

NOVEL TRENDS OF INTERNAL AUDIT IN VARIOUS FINANCIAL SECTORS

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Abstract

Internal audit is the independent appraisal activity which should be done continuously by an organization's employees appointed for this purpose. Internal audit of financial sectors is primarily intended to provide the management with clear and comprehensive analysis, which is unbiased, of the adequacy and effectiveness of internal controls and risk management framework of the entity. Financial sectors such as banking and other financial services sectors are set to grow exponentially in India. As the demands of traditional audits responsibilities and the growing burden of information security evolve, the sector is beginning to see emerging trends in internal auditing departments across many organizations. As technology has evolved in recent years, erasing global barriers, companies worldwide have dramatically transformed their operations. The transaction-based traditional audit approach that evolved during the last decade is not suited to the present scenario of financial sector, when inventory arrives fast in time, processes have value, and property is many times intellectual. Novel Audit Process Knowledge category such as Computer-Assisted Audit Techniques or CAATs is being increasingly prevalent as financial sectors work to automate and streamline internal audit processes. The overall findings will suggest a clear trend within many organizations to rebalance their internal audit departments and allow state-of-the-art technology to assist with continuous monitoring of controls and fraud detection. Therefore, now is the time for internal auditing to respond to these new challenges and opportunities. The present paper will review the functional efficiency of the organizations in the context of Internal Audit, with a view to suggest areas for possible improvements by the use of modern innovative auditing techniques.

1. Introduction

1.1 Introduction of Financial Sector

The economic reform process that began in 1991 took place amidst two acute crises involving the financial sector: (i) The balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and (ii) The grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies.

The present Rs 64 trillion (US\$ 1.17 trillion) Indian banking industry is governed by the Banking Regulation Act of India, (1949) and is closely monitored by the Reserve Bank of India (RBI). RBI manages the country's money supply and foreign exchange and also serves as a bank for the Government of India and for the country's commercial banks. As of now, public sector banks account for 70 per cent of the Indian banking assets.

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Liberal policies, Government support and huge development in other economic segments have made the Indian banking industry more progressive and inclusive with regard to global banking standards. (Barua et al 3-22)

The banking industry is challenged by competitive pressures, changes in customer loyalty, stringent regulatory environment and entry of new players, all of which are pressuring the organizations to adopt new business models, streamline operations, sound internal audit control system and improve processes.

This paper begins with a critical review of financial sector reforms with respect to internal audit system. Finally, the paper outlines the unfinished agenda of reforms in the financial sector with respect to internal audit system.

1.2 Introduction of Auditing and Need of Internal Audit

The word audit is derived from the Latin word audire which means "to hear." In older times whenever the owners of a business suspected fraud they appointed some impartial and experienced persons who used to hear these accounts and express their opinion about their correctness or otherwise. Such persons are known as "auditors". Audit is not only conducted in business but it is widely used in other sectors like banks, corporate, companies, etc.

Internal auditing is an independent appraisal function established within an organization to examine and evaluate which is done by a staff of auditors functioning as full time salaried employees.

A sound internal audit function plays an important role in contributing to the effectiveness of the internal control system. It should provide the management with accurate information on the effectiveness of risk management and internal controls including regulatory compliance by the bank. As Sharma points out:

At present, there are various types of internal audit, which basically adopt the methodology of transaction testing, testing of accuracy and reliability of accounting records and financial reports, integrity, reliability and timeliness of control reports, and adherence to legal and regulatory requirements. However, all these do not provide any opinion on the qualitative dimension of business management. As such, there is a need for redefining and redirecting the scope of audit so as to take care of adoption of modern tools of risk management, adequacy and effectiveness of such tools, as well as to assist the business units to mitigate the risks.

The internal audit function is not to monitor and detect but also to investigate fraud incidences when they arise. The role of internal audit in fraud risk management by way of preventing, detecting and investigating fraud has amplified as a result of economic uncertainty and increased focus of certain organization's management on fraud risks (KPMG LLP 2002).

2. Objectives of Research Work

The main objective of present paper is to review the functional efficiency of the financial organizations in the context of internal audit, with a view to suggest areas for possible improvements by the use of modern innovative auditing techniques which will lead to maximize the profits and to detect the frauds and errors in time.

3. Review of Literature

3.1 Role and Functions of Internal Audit in Banks

According to Literature cited by V Venugopal, the role and functions of the Internal Audit in Banks, whether Listed or Unlisted Public Sector or the Private Sector, as laid down by the RBI, are as under:

- 1) Provide directions and also oversee the operation of the total audit function in the Bank
- 2) Ensure proper organization, operationalization and quality control of the internal audit and inspection
- 3) Follow up of the statutory external audit and inspection of RBI
- 4) Review of internal inspection/audit function, its system, its quality and effectiveness in terms of follow up
- 5) Review the Inspection Report of specialized and extra large branches and branches with unsatisfactory rating
- 6) Focus specially on:
 - a. Inter-branch adjustment account
 - b. Arrears in balancing of books at various branches
 - c. Frauds
 - d. Other major areas of book-keeping
- 7) Review the half-yearly report obtained from the Compliance Officer appointed in the Bank
- 8) Follow up all issues raised in the Long Form Audit report (LFAR) of the Statutory Auditors
- 9) Interact with External Auditors before the finalization of the Annual/Half Yearly Financial Accounts and Reports
- 10) Follow up all issues/concerns raised in the RBI Inspection Reports
- 11) Reviewing with the Management, the Annual Financial Statements before submission to the Board
- 12) To look into reasons for default, if any, in payment to the Depositors, Debenture holders, Shareholders, Creditors, etc. (1079-82)

3.2 Internal Audit – The Traditional Role

According to Chartered Institute of Internal Auditors, "The role of internal audit is to provide independent assurance that an organization's risk management, governance and internal control processes are operating effectively. Unlike external auditors, they look beyond financial risks and statements to consider wider issues such as the organization's reputation, growth, its impact on the environment and the way it treats its employees" (Sharma).

3.3 The Changing Role of Internal Audit (Nishkam Ojha et al)

The ever increasing regulations and expansion of organizations across the globe into new markets exposed the organizations to greater regulatory and compliance risks. Regulators expect thorough due diligence, oversight and background checks to be performed on partners, vendors, suppliers and others. As fraud has a

number of negative impacts on organizations – financial and reputational – it is important for the organizations to have a strong fraud prevention programme and that could be possible only if sound internal audit system is present over there.

As organizations work towards reducing the losses due to fraud, their anti-fraud programmes are increasingly looking towards the internal audit function for support in light of the fact that over time as internal auditors review systems in the organization, they develop an overall knowledge of the organization's processes, risks, control systems and personnel which can contribute to an effective fraud risk management.

3.4 Internal Audit Guidance (Meigs and Meigs et al)

According to Financial Accounting a Handbook by Meigs and Meigs the Internal Audit can give maximum results if followed with proper guidance as mentioned.

The internal audits should be performed by personnel from within the organization or by external persons selected by the organization, working on its behalf. It should be ensured that persons conducting audit are competent and in position to do so impartially and objectively. The internal audits should identify opportunities for improvement in environmental system and establish an audit program to direct the planning and conduct of audits and identify the audits needed to meet the program's objectives.

Each internal audit need not cover entire system, so long as audit program ensures all organizational units and functions, system elements, and full scope of the EMS are audited periodically

1. Plan and conduct of audits by objective and impartial auditors, aided by technical experts, as appropriate, selected from within organization or from external sources
2. Collective competence of auditors should be sufficient to meet objectives and scope of the particular audit and provide confidence as to the degree of reliability that can be placed on results
3. Results of an internal EMS audit can be provided in the form of a report and used to:
 - (a) Correct or prevent specific nonconformities
 - (b) Fulfill one or more objectives of the audit program
 - (c) Provide input to the management review

3.5 Satyam Audit Fraud – A Case Study (Madan and Winkler)

Satyam Computer Services Limited was a 'rising-star' in the Indian 'outsourced' IT-services industry. The company was formed in 1987 in Hyderabad (India) by Mr. Ramalinga Raju. Satyam won numerous awards for innovation, governance, and corporate accountability. "In 2007, Ernst and Young awarded Mr. Raju with the 'Entrepreneur of the Year' award. On April 14, 2008, Satyam won awards from MZ Consult's for being a 'leader in India in CG and accountability'. In September 2008, the World Council for Corporate Governance awarded Satyam with the 'Global Peacock Award' for global excellence in corporate accountability." Unfortunately, less than five months after winning the Global Peacock Award, Satyam became the centerpiece of a 'massive' accounting fraud.

4. The Auditors Role and Factors Contributing to Fraud

Global auditing firm, Price waterhouse Coopers (PwC) {External Auditors}, according to Bhasin,

audited Satyam's books from June 2000 until the discovery of the fraud in 2009. Several commentators criticized PwC harshly for failing to detect the fraud (Winkler, 2010). Indeed, PwC signed Satyam's financial statements and was responsible for the numbers under the Indian law.

The large amount of cash thus should have been a 'red-flag' for the auditors that further verification and testing was necessary. Furthermore, it appears that the auditors did not independently verify with the banks in which Satyam claimed to have deposits.

Numerous factors contributed to the Satyam fraud. Actually the main reason for the fraud was the absence of internal auditors in the whole scene.

5. Methodology

The study of "Novel Trends of Internal Audit in Various Financial Sectors" is the secondary data. The data have been collected from reliable sources such as RBI Audit guidelines and case study is supported by Satyam Audit Reports. The novel audit techniques are studied from various possible resources such as books of high repute, journal and periodicals.

6. Findings and Suggestions

6.1 Novel Techniques of Internal Auditing System

Various Novel Audit techniques that can be possibly used for sound internal audit are CAATs. These are computer programs and data that the auditor can use as part of the audit procedures to process data of audit significance contained in a client computer information system (CIS). These can be used by the auditor to examine the entity computer files and may be used during both test of control and substantive testing of transactions and balances as the program can scrutinize large volume of data and extract information, leaving skilled manual resources to concentrate upon the investigation of the results.

An article on the web titled "Computer Assisted Audit Techniques (CAAT)" lists the following audit programs:

- Generalized packaged programs: however they need to be tailored to each specific case by defining the format of the files to be interrogated by specifying the parameters required and the form of that output.
- Purpose written programs: these are specially written programs where it is not possible to adapt a package program because of the type of machine, processing or file organization used.
- Utility programs used by the client: used by the entity to perform data processing functions such as sorting and printing of files e.g. excel.

The article mentioned above, namely, "Computer Assisted Audit Techniques (CAAT)" specifies the following uses of audit software:

- Calculation checks
- Detecting system violation rule
- Detecting unreasonable items
- New calculation and analysis

- Selecting items for audit testing
- Completeness checks

Advantages of CAAT to the Auditor

The same article mentioned above lists the advantages of CAAT:

- Test programmed controls: In a computer based accounting system, there are large volume of transactions which the auditor will have to audit. The auditor will have to check if the programmed controls are functioning correctly. The only effective way of testing programmed controls is through CAAT.
- Test on large volume of data: CAAT enables auditors to test large amount of data quickly and accurately and therefore increases the confidence they have in their opinion.
- Cost effective: once set up CAAT is likely to be a cost effective way of obtaining audit evidence year after year provided that the client does not change the accounting system regularly.
- Comparison: Allows results from using CAAT to be compared to traditional testing. Where the two results agree will increase the overall internal auditor's confidence.

6.2 Novel Trends in Audit Guidance for Other Financial Services

An article on the Web "Regulation on Internal Audit Requirements for Commercial Banks" lists the following as the novel trends in audit guidance:

1. The activities of the Internal Audit at a commercial bank must be based on the principles of independence and impartiality, which must be ensured by non-interference from the bank's Supervisory Council and Board of Directors, structural independence, independent staffing policy and remuneration system.
2. For the purpose of ensuring structural independence of the internal audit, the Department must be accountable to the bank's Audit Commission.
3. For the purpose of pursuing an independent staffing policy in the bank's internal audit:
 - a) Staffing schedule of the Department must be approved by the Supervisory Council, only when presented and agreed to, by the Audit Committee;
 - b) The Director of the Department and his/her Deputy must be appointed to, or dismissed from their position only when presented and agreed to, by the Audit Committee;
 - c) Other employees of the Department must be appointed to, or dismissed from their positions by the bank's Board of Directors, only when presented and agreed to, by the Internal Audit Director, which may require the consent of the Audit Committee according to the bank's internal procedures.

6.3 Responsibility of the Internal Audit Department

The same article mentioned above, namely, "Regulation on Internal Audit Requirements for Commercial Banks" further specifies the guidelines for information systems audit:

6.4 Guidelines for Information Systems Audit

To monitor the protection of the safety of the bank's assets, the Internal Audit Department should be charged

with the following responsibilities:

- a. To review the bank's internal controls system, assess adequacy and efficiency of this system, and to prepare recommendations for improving this system and to provide its monitoring
- b. To verify the compliance of the bank's management system, policies and strategies with the current normative acts and requirements of the National Bank;
- c. To periodically inspect the bank's transactions, the programs and activities of each structural unit, and to define their compliance with the bank's business plans, objectives and tasks;
- d. To inspect the compliance of the bank's employees' performance with the bank's internal instructions, policies and procedures as well as with current legislation and requirements of the National Bank;
- e. To assess the efficiency of usage of the bank's own resources and to report the findings to the Audit Committee;
- f. To coordinate the bank's programs in concert with the external auditors in order to verify that they are in compliance with the requirements of internal and external audit;
- g. To prepare and present to the Audit Commission for its review and approval, the internal audit program for each fiscal year, by quarters;
- h. To plan each internal audit inspection and report its findings, when completed, to the Audit Committee;
- i. For the purpose of conducting an audit in an impartial manner, to review the results and recommendations of the audit inspection, both during that inspection, or upon completing it, in concert with the persons, whose activities have been audited;
- j. To verify that the bank's Board of Directors have taken timely and adequate actions, consistent with the results and recommendations of the internal audits;
- k. To assist the bank's security service in investigating and determining wrongful actions;
- l. To maintain confidentiality of the information obtained while conducting the audit, not to reveal information containing commercial secrets; not to use it for his/her own interests or those of a third person; and to strictly adhere to banking secrecy.

6.5 Suggestive Measures for Companies Like Satyam

One of the key objective of this research study was "to examine and analyze in-depth the Satyam Computers Limited's accounting scandal by portraying the role of internal auditors. The fraud committed by the founders of Satyam is a testament to the fact that "the science of conduct is swayed in large by human greed, ambition, and hunger for power, money, fame and glory." All kind of scandals/frauds have proven that there is a need for good conduct based on strong ethics. The Indian government, in Satyam case, took very quick actions to protect the interest of the investors, safeguard the credibility of India, and the nation's image across the world. Moreover, Satyam fraud has forced the government to rewrite CG rules and tightened the norms for auditors and accountants.

It is universally accepted that "lasting solutions can be found by transforming human consciousness through an inner discipline and higher moral reasoning."

A transformed organizational culture, which pays highest attention to ethical conduct and moral values, will strengthen sustainable roots of the company. Transparency and effective auditing and regulatory checks, through internal and external auditors and monitoring agencies, will also help to establish long-lasting credibility for a company. The novel Audit software such as CAAT's should be employed at internal level for early detection of errors and fraud. Transparency in financial reporting, as a moral duty and ethical code of conduct, are also very important for companies to adhere to in order to uphold ethical standards.

7. Conclusion

Fraud is a deception. Whatever industry the fraud is situated in, or whatever kind of fraud we visualize, "deception is always the core of fraud." Furthermore, frauds and scandals have significantly increased uncertainty and volatility in the financial sector, thereby shaking investor confidence worldwide.

Thus, it is found that the banks and other financial sectors in India would like to incorporate the role of internal audit along with traditional external audit at earliest at all possible levels.

The internal audit is of great help to the statutory auditor but it is not a substitute of statutory audit. The extent to which an external auditor chooses to rely on internal audit will be a matter of his individual judgment and responsibility. The recommendations of the internal audit committee on any matter relating to the financial management including the audit report shall be binding on the board.

There are a few lessons learned and noted by stories like Satyam and they highlight the importance of internal audit.

Novel audit process knowledge category such as Computer-Assisted Audit Techniques or CAATs should be used in all financial sectors to automate and streamline internal audit processes. Therefore, now is the time for internal auditing to respond to these new challenges and opportunities.

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