

TOPIC 9: INTERNAL AUDIT FUNCTION

Definition of internal Audit

Internal auditing is a continuous independent appraisal of all the activities and procedures of the entity to determine their relevance, effectiveness and efficiency and provide feedback to the management. The institute of internal auditor defines internal audit as an independent consulting and appraisal activity designed to add value to the company operations.

ISA 610 defines internal audit as a function of the entity that perform assurance and consulting activities designated to evaluate and improve risk management and corporate governance.

Scope of work and responsibilities of internal auditors

- 1) Examining and evaluating the adequacy and effectiveness of the ICS and the accounting system.
- 2) Reviewing the credibility and integrity of the financial statements by checking whether they have been prepared in line with identified financial report framework.
- 3) To review the company's compliance with laws and regulations.
- 4) To conduct special invigilation where frauds and errors are suspected.
- 5) To carry out routine function of verification of assets and liabilities.
- 6) To carry out value for money audit.
- 7) The department acts as a consulting department for the other departments.
- 8) To provide feedback to the management regarding failure or success of operation.
- 9) To assist the Board in the governance process e.g. by ensuring compliance with the code of conduct.
- 10) It acts as a preventive and detective measure against commission of frauds and errors.

Preliminary assessment of the internal audit function The internal auditor should carry a preliminary assessment of the internal audit function before placing a reliance on the work of the internal auditors.

Factors to consider before placing reliance on the work of internal audit function.

- 1) Competence and qualification of the internal auditors such as, the professional qualification and experience.
- 2) Scope of work of the internal audit function such as, the depth of coverage and nature of the internal audit assignments and also the relevance of their work.
- 3) The level of resources available to the internal audit functions in terms of personnel, and computer facilities.
- 4) The objectivity and the status of the internal audit function

Factors to consider in determining objectivity

- The organizational status of the internal audit function, e.g. reports to who?
- Whether the internal auditors are actively involved in the other activities of the firm.
- Whether the internal auditors experience restrictions from the management.
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- 5) Due-professional care. The external auditor should assess the quality of internal auditors by chewing whether:
 - The work appears to be properly planned, documented and supervised.
 - Whether their recommendations are acted upon by the management.
- 6) Effectiveness of the internal audit function by considering the following:
 - Whether the department is headed by a competent chief internal auditor.
 - Whether the duties of the internal auditors are clearly defined.
 - Whether the department has relevant resources. ➤ Whether the internal audit program is effective.
- 7) Previous experience with the internal audit function of the entity e.g. was they co-operative in the past?

Areas of reliance by external auditor on the internal auditor's work

- 1) Visiting branches on behalf of the external auditor.

- 2) Attending the physical stock take on behalf of the external auditor. 3) Preparing support schedules on behalf of the external auditor.
- 4) Administering the internal control questionnaire of the external auditor.
- 5) Carrying out headcount of employees
- 6) Pinpointing areas of known problems such as suspected frauds, ICS etc.
- 7) The external auditor can use the internal auditor's working papers to obtain audit evidence concerning the company's operations.

Outsourcing of the internal audit function

This is a new phenomenon where firms are moving away from maintaining an in-house internal audit department instead contracting an external service provider to provide the internal audit services.

Advantages of outsourcing internal audit functions

- i. The quality of the service is higher since the professional firm has more qualified staff.
- ii. Cost-savings related to staffing e.g. pensions
- iii. The independence of the outsourced function is higher and hence the external can place more reliance on their work.
- iv. The firm will be able to access different specialized skill at no extra cost.
- v. The firm is able to learn in the hands of the experts.
- vi. The company can concentrate on its core business.
- vii. The company can be indemnified in case of compromised services.
- viii. Focused effort. Outsourcing avoids disruptions such as the staff attending meetings coming late and leaving early, workers attending to their personal issues during office time etc.
- ix. The service contract can be for the appropriate time scale.
- x. The firm is able to access experienced and best practices since the service provider has provided the services to the many companies and industries.
- xi. It can provide an immediate internal audit function with minimum set-up time and cost.

Disadvantages of outsourcing internal audit functions

- i. Risk of leakage of confidential information.
- ii. The management may lose control over the function.

- iii. The professional firm may lack intimate knowledge of the business that the employees would have.
- iv. The professional fee tends to be quite high.
- v. The professional firm will be subject to its contract and cannot be issued with instructions in the same way as employees.
- vi. The service provider may not be available on emergency.
- vii. Relationship problems could arise where the employees of the professional firm aren't readily accepted by the employees of the company.
- viii. It reduces the learning curve due to over-dependence on the professional firm.
- ix. If the firm already had an in-house department outsourcing would mean huge redundancy cost.

Effects of outsourcing the internal audit functions on the work of the external auditor

- a) More reliance will be placed on the work of the internal auditors.
- b) Fewer tests will be carried out leading to reduced audit fee.
- c) The internal control environment will be stronger, minimizing the chances of frauds and errors.
- d) Smaller samples will be used by the auditor.
- e) The auditor will place more reliance in the ICS since they are likely to be more effective.

Internal check system

Meaning: The internal check is an arrangement of the duties of the staff members of the accounting functions in such a way that another automatically checks the work performed by a person.

Essential Characteristics of Internal Check System

Certain qualities are needed to make an internal check system more effective and efficient. Such qualities are known as features of internal check system, which are as follows:

1. Division of Work

No one should be allowed to have the right to perform the work from origin to end.

For example – a transaction of sale may have to be split into a display of article by staff, the preparation of invoice by another, the receipt of cash against the invoice by a third clerk, the delivery of article against the proof of receipted invoice by another clerk, checking of outward movement of an article against delivery order by a clerk and so on.

In big business houses, such specialized tasks increase the speed of work and automatically introduce internal checks.

2. Provision of Check

An organization should set up such provisions so that work can be checked by another staff. An officer can check the work of one staff by transferring to the staff and again.

3. Use of Devices

In this modern world, various devices can be used to do various functions like the use of time record machines, wage determination machines, etc. An organization should use machines that help to make work of internal check easier.

4. Self-balancing System

An organization can use self-balancing ledger accounts, which help to make the work of internal check easier. Its effectiveness depends on its management.

5. Job Rotation

No individual clerk should be allowed to occupy a particular area of operation for long. Familiarity with and exclusiveness in a position offer a person greater flexibility to attempt manipulation with the system.

6. Specialization

Every staff may not have such specialized knowledge to maintain accounts properly. So, an organization should give the training to increase their skills so that internal checks can be made more effective.

7. Control

There is more chance of frauds where there is direct contact between consumers or the public. So, a manager can keep eyes in those works so that the internal check system can be made more effective.

8. Authority Level

There must be clear cut authority levels according to sanctions to various transactions. Commensurate to the authority vested, responsibility must be extracted. The existence of authority levels results in a review of the operations of subordinates.

Objectives of Internal Check

There are several objectives of the internal check. They are given below:

1. To minimize the possibility of error, fraud, and irregularity.
2. To prevent the misappropriation of cash and goods.
3. To allocate duties and responsibilities to every clerk in the organization.
4. To ensure an accurate recording of all business transactions.
5. To enhance the efficiency of the clerk in the organization.
6. To exercise moral influence over the staff member.
7. To prepare a final account with ease and efficiency.

Principles of Internal Check

An internal check is based on some specific principles. Without which, an internal check is of no use. These principles are given below:

- a. The process should be allocated among the staff of the business according to the duties, responsibility, and rights in such a. There is no room for interference.

- b. No single person should have independent control over the allimportant aspects of the business.
- c. The duties among the staff of the business should be changed from time to time so that no staff should be engaged in a particular job for a long time.
- d. Every member of the staff should be encouraged to go on leave at least once in a year .this will help in detecting concealed fraud.
- e. An efficient system of internal check should provide for automatic checking of the work of an assistant by others.
- f. The division of work should not be much expensive.
- g. The self-balancing system should be invariably used.
- h. The financial and administrative power should be assigned very judiciously to different officers.
- i. A person having physical custody of assets must not be permitted to have access to the books of account.

Advantages of Internal Check

The main advantages of an internal check are listed below:

1. Moral Influence on Employees

The system of internal check puts a morale check on members of staff and enables them to learn honesty, hard work, and straightforwardness.

2. Determination of Employees Liability

The system of the internal check determines the responsibilities of employees. The member of the staff may be held responsible for any irregularity carried on by him.

3. Less Possibility of Frauds

There is less possibility of fraud under the system of the internal check because errors and frauds can be detected at an early stage.

4. Increase in Efficiency

The system of internal check ensures greater .efficiency and speed because the arrangement of internal check is based on a division of labor.

5. Auditing Made Easy

The system of internal check facilitates the work of auditors to a great extent by enabling him to rely on test checking.

6. Final Accounts Can Be Prepared

In an internal check system, the 'Profit and Loss Account' and Balance Sheet is prepared without any loss of time.

7. Correct and Complete Records of all the Transactions

The system of an internal check may also result in correct and complete records of all the transactions on each balancing of the books of accounts.

8. Detection of Dishonesty or Irregularity

Any dishonesty or irregularity in the concern by the members of staff can be detected before they assume any complication.

9. Test Checking Possible

Suppose the auditor finds the system of internal check satisfactory. Then by taking into mind, its defects or weak points he can take the help of test checking.

Disadvantages of Internal Check:

1. Expensive

The system of Internal Check is more expensive and time-consuming.

2. Slackness in the Work

This is also a serious defect of the system of internal check. The auditor may show slackness at work. He may rely on the system of internal check blindfold, which may affect the quality of audit work adversely.

3. Not Suitable for Small Concern

The system of internal check is not suitable for small concern as it may be uneconomical in small concern.

4. Grouping among Employees

If the employees of the concern join hand, they may keep the employer in the dark and may cause many irregularities defying any-detection thereof. This groupism amongst the employees may not be healthy.