

Modernisation of Internal Audit in the Public Sector

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In this Session the panellists were *Mr. G.C. Iyer*, Former CGA (India), *Mr. William F. Radburn*, (World Bank) and *Mr. N. P. Simal*, (Nepal) who chaired the session.

Initiating the discussion the Chairman mentioned that traditionally Internal Audit is considered to be a mechanism whereby the management is assured that the funds which are being deployed are managed with due diligence and compliance of the law and the revenue being collected is used efficiently, effectively and economically. That is the traditional concept of Internal Audit. But in due course of time the scope and the nature of Internal Audit has changed in commercial business and the essence has also changed in the Government Accounting.

The first aspect to be considered is how can Internal Audit in a Government Department be made **effective** because the same Accountants will have to undertake the Internal Audit. Their role will change, at times he functions as an Internal Auditor and at others, he may be a Treasurer. If this is the situation then how can a Internal Auditor produce good results. The second point is regarding **jurisdiction** of the Internal Auditor. The Accounts Departments is part of the executive and do not have the constitutional powers. The Auditor General has constitutional power and his jurisdiction is very wide. On the other hand, for example, as an Internal Auditor the District Treasury Office cannot examine the regularity of revenue. It is beyond the authority of the Treasurers to examine whether the revenue has been collected by different Government Agencies as it should have been collected. The third aspect is the **role** of an Internal Auditor in Government offices i.e. whether they are supposed to examine the compliance to the law or whether they should examine performance. If they examine the performance then what is the relationship between Internal Audit and external audit.

G. C. Iyer stated that some of the Public Sector undertakings have produced very good Internal Audit Manuals and their vision of Internal Audit is quite impressive. Things have come about in a positive sort of way. Internal Audit was and is a traditional tool of Management and was in practice before what is generally referred to as Statutory Audit came to be established. Statutory audit came later to fulfil a larger role that the relevant law envisaged. The two Audit cousins have grown in scope and content and have had to adapt to changes in the environment in which they function. Statutory Audit by its very nature is more visible and its target audience is normally external to the organization audited. Its findings and comments are turned over to the public domain. Internal Audit is the tool of management, tailored largely to keep an eye on what

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management perceives as its vulnerabilities. The two complement each other. Statutory Auditor's role is defined by statute and encompasses an appraisal or report on the effectiveness of the Internal Audit function. Public Sector audit has a wider range than normal statutory audit. In the case of Public Sector Audit whether it is transaction of general Government or of enterprises owned by Central Government, in addition to evaluating the Economy Efficiency and Effectiveness, audit has also to examine the legality and propriety in the usage of Public funds. Therefore the scope of Internal Audit in Public Sector includes proprietary audit also.

Process of Planning for audit is the same as statutory or external audit. First is the *Survey phase*. Survey phase is a process for gathering the needed information on the most significant and material areas and for identifying risk and exposure in order to decide whether audit should continue into fieldwork phase. *Fieldwork phase* is where the people actually go and examine the records. In the *Reporting phase*, the report on audit finding is given. So these three phases should be clearly understood and effectively strengthened when we modernize the audit functions in the Public Sector. In the phase of the fast changing environment, Internal Audit has to recast its role while at the same time retaining its traditional role because you cannot do away with the traditional functions; the Internal Audit has to do, i.e. to see the adherence to internal control systems and procedures and reduction of unnecessary time consuming controls. It should work as the extended arm of the external audit so that external audit can feel satisfied that these internal checks are working satisfactorily in the areas where fraud or defalcations can take place.

When we talk of Public Sector we also talk of Public Sector Enterprises. The general trend these days is to **outsource** Internal Audit functions to Chartered Accountants firms. Previously, Internal Audit was normally an in-house function but now it seems many of them prefer outsourcing. They prefer this outsourcing arrangement because cases of collusion between the Internal Audit staff and the various departments came to notice and the Internal Audit credibility stood affected to that extent. It is a positive development though not cost effective as having Internal Audit unit in your own organization. It is also better because initial phase – Survey phase would be done better when the areas are identified for Internal Audit to check. When work is given it to an outsider giving a substantial sum of money more time will be spent on thinking on what should be the areas where a specific report is needed. Outsourcing Internal Audit to specialized firms is a progressive development. All this strengthens Internal Audit. But one has to take it with a bit of circumspection and caution given the experience one has with some of the very big concerns like Enron and World Com which sank like the Titanic, despite their having the best of Internal Audit and checks and balances. Nothing can replace good, sensible and circumspect approach of internal checks and controls.

While extraneous forces such as globalisation has given fillip to modernization of Internal Audit in the Public Sector undertakings we shall have to see whether any such extraneous forces are

impelling improvement in Internal Audit within General Government as such. Outsourcing the work in General Government is out of question.

- ❖ Ministries must come out with a **good document** to project the usefulness of Internal Audit. At the beginning of the year when the budget is passed Internal Audit must come out with a booklet outlining the budget that the spending units will have and what they are expected to do with the money that has been voted by the Parliament. This would give them a signal that at a later date Internal Audit may come to see how much is achieved.
- ❖ Another essential thing is **good energetic staff** that can see the viewpoint of the Administrator. There should be a slot or two reserved for experts when Internal Audit of a particular department or section is taken up.
- ❖ CGA also comes out with year-end review of Internal Audit conducted, which goes up to Secretary (Expenditure). It is worthwhile to make this report available to the other heads of departments and Ministries to make them aware of the pitfalls that they may encounter in conducting their business.
- ❖ Internal Audit should have specialists of Information Technology to advise the management on any problems they may have with their computerization programme, especially large revenue earning departments who have their own audit mechanism to check revenues.

Internal Audit can be a powerful force to improve governmental accountability, in a manner similar to the important role that External Audit plays in strengthening Parliamentary accountability.

The third speaker, *William Radburn* made an elaborate presentation on the various facets of Internal Audit. He mentioned the two approaches on which internal audit is generally structured. The first is Centralized approach characterized by strong role played by a central agency, such as a Controller General, that provides leadership through establishing central policies, providing written methodology and professional development. Primary internal audit reporting is to the Chief Internal Auditor or Controller General, who in turn reports to the government, with secondary reporting to the governmental entity that is subject to audit. The other is Decentralized approach characterized by a lesser role being played by a central agency and a stronger role-played by managements of the government entities. Internal auditors are located within individual government entities. Primary reporting is to the management of that entity, while secondary reporting is to the central body. In fact, in many countries internal audit fits somewhere in between these two extremes. However, when a country is establishing a new internal audit function, it is preferable to start with the centralized approach for a period of time. This would allow good practical experience to be captured, upon which sound methodology and training would be based. Once internal auditors understand their responsibilities and carry them out in a

professional, constructive and consistent manner then, over time, internal auditors can be dispersed to individual governmental entities. Then, the central agency can fall back to more of an oversight and monitoring role.

William Radburn defined the various types of internal audit. Compliance audit address the question: *Are laws, regulations and other authoritative requirements being complied with?* However, to focus excessively or exclusively on this question may be at the opportunity cost of not adequately addressing other important questions. Financial Audit concern is- *Are financial systems sound and can financial statements be relied upon?* Value for money Audit focus is on the “three Es” – economy, efficiency, and effectiveness. This type of audit work addresses the question: *Are objectives being achieved at a reasonable cost?* Another way to differentiate among the types of audits according to him is to look at the different levels at which work is carried out:

- ❖ Compliance audits tend to focus at the **transaction level**;
- ❖ Financial audits tend to focus at the **systems level** (with systems being a logical collection of like transactions); and
- ❖ Value for money audits tend to focus at the **program level** (with program being a logical collection of systems to achieve a particular purpose).

William Radburn emphasised that focusing excessively on systems, processes and activities may give us a false sense of satisfaction that results are being achieved. In essence, various accountabilities may exist, but in the public sector additional emphasis should be given to ‘accountability for results’. As more and more governmental entities are giving more attention to results, internal auditors should be doing likewise.

The critical success factors for internal audit are: a strong clear mandate, support from top management, independence, access to all needed information, appropriate resources to do what is required, reporting to the highest levels within the organization, recommendations to correct weaknesses, timely follow-up etc.

William Radburn stated the importance of developing a practical approach in internal audit. Towards this the first objective **should be to build strong relationships and linkages**. The internal auditor is always in an awkward position, having to report shortcomings of others. At a minimum, this usually causes embarrassment and even resentment. To counter this natural tendency, time and effort must be invested in ensuring that the internal audit function is well understood, respected and supported. The second objective **should be to focus on significant and high-risk issues**. There are too many lengthy internal audit reports that go on page after page listing similar detailed audit findings. Often, there is no indication as to which the auditor views ones as significant or high risk. Readers of audit reports usually do not have the time to sort out for themselves what is important and what isn't. It is a role for the auditor to make it very clear in audit reports where the attention of management should be placed. If initial audit planning would have been risk-based to start with, then the probability would be much greater

that whatever was found would be of importance. The reality is that auditors, whether internal or external, usually do not have unlimited resources available. They cannot audit everything. Everything does not need to be audited to the same extent. The important things should be audited regularly, the less important things less regularly. A simple ABC categorization approach is easy to use, whereby A represents the most important areas, and C the least important, with B representing those in between. The annual audit plan should reflect relative importance of matters to be audited. A multi-year internal audit plan could be used to show the audit cycle for the entire internal audit universe. Maybe 10 to 15% of audit resources should remain unscheduled and available for those unexpected and unplanned issues.

The third objective **should be to deliberate on results vs. process**. Auditors examine transactions, systems, processes, activities and controls and when they do so, they usually find some weaknesses. As a result, the auditors recommend improvements, usually in the form of additional controls. Over time, the systems, processes, activities and controls can become unwieldy and cumbersome because of all the controls that have been added. The auditors can easily become part of the problem, rather than being part of the solution. While audit rigor is required, one must make sure that rigor mortis doesn't follow, that is, so many rules and controls that have the effect of stifling creativity. When a weakness is identified, auditors should take time to assess whether or not the effect or consequence is material or not. If material, then the next step is to identify the main cause. Is the main cause something that is within the responsibility of the entity, in which case it is reasonable for management of the entity to be able to take corrective action? Another concern is that auditors tend not to analyse the cost to the organization of implementing audit recommendations. Some internal audit time should be devoted to making sure that the solution costs less than the cost of the problem itself. Finally **constructive audit approach** is needed. Internal audit should pay attention to what caused the problem, and how best can it be addressed so that the same thing will not happen again and again. Helping management to identify and fix costly problems is the real role of internal audit. In this manner, auditors and others will not always be in conflict and the perception of auditors, as a 'necessary evil' will evolve to a 'necessary element' in the overall movement for improvement.

William Radburn also gave suggestions for improving internal audit reports. Some of these are: for audit reports that are over 8 to 10 pages, include a one-page Executive Summary; use a Table of Contents for ease of locating sections; use standard headings, such as Background, Objective, Scope, Findings, Conclusion, and Recommendations; ensure that there is a logical consistency from objective to scope to findings and to the conclusion; use simple non-technical terms; Use charts, graphs, tables, and even photos, to reduce repetition, and monotony of the written word page after page; use short concise sentences; consider using point form reporting to make it easier for readers to follow and to avoid rambling and mixing different points together.; put

details in a separate Appendix; with the technology that is now available, you should also run the draft report through a spell check, a grammar check and a readability check; if the content of your audit report is good, make sure that the report's appearance reflects the quality of what is being reported.

William Radburn also emphasised the necessity of being *current on accounting, audit and ethical issues*. A good knowledge of financial and cost accounting can be of benefit to internal auditors when assessing information used by management in planning and in decision-making. It is important that internal audit be current on changing rules on both accounting and what is expected regarding ethical behaviour of management. Internal auditors should *promote professionalism*. Internal audit should *adopt appropriate audit standards*. If not, the audit standards published by the Institute of Internal Auditors could be a suitable starting point. Internal audit should *adopt a Code of Conduct* setting out the values to be followed by its staff. Internal audit needs to have a *mechanism for ensuring that its Standards and Code are being followed*. Is there a "Quality Assurance" process in place? If not, then maybe one should be adopted to help ensure consistency and high quality in internal audit work. In the end *William Radburn* felt that the internal auditors should take pride in the internal audit work being done.

Concluding the session the chairman struck a positive note that internal audit is a necessary and helpful function. It should be a key link in the chain of management's accountability. It needs constant review and attention. Interacting with others, such as at seminars like this, is a very good way to help ensure that internal audit is the "lighthouse" that management regularly relies on and respects. While many accept the need to focus more on accountability for results, few are actually doing it. Hopefully, the Internal Auditors will get encouraged, and adopt more of a results-focused approach to their work. It will help to lead to a more rewarding and meaningful internal audit practice.

Conclusions & Recommendations:

- ❖ Internal Audit should expand its scope to include Performance Audit and Value for Money audit.
- ❖ While evaluating internal control systems, internal audit should ensure that these systems are cost effective and designed to achieve results. Observance of due diligence must also be constantly reviewed.
- ❖ Recommendations of Internal Audit should be closely aligned with organizational priorities. Significant and high-risk areas should clearly be the focus of audit recommendations.
- ❖ Internal Audit Standards must be developed and adopted at the earliest. To facilitate efficient discharge of its changing responsibilities, sufficient attention should be paid to capacity building in this field.