Internal Auditor: Often Underappreciated but Immensely Valuable

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The preface to the Standards on Internal Audit (IA) issued by The Institute of Chartered Accountants of India defines Internal Audit as follows:

> *"Internal Audit (IA) is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system. IA, therefore provides assurance that there is transparency in reporting, as a part of good governance."*

The Companies Act 2013 mandates certain classes of companies to appoint an internal auditor. The Rules specify that the Audit Committee or the Board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. Neither the Act nor the rules has specified the duties and responsibilities.

While the scope of internal audit is not prescribed either under the Companies Act or the Rules, the fact that it has been brought under the purview of both the Companies Act and SEBI LODR Regulations, however, shows the regulatory attention to this area.

Historically, an Internal Auditor was expected to:

Evaluate the efficiency of the operations of an organisation and their effectiveness and to provide an assurance to the Audit Committee, the Board and the top management that the controls were adequate to take care of risks.

He/she did this by scrutinizing records and transactions to identify:

- operational lapses in following the laid down policies, procedures and regulations and follow up for their rectification.
- process gaps and systemic issues and suggest remedial action.
- gaps in compliance with the various regulations applicable to the organization and follow up for remedial action.

Internal Audit has a significant role to play in sustainable growth of organizations. ICAEW (the Institute of Chartered Accountants in England and Wales) founded in 1880, has identified corporate governance and internal control weaknesses as very often being the root cause of corporate failures, although the general perception tends to be that corporate failures are on account of malfeasance, high leverage, poor business decisions and even macro economic factors.

Sometimes organizations, in their quest for growth and increased market share, overlook risks, prioritising short term gains over long term risk. Small problems and irregularities may be ignored or pushed under the carpet as of little or no significance. Problems, however, have an irritating habit of festering and growing, if ignored, and can push an organization to the brink of disaster or even to keel over. By virtue of a continuous and critical appraisal of the organization's functioning the internal auditor is in a prime position to identify any problems, risks, deviations from the organization's laid down policies and processes, at an initial stage, before they blow out of hand. This in-depth knowledge equips the auditor to take an informed objective view, particularly in process flows and in strategy development.

During the course of his/her work the internal auditor interacts with management at various levels. At times executives tend to downplay red flags raised during the internal audit processes. As a result, the Audit Committee/ Board papers may not reflect the true picture, which would affect decision making adversely. Since the internal auditor reports to the Audit Committee/ Board, he/she interacts with them periodically. It is very important that the internal auditor is independent (irrespective of whether he/she is an employee or is external to the organization) and that the Audit Committee/ Board creates an environment where the internal auditor is encouraged to interact with them fearlessly and without restraint.

The scope of IA is steadily going up due to an escalation of risks caused in part by:

- emerging technologies like generative AI
- cyber security attacks and data privacy issues
- inadequacy of existing technology platforms to comply with changing regulatory requirements.

The question that then needs to be asked is why does the internal auditor continue to be underrated and under-appreciated, particularly in relation to the development of an organization's strategy, as risk management and strategy have a symbiotic relationship.

The reasons are threefold:

1) Unlike statutory auditors whose roles and responsibilities are well defined both in the Companies Act and LODR Regulations and who are held to account in cases of malfeasance, negligence and lapses, internal

auditors do not have a defined set of responsibilities or liabilities. The internal audit plan is customised in every organisation (and very rightly so) based on risk perceptions of senior management and the internal auditor and the scope, periodicity and methodology for conducting the audit is approved by the Audit Committee/ Board in consultation with the internal auditor. When corporates fail, generally the focus has been on the promoters, regulators, statutory auditors, boards and the management. Internal auditors have rarely, if ever, come under scrutiny. The role and significance of internal auditors has not received the attention in the debates and reforms that followed corporate collapses.

i) The internal audit practice has not kept pace with the enhanced scope and requirements. Other than some exceptions, Internal auditors have, in general, not acquired multi-disciplinary skills with an organisation wide risk based approach. For a larger role it is important that internal auditors embrace technology, incorporate data analytics, artificial intelligence and machine learning in their approach to audit. Then alone will they be able to meaningfully engage with the management and the Audit Committee and Board on strategy and the ways to improve economy and efficiency. It is also important for internal auditors to deepen their domain knowledge of the corporates they audit.

As stated by The Institute of Internal Auditors *"The value of internal auditing cannot be fully realized without very important requisite qualities possessed by absolute professionals. Internal audit professionalism means competence and quality. It means standing up for transparency and integrity and speaking out against unethical business practices. And it means embracing growth and change, seeking new ways of doing things, and providing fresh ideas for ensuring risks are mitigated."*

• INTERNAL AUDITING	=	ASSURANCE	+	INSIGHT	+	OBJECTIVITY
• ASSURANCE	=	Governance	+	Risk	+	Control
• INSIGHT	=	Catalyst	+	Analyses	+	Assessments
• OBJECTIVITY	=	integrity	+	Accountability	+	Independence

ii) In a large number of corporates there is still fairly little interaction of the internal auditor with the CEO, despite the increasing complexities of business and the risks associated with that. Further, few Audit Committees and Boards have vigorously demanded from their internal auditors an analytics based forward looking approach, offering insights, to drive informed decisions. They have often settled for the hindsight 'fault finding' and 'rectification' approach.

It is imperative that Audit Committees and Boards demand a greater involvement from internal auditors and engage such professionals who have evolved to bring value in strategic thinking. This would compel internal auditors to upskill and equip themselves.

A robust internal audit should also focus on qualitative aspects. For example, a sustainability audit would require not only assessing and verifying the accuracy and reliability of the ESG information provided by the management but also to examine the qualitative aspects that define an organization's ESG policy. They should examine whether there is a general awareness regarding ESG implementation actions amongst the staff and whether there is high level oversight of ESG. Both these are essential elements for a successful outcome.

The evaluation and effectiveness of the MIS followed by the business entity can also be made a part of internal audit from the 'Performance Management and Decision Making' point of view. The internal auditor, as a system evaluator, would go through the data flow, conversion of data to meaningful information and the availability of such information for the decision maker.

There is no doubt all this would increase audit costs. Some increase in costs should be viewed by the Audit Committee/ Board and the management as necessary for a sustainable long term growth of the organisation.