

The changing role of internal audit

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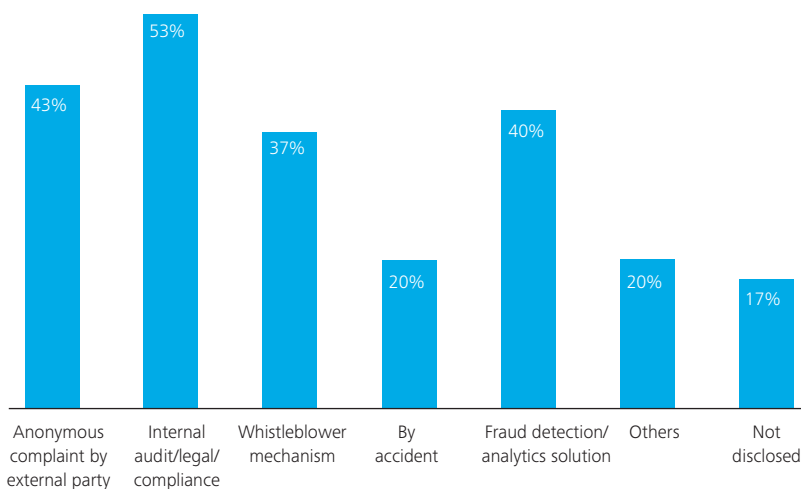
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The current scenario

All organisations are subject to fraud risks and there have been several instances in the past couple of decades when frauds have led to the downfall of organisations as a whole. Some notable examples include, Enron and Worldcom in the USA and Satyam near home. The current economic slowdown has brought to surface a number of high profile frauds like the Reebok and Citibank cases thereby increasing the focus on fraud risk management. Global regulations like the US Foreign Corrupt Practices Act (FCPA), UK Bribery Act, Sarbanes Oxley Act have increasingly put responsibility on the management of organisations to implement an effective fraud risk management framework. In the wake of increasing incidents of frauds in the financial service sector, the Reserve Bank of India (RBI) introduced guidelines for comprehensive Fraud Risk Management (FRM) system for banks.

With increased regulatory focus and widespread negative impact of frauds, the managements and senior executives are increasingly concerned about the vulnerability and exposure of their businesses/ organisations to frauds and whether or not they are adequately protected. A recent survey undertaken by Deloitte for fraud in Indian banks indicated that more than half the frauds were detected by internal audit reviews. This brings into focus the role of internal audit in fraud risk management.

Fraud Detection mechanism



Source: India Banking Fraud Survey 2012

As the mandate and role of internal audit continue to evolve, managements are increasingly counting on internal audit functions in their efforts for managing fraud risks and keeping organisations protected. Increasingly, 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 organisation's management on fraud risks.

Internal Audit - the traditional role

According to Chartered Institute of Internal Auditors, the role of internal audit is to provide independent assurance that an organisation'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 organisation's reputation, growth, its impact on the environment and the way it treats its employees.

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|---------------------------------------|--|
| Assurance | Objective examination to provide accurate and current information to the stakeholders about the efficiency and effectiveness of its policies and operations, and the status of its compliance with the statutory obligations |
| Assessment and Recommendations | Assessing and making recommendations on the effectiveness of the existing controls Demonstrates informed, accountable decision making with regard to ethics, compliance, risk, economy and efficiency |
| Oversight | Assessing and making recommendations on the effectiveness of the existing controls Demonstrates informed, accountable decision making with regard to ethics, compliance, risk, economy and efficiency |
| Advisory Services | Assessing and making recommendations on the effectiveness of the existing controls Demonstrates informed, accountable decision making with regard to ethics, compliance, risk, economy and efficiency |

The below chart provides the fundamental functions of an internal audit team.

The changing role of Internal Audit

The ever increasing regulations and expansion of organisations across the globe into new markets exposed the organisations 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 organisations – financial and reputational – it is important for the organisations to have a strong fraud prevention programme.

As organisations 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 organisation, they develop an overall knowledge of the organisation’s processes, risks, control systems and personnel which can contribute to an effective fraud risk management.

The IIA provides mandatory guidance for internal auditors in its International Professionals Practices Framework (IPPF). Internal auditors are expected to have sufficient knowledge to evaluate the risk of fraud in their organisations, and are required to report to the board any fraud risks found during their investigations. IPPF also expects the internal audit activity to evaluate the potential for the occurrence of fraud and how the organisation manages its fraud risk. The expectation is that internal auditing should provide objective assurance to the board and management that fraud controls are sufficient for identified fraud risks and ensure that the controls are functioning effectively. Internal auditors may review the comprehensiveness and adequacy of the risks identified by management — especially with regard to management override risks.

So how can this work in practice?

While planning their annual audit plan, internal auditors should consider the assessment of fraud risk and review management’s fraud management capabilities periodically. They should regularly and closely communicate with those responsible for risk assessments in the organisation and also others in key roles throughout the organisation, to ensure timely fraud risk management. Internal auditors, during their assignments, should spend an adequate time and attention to evaluating the framework and internal controls related to fraud risk management. It is also imperative to have a well-defined response plan to handle potential frauds uncovered during an internal audit assignment.

Coping up with the new role

Though the role and responsibility of internal audit function may vary in scope and authority in different organizations, there is a clear trend that internal audit is taking on a more strategic and central role. With these changes, the increased interaction between the evolving internal audit function and its major stakeholders is an important area for organisations to focus on and develop. Organisations can be walking on a dangerous tightrope where senior management believe that the internal audit function is providing assurance in respect of fraud risk assessment, detection and investigation, whereas reality is that internal audit are under resourced or inadequately trained and constrained in their ability to meet the expected delivery. Apart from this, gaps can also exist in the levels of support and training that are provided to internal auditor and could mean that their ability to be effective could be highly compromised.

The way forward

An organisation’s commitment to effective internal control should be reflected directly in the importance it attaches to its internal audit function. The internal audit charter, approved by the board or audit committee, should clearly identify the roles and responsibilities of internal audit with respect to fraud risks. This could include roles in relation to fraud risk management, initial or full investigation of suspected fraud, root cause analysis and control improvement recommendations, monitoring of a reporting/whistleblower hotline, and providing ethics training sessions. If the internal audit activity is responsible for the investigation, it may conduct an investigation using in-house staff, outsourcing, or a combination of both. This will require fraud investigation teams to obtain sufficient knowledge of fraudulent schemes, investigation techniques, and applicable laws. In organisations where primary responsibility for the investigation function is not assigned to the internal audit activity, the internal audit activity may still be asked to help gather information and make recommendations for internal control improvements.

It is, therefore, of utmost importance that internal audit functions are adequately funded, staffed, and trained, with appropriate specialised skills depending upon the nature, size, and complexity of the operating environment of an organisation. Also it is essential for the internal audit function to have independent authority and reporting lines and have adequate access to the audit committee.

Sources:

1. IPPF – Practice Guide on Internal Auditing and Fraud
2. Managing the Business Risk of Fraud: A Practical Guide – Paper sponsored by IIA, AICPA and ACFE.

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