**RISK-BASED INTERNAL AUDIT**

Internal Audit as a profession is at a very important stage. Though technically, the Internal Audit function reports to the Audit Committee, there are various stakeholders involved and interested in the work that the internal audit team performs. Over the next few paragraphs, let’s try to understand the scope of internal audit and the changing expectations in the current business environment.

***Introduction***

As defined by the Institute of Internal Auditors (IIA), “Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” The internal auditor is often described as the organizations’ critical friend – the independent advisor who can challenge current practice, champion best practice and be a catalyst for improvement, with the objective of ensuring that the organization as a whole can achieve its strategic objectives.

***Scope of Internal Audit***

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. Internal auditing frequently involves measuring compliance with the entity’s policies and procedures. However, internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds.

***Internal Audit Structure***

Publicly-traded corporations typically have an Internal Audit Department, led by a Chief Audit Executive (“CAE”) who generally reports to the Audit Committee of the Board of Directors, with administrative reporting to the Chief Executive Officer. There are a few other models that are in practice. Certain organizations outsource the internal audit function to a third party service provider. Another prevalent model is one of co-sourcing – a combination of in-house Internal Audit resources supplemented by resources from a third party service provider, depending on skill sets and expertise needed.

Typically, the internal audit plan for an organization is drawn up at the beginning of the financial year and presented before the Audit Committee for guidance and approval. Depending on the suggestions and inputs provided by the Audit Committee, the plan is operationalised. In terms of the processes covered in the internal audit plan, increasing focus is also being laid on operational aspects, in addition to evaluation of internal controls over financial reporting.

***Role of Internal Auditor***

Internal audit activity is primarily directed at improving the internal control and effectiveness of internal control environment in an organization. Under the COSO Framework, internal control is broadly defined as a process, affected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following internal control categories:

* Effectiveness and efficiency of operations.
* Reliability of financial reporting.
* Compliance with laws and regulations.

The primary responsibility for maintaining internal control lies with the management of the company. The organization establishes policies and processes to help the business achieve specific objectives in each of these categories. Internal auditors perform audits and reviews to evaluate whether the policies and processes are designed and operating effectively and based on the review, provide recommendations for improvement.

***Rising importance of Risk Management***

In the current economic situation and the slowdown faced by economies worldwide, the risk landscape is undergoing a significant change. Organization would have to be aware of the risks and the criticality of the risks, considering the impact and likelihood. This awareness would help the Senior Management in institutionalizing the right strategy to address the risks. Certain risks can be mitigated effectively with a strong control environment. However, as far as external risks such as economic slowdown are concerned, change in government policy or regulations, can only be monitored by the organization keeping abreast of the changing environment and having the internal processes robust enough to adapt for the change.

Emerging risks, which are difficult to predict from past experience, are now reverberating across entire industries and economies. To respond effectively, internal audit helps the management to adopt more sophisticated and integrated risk management approach. Aligning internal audit priorities to the risks flowing from changing business priorities and conditions has therefore, become the central mission of forward looking internal audit executives.

Successful internal audit departments are those that would maintain alignment with the changing risk profile, and the evolving needs and expectations of the various stakeholders. One of the key areas of focus would therefore, be a shift from merely evaluating financial reporting controls to focusing on the sources of risk that might reduce shareholder value. It would therefore be important to begin by having a risk library, enlisting all likely risks. Based on the likelihood and impact of the risks, list of prioritized risks would then have to be identified. This would form a critical input to the risk-based internal audit plan. While preparing the risk-based plan, adequate consideration is to be given to other forms of assurance that exists within the organization. Such assurance would be available, in part or in full, by teams such as Quality Control, Legal and Secretarial and similar functions. The aim is to avoid duplication of efforts and to effectively use the limited time and resources that internal audit would have.

From an internal audit perspective, the controls institutionalized would have to be tested for both design effectiveness and operating effectiveness. In a design evaluation, the Internal Auditor would perform an assessment of the design of the controls, to evaluate whether the controls are designed appropriately to address the level of risk that exists for that particular process. Once comfort over the design is established, the internal auditor would thereafter, evaluate the operating effectiveness of the control by testing the control with regard to the various attributes, by a combination of walkthrough, observation, re-performance and sampling to evaluate whether the control is consistently operating over the review period.

***Use of technology in Internal Audits***

All business and business processes have become increasingly dependent on technology. Most organizations have either an integrated ERP system or disparate IT applications to support their operations. Therefore, risks related to the use of technology also would have to be identified and evaluated. Traditional methods of sampling and manual evaluation of controls would have to be therefore, supplemented by effectively using technology to drive the efficiency and effectiveness in internal control reviews. High performing internal audit functions would use technology as under:

* To increase efficiency, internal audit should automate issues tracking and reporting to achieve paperless audits and reports, and use capacity multipliers to mitigate the impact of constrained resources.
* To improve effectiveness in the search for errors or unusual transactions, internal audit should test entire data populations automatically, through use of analytic tools.
* To strengthen quality, internal audit should apply technology to conduct real-time reviews, escalate issues, and ensure compliance with standards.

In times wherein the budget for internal audit function would be at a constraint, it would be very important for internal auditors to leverage technology to drive efficiencies as mentioned above. However, most internal auditors are not prepared to audit in an automated environment, which could be as a result of lack of relevant IT experience within the internal audit teams. The skill gap within the internal audit team would have to be adequately bridged with supplementing the team with the right skills or cosourcing the audit of the processes which require specific expertise.

***Summary***

In the past, incremental contribution from the internal audit team by reviewing additional processes or locations, by rotation, was considered good enough. However, as mentioned, with the challenges posed by today’s business scenario – internal and external – the stakeholders look at internal audit as a business partner and seek pro-active advice on the risk and control framework that would be ideal for their operating environment. In such a scenario, the internal auditors are expected to contribute more in the following:

* Adopting a risk-based audit approach – this would help in achieving prioritized coverage on the critical challenges faced by the business.
* Increasing the dialogue with the senior management, audit committee, external auditors and the board of directors – such dialogue would help the team in building trust and credibility, thereby increasing the confidence of the stakeholders on the function, in terms of viewing the internal audit team as a business partner.
* Constantly upgrading the skill sets within the team – evaluating the current skills available within the team, understanding the skill gap that exists considering the audit plan, evolving strategies to bridge the skill gap by training, outsourcing or use of guest auditors.
* Implementation of clear performance metrics for the internal audit team - this would help in the internal audit team showcasing the value added contribution made, in terms of efficiency, process improvements and effectiveness.

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