides assurance services for which he had responsibility within the previous year.

It is also required that if independence or objectivity is impaired, whether in fact or in appearance, the details of the impairment should be disclosed to appropriate parties.

- e) Results of an audit should be reviewed before the audit report is released in order to provide reasonable assurance that the work was performed objectively.

**8.7.1. Qualities and Qualifications of an Internal Auditor:** Though no formal qualification has been prescribed for internal auditor, it is desirable that he is a professionally qualified auditor. Apart from holding professional qualification, he should have special expertise necessary for evaluating management control systems, especially accounting and financial controls. Also since the internal auditor is also required to review non-financial areas he should acquire or have basic knowledge of the technology and commercial practices prevailing in the organization.

He should have fairly good knowledge of costing, taxation and other statutory laws which are applicable to the organization.

Computer literacy is an absolute necessity in the present day working environment.

The Institute of Internal Auditors, USA, has enunciated certain moral principles which the Internal auditors should follow. These rules of conduct, which are recommendatory in nature, are as below:

**8.7.2. Integrity: Internal Auditors-**

- shall perform their work with honesty, diligence, and responsibility.
- shall observe the law and make disclosures expected by law and the profession
- shall respect and contribute to the legitimate and ethical objectives of the organization.
- shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.

**8.7.3. Competency: Internal Auditors-**

- shall engage only in those services for which they have the necessary knowledge, skills and experience.
- shall perform internal auditing services in accordance with the International standards for the professional practice of internal auditing
- shall continually improve their proficiency and effectiveness and quality of their services.

**8.7.4. Objectivity: Internal Auditor-**

- shall not participate in any activity or relationship that may impair or presumed to impair their unbiased assessment. This participation includes those activities or relationship that may be in conflict with the interest of the organization.

- shall not accept anything that may impair or presumed to impair their professional judgement .
- shall disclose all material facts known to them that , if not disclosed , may distort the reporting of activities under review.

#### **8.7.5. Confidentiality: Internal auditor-**

- shall be prudent in the use and protection of information acquired in the course of their duties.
- shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

He should have an analytical mind and pragmatic approach to do his work.

**8.7.6. Duties of Internal Auditor:** The internal auditor's duties can be classified into two categories i.e. specific duties and routine duties. Specific Duties may be decided by the management from time to time and the routine duties are those which the internal auditors are normally expected to perform.

#### **8.7.7. Specific Duties**

- Examination of the organizational structure to see whether optimal use of resources and intellectual assets is being made without conflict and confusion and line of accountability is clear covering all the significant activities.
- Evaluation of the performance of service departments and ascertaining their productivity.
- Assessment of plans, and target and machines the compatibility of management/ human and financial resources in the attainment of these objectives.
- Evaluation of the management information system (MIS) in regard to their adequacy, reliability, timeliness and usefulness.

- Examination of the delegation of authorities and accountability of the key officials
- Carrying out investigations, suo moto or as desired by the management
- Carrying out the resource utilization and identification of problems which are impeding organization's plans and targets.
- Carrying out social audit in regard to environment laws/public image and organization's obligation towards government, customers, staff and public in general.
- Any other area which the management may decide from time to time.

**8.7.8. Routine Works:** The following are the areas in which the internal audit department would normally carry out its reviews as a routine:

- Appraisal of existing control and identification of their strength and weaknesses to determine the impact of weaknesses on various aspects.
- Testing the adequacy of internal controls which are designed to control/minimize the risk of misappropriation and fraud. Some of these are payroll cash and stocks.
- Periodical verification of assets and liabilities. These may include Cash, Stocks, Fixed assets etc.
- Verification of timely compliance of statutory formalities in regard to applicable provisions of Companies Act, Tax Laws, ESI, Provident Funds and Labour laws.
- Carrying out surprise verifications of cash, stock items, wage disbursement etc.
- Reviewing of the system of authorization of payments to satisfy that there is adequate control over payments.
- Where there is computer system in operation, the internal audit department may regularly carry out test packs or computer audit programmes to see proper functioning of the organization and to guard against manipulations in the computer or in the programme.

**8.7.9. Essential Feature of an Internal Audit Report:** An internal report like any other report is essentially a vehicle of communication of information and ideas to the management. Utmost attention needs to be given to the reports of the internal auditor. The approach in framing an internal audit report has to be qualitatively different than in case of other types of audits, particularly independent financial audit.

Unfortunately many internal auditors overlook this aspect. As a result, their reports fail to evoke a positive response from the managers.

The internal audit report should contain the following important information with regard to the organization:

- The weaknesses in the internal control or operating procedure
- Deficient Record keeping
- Facts and figures examined during audit which may disclose
  - non-compliance of statutory regulations
  - deviations from laid down policies
  - infructuous expenditure
  - failure to attain corporate goals and objectives
  - inefficient use resources
  - erroneous decision affecting functioning of the organization
  - flouting of financial regulations and procedures
  - accounting errors and fraud reflecting bad book keeping and/or break down of the accounting system, non-availability of proper evidence to support a recorded transaction, incomplete records, delay in recording etc.

The above mentioned observations may adversely affect the financial position of the auditor and as such it is the duty of the internal auditor to report them.

**Essential Features** - There are certain characteristics of report writing which the drafting auditor should bear in mind. These characteristics are:

- Conciseness
- Clarity
- Objectivity
- Accuracy

- Observations supported by facts and figures
- Marshalling of Findings
- Discussion of the draft report with the concerned officials.
- Recommendations
- The non-critical tone
- Matters requiring further study
- Recognition of improvements

**a. Conciseness**

- The reports should be concise as far as possible, but at the same time clear and complete enough to communicate the information, the auditor is reporting.
- Reports should not be unduly long and should not contain superfluous and irrelevant information or data. Too many details may distract, confuse or discourage the users.
- Any facts, figures or words or sentences which do not clearly tie in with the idea which the auditor wants to convey should be avoided.
- Although conciseness in report is desirable, care should be exercised to see that it is not carried to the point of incompleteness. The incompleteness may result from the use of too few words or the omission of essential facts.
- If some relevant detailed working has been made to support a position, the same may be given as annexure.

**b. Clarity -**

- It is most important that the text of the report should convey the important audit findings and specific recommendations in clearly understood language.
- Reports should only contain information which is necessary to communicate the essential facts and to provide an adequate understanding of the problem.
- They should be written as far as possible in non-technical terms which



should clearly explain the situation the auditor wants to describe.

**c. Objectivity -**

- The audit findings should be presented in an objective and unbiased manner.
- The objective should not be to merely criticize but to emphasise matters needing attention. Primary emphasis should be on improvements in the future rather than mere criticism of the past.
- Auditor's comments should take cognisance of any unusual difficulties or circumstances faced by the auditee. The auditor should guard against the tendency to exaggerate or over-emphasise the deficiencies noted during the audit. Similarly, he should not understate or omit facts to protect some persons.

**d. Accuracy -** The need for accuracy of facts and figures in reports is essential to prove fairness and impartiality. Any inaccurate data or insufficiently supported statements reflect on the reliability of the report. One inaccuracy in the report can cast doubt on the validity of the entire report. An audit report may be seriously discredited if it contains some significant factual error.

**e. Supporting Data -**

- All the findings and conclusions included in the report should be supported by factual data and audit evidence adequate to prove their accuracy or reasonableness.
- Detailed supporting data need not always be included in the body of the report unless it is considered necessary to convince the users.
- If the data is too much and it is considered necessary to include it in the report, it may be attached as an annexure. Otherwise it should be retained in the working papers.
- Opinions or conclusions in the report to prove the trend should be based on enough audit work or samples and not on the basis of solitary

instances. In most cases, one or two examples of a routine deficiency cannot be construed to support a broad conclusion.

**f. Marshalling of findings -**

- It should be remembered that audit reports are action documents; therefore, all matters included therein should be important enough to justify reporting them.
- Major findings or important problems must be distinguished from insignificant ones or isolated clerical errors.
- The marshalling of findings, therefore, must be established in the report itself by keeping in view the concept of materiality. This will also assist in preparing the summary of major findings.

**g. Discussion on the Draft Report -**

- One of the most effective ways of ensuring that internal audit reports are fair, complete and objective is through its discussion in draft with the concerned operating officials.
- This approach aims to establish that information presented in the report is factual, adequate and relevant. May be, as a result of discussions, these officials furnish additional facts or material which may have an important effect on the findings or recommendations proposed to be included in the report.
- This kind of report is more useful and acceptable to the management. Comments on draft report by the officials may not necessarily merit a change in the auditor's opinion. The auditor in that event should include the viewpoints of the officials, if material, and his reasons for not accepting them.

**h. Recommendations -**

- The report should contain appropriate recommendations which represent the actions required to correct the deficiencies. These should follow logically from the findings and supporting data included in the report.
- Recommendations should be objective, constructive, economically feasible and specific as far as possible about the action required.
- Report should not contain recommendations for which actions have already been taken during the course of audit but the fact of such action may be mentioned in the audit findings.
- Recommendations, where appropriate, should be serially numbered.

**i. The Non-critical Tone -**

- The tone of report should be such that it is read with interest and that it encourages favorable reactions to audit findings and recommendations.
- The language used should be soft. Harsh language may unnecessarily generate ill-feeling, uneasiness and even aggressive attitude by the users of the report.

**j. Matters requiring further study -**

- Matters, which due to certain limitations or constraints, could not be studied or examined thoroughly to draw some conclusions or to make some recommendations, should be stated clearly in the report.
- If the auditor feels that they are important enough to warrant further probe or study, he should mention circumstances and the reasons as to why complete study could not be made.

**k. Recognition of improvements -**

- Audit reports are generally written for highlighting exceptions and deficient aspects only.
- It is, however, desirable that information recognizing the improvements either as a result of audit or the managements own efforts should be

included in the report. Such information is often necessary to provide appropriate balance to the report.

- In addition, mentioning of improvements not only boosts up the morale of the concerned officials, but encourages others to emulate them. The noteworthy accomplishments should, therefore, be recognized by the auditor.

#### **8.8. RELATIONSHIP BETWEEN INTERNAL AUDITOR AND STATUTORY AUDITOR**

From the above discussions, it is evident that there is a close similarity between the means by which the statutory auditors and the internal auditors carry out their respective duties. Both of them have a common interest in ensuring that an effective system of internal control exists and that the accounting system is adequate to generate true and fair financial statements.

Accordingly, the nature of work carried out by both is similar as regards examination of the system of internal control, testing and checking of accounting books, records and statements, and verification of assets and liabilities. Both of them examine the same set of accounting documents and carry out similar physical and other verificatory checks.

It is, therefore, necessary for both to establish an understanding and co-operation to avoid duplication of work. The experience of the external auditor (because of variety of audits) can be of great assistance in an advisory capacity in connection with the installation and operation of internal audit. In return the statutory auditor may derive assistance from the internal auditor's intimate knowledge about the organization's activities and functions.

Despite these similarities, there are certain fundamental differences in the status, responsibility, approach, and the scope of operations of an internal auditor and a statutory auditor. The internal auditor is a representative of the management. The nature and scope of his functions are determined by the management and may, therefore, differ from one organization to another according to the needs and perceptions of different managements.

The rights and duties of the statutory auditor, on the other hand, are defined by the statute. For example, section 227 of the Companies Act, 1956, contains the detailed provisions in this regard. The statutory auditor is independent of the management whereas the internal auditor does not enjoy a totally detached position. Thus, the internal auditors approach is to report on matters vital from the point of view of the management, whereas the statutory auditor is primarily concerned with the truth and fairness of financial statements presented to the shareholders.

Auditing and Assurance Standard (AAS) 7, Relying upon the Work of an Internal Auditor, also recognizes that "the role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objective often similar and thus much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures."

Since the internal audit function is a part of the overall internal control system, the statutory auditor should evaluate its effectiveness. The evaluation of the internal audit function assists the statutory Auditors in determining the nature, timing and extent of his other audit procedures. Thus, if an auditor finds that internal audit is adequate and effective in certain areas, he may limit the related substantive procedures.

In evaluating the effectiveness of the internal audit function, the statutory auditor should consider organizational status of the internal auditor, the scope of his function, his technical competence, and the level of professional care exercised in conducting internal audit. If the internal auditor reports to the highest level of management and is free of any operating responsibility, the statutory auditor can place greater reliance on his work. The statutory auditor should also review whether any constraints or restrictions have been placed on the work of the internal auditor by the management. In particular, the internal auditor should be free to communicate fully with the statutory auditor. The statutory auditor should

also ascertain the nature and scope of coverage of internal audit. He should review the effectiveness of the system of follow-up of internal audit reports. The statutory auditor should also review whether or not the internal audit work is being performed by persons possessing adequate technical training and proficiency. Finally, he should ascertain whether the internal audit work appears to be properly planned, supervised, reviewed and documented. It would be helpful if statutory auditor ascertains the tentative plan of internal audit for the year and discusses the same with the internal auditor to determine areas where he considers that he could use the work of the internal auditor.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is a matter of individual judgement in a given set of circumstances. As AAS 7 states, "the report of external auditor is his sole responsibility and that responsibility is not by any means reduced because of the reliance he places on the internal auditor's work." Further, the responsibility of the internal auditor is towards the management and he can be of specific assistance to the statutory auditor or only if the management so wishes. However, both the statutory auditor and the internal auditor can, by mutual consultations, arrange their audit programmes in such a manner that unnecessary duplication of work is avoided.

#### **8.9. ORGANIZATIONAL INDEPENDENCE**

A proper organizational status for the internal audit department ensures its relative independence so that it can carry out its work freely and objectively and render impartial and unbiased judgements.

The internal auditing activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results. To ensure this, the following steps may be taken.

- The senior management and board of directors should give full support to internal auditors
- The chief audit executive should submit activity reports to senior management and to the board highlighting the significant audit findings and recommendations.
- The chief audit executive should have direct communication with the top management and the governing body

- The chief audit executive should be responsible to an officer of sufficient rank and authority so as to ensure broad audit coverage as well as sufficient and prompt consideration and action on audit reports.
- The chief audit executive should regularly attend and participate in those meetings of the board which relate to its oversight responsibilities for auditing, financial reporting, organization governance, and control.

#### 8.10. SELF ASSESSMENT QUESTIONS

- i) What is internal audit?
- ii) What is the difference between internal and external audit?
- iii) Why there is a need for internal audit?
- iv) What should be the procedure for the internal audit?
- v) While writing an internal audit report what are the key points which auditor should observe?
- vi) Who can be appointed as an internal auditor?
- vi) What is the relationship appears in between internal auditor and external auditor?