



Internal Audit and SOX

December 21, 2013

Agenda

- Internal Audit - Definition
- Role of Internal Audit as a function
- Reporting lines of Internal audit
- Internal audit processes
- SOX
- Collaboration

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- **Internal Audit - Definition**
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Internal Audit - Definition

- The Institute of Internal Auditors (IIA) definition of internal auditing is:

“Internal auditing 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.”

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- **Role of Internal Audit as a function**
- Reporting lines of Internal audit
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- Collaboration
- Conclusion

Role of Internal Audit

(1/2)

- The key role of Internal Audit is to assist the board and/or its audit committee in discharging its governance responsibilities by delivering:
 - reasonable assurance that risk management, control, and governance systems are functioning as intended
 - reports risk management issues and internal controls deficiencies identified directly to the audit committee
 - provides recommendations for improving the organisation's operations, in terms of both efficient and effective performance
 - evaluates information security and associated risk exposures

Role of Internal Audit

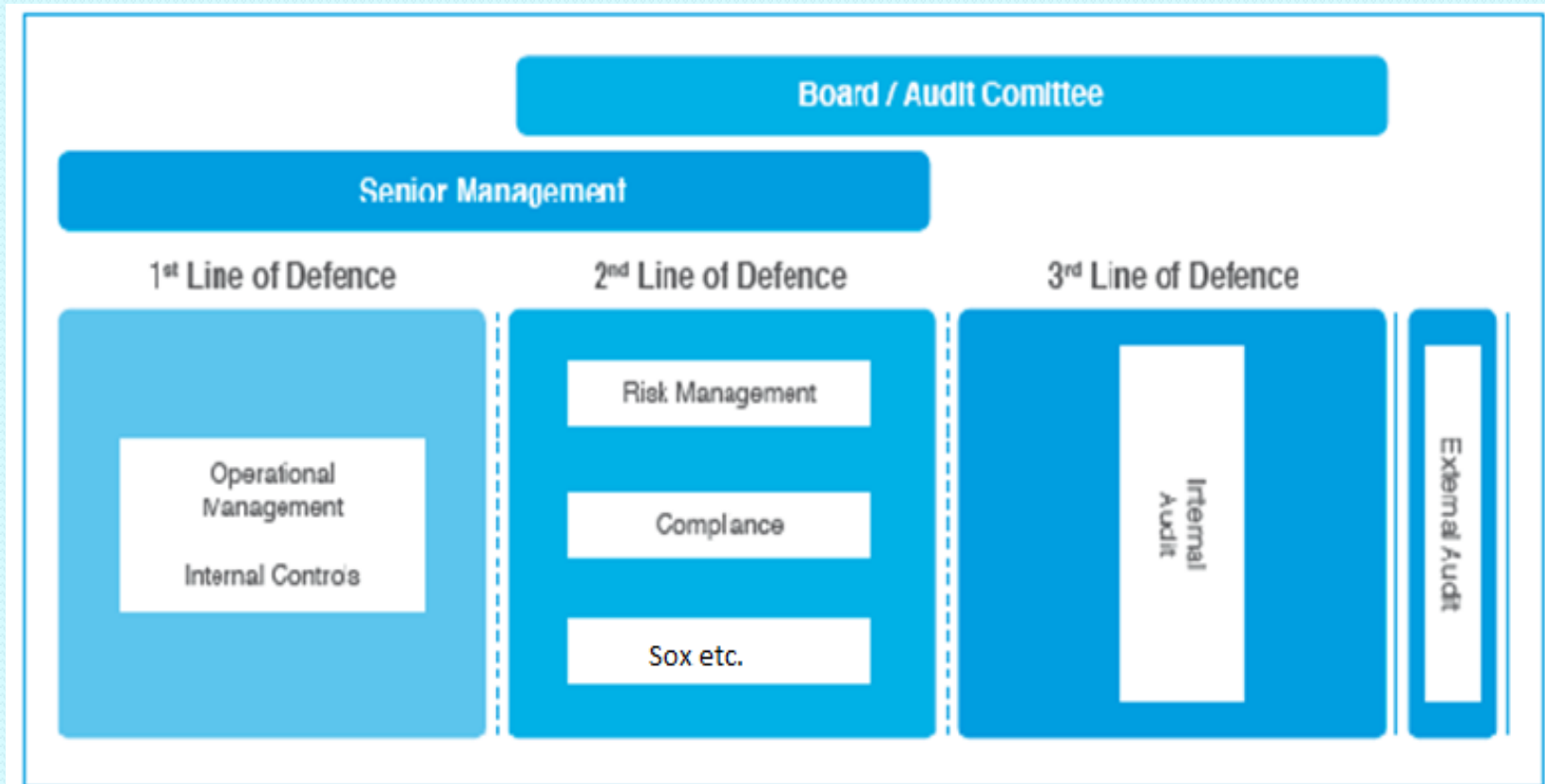
(2/2)

- Key role:
 - evaluates regulatory compliance program with consultation from legal counsel
 - evaluates the organisation's readiness in case of business interruption
 - maintains open communication with management and the audit committee
 - engages in continuous education and staff development
 - provides support to the company's anti-fraud programs.

Role of Internal Audit

- IA should have a audit charter and audit policy in place
- Design annually a Risk based audit plan covering the entire **Universe** of an Organisation.
- Keep in mind the key risk:
 - Operational risk
 - Financial risk
 - Credit risk
 - Market risk
 - Reputation risk
 - Legal and compliance risk
 - Information Technology risk
 - Strategic risk

Role of Internal Audit



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Reporting lines of Internal Audit

(1/3)

- Ideally Internal audit function should report
 - functionally to the chairman of the audit committee,
 - administratively to the CEO of the organisation.
- Institute of Internal Auditors had suggested key measures to ensure independence of IA department:
 - The head of IA should meet privately with the board/audit committee without the presence of the management.
 - The AC should have the final authority to review and approve the annual audit plan and all major changes to the plan.

Reporting lines of Internal Audit

(2/3)

- Key measures:
 - The AC should review the performance of the head of the IA and the overall IA function at least once a year, as well as approve the compensation levels for the head of IA.
 - The charter for the IA function should clearly articulate both functional and administrative reporting lines for the function as well as its principal activities
 - The reporting line should facilitate open and direct communications with the CEO, the senior executive group and line management

Reporting lines of Internal Audit

(3/3)

- Key measures:
 - The IA should have unrestricted access to information flows so that it receives adequate and timely information concerning the activities, plans and business initiatives of the organisation.
 - Budgetary controls and considerations imposed by the administrative reporting line should not impede internal audit in accomplishing its brief.

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Internal Audit process

(1/2)

- A typical internal audit assignment involves the following steps:
 - Establish and communicate the scope and objectives for the audit to appropriate department.
 - Develop an understanding of the business area under review.
 - Describe the key risks facing the business activities within the scope of the audit.
 - Identify management practices and control used to ensure each key risk is properly controlled and monitored.

Internal Audit process

(2/2)

- Steps (contd...)
 - Develop and execute a risk-based sampling and testing approach to determine whether management controls are operating as intended.
 - Report issues and challenges identified and negotiate action plans with management to address the problems.
 - Follow-up on reported findings at appropriate intervals. Internal audit departments maintain a follow-up database for this purpose.

Audit Process.

Planning

Determine objectives, scope, timing and resources. May involve:

- Process Discussions
- Information Gathering
- Relationship Building

Fieldwork

Test processes, transactions, and controls. Analyze test results and formulate conclusions. May involve:

- Direct Observation
- Shadowing
- Documentation Review
- Reperformance

Reporting

Communicate audit results to audit client, management and stakeholders. May involve

- Develop Draft Report
- Collaborative Review
- Mgmt Responses
- Report Distribution

CONTINUOUS COMMUNICATION

Internal audit report structure

- An audit report may have:
 - an executive summary
 - scope and objective of the assignment
 - an objective view of the IA on the function reviewed
 - sampling process/method
 - a body that includes the specific issues or findings identified and related recommendations or action plans;
 - and appendix information such as detailed graphs and charts or process information

Quality of IA report

- Objectivity - The comments and opinions expressed in the Report should be objective and unbiased.
- Clarity - The language used should be simple and straightforward.
- Accuracy - The information contained in the report should be accurate.
- Brevity - The report should be concise.
- Timeliness - The report should be released promptly immediately after the audit is concluded, say within a month.

Key elements of IA findings

- An audit finding within the body of the report may contain five key elements:
 - Condition: What is the particular problem identified?
 - Criteria: What is the standard that was not met? The standard may be a company policy or other regulatory guideline.
 - Cause: Why did the problem occur?
 - Consequence: What is the risk/negative outcome (or opportunity foregone) because of the finding?
 - Corrective action: What should management do about the finding? What have they agreed to do and by when?

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Role of IA in Sarbanes Oxley Era

- Sarbanes-Oxley Act (2002) –
- An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.
- Sarbanes-Oxley specifies the various roles of:
 - Audit committee,
 - Management and
 - The external auditors.
- Surprisingly it does not specifically address the role of internal auditors.

Role of IA in Sarbanes Oxley Era

- Audit committee:
- Section 301 establishes certain general standards with which audit committee members are required to comply. These standards are:
 - Except for board of director fees, audit committee members may not accept consulting, advisory, or other compensatory fees
 - Audit committees must be directly responsible for the appointment, compensation, retention, and oversight of all registered public accounting firms
 - Audit committees must establish procedures for receiving, retaining, and addressing complaints received by the issuer related to accounting, internal controls, and auditing.
 - Issuers must provide the audit committee with appropriate funding to enable it to fulfill its responsibilities.

Role of IA in Sarbanes Oxley Era

- Audit committee:
- Section 407 requires an issuer to disclose in its annual report whether it has at least one audit committee financial expert serving on its audit committee, and if so, whether the expert is independent of management. An issuer that does not have an audit committee financial expert must disclose this fact and explain why.

Role of IA in Sarbanes Oxley Era

- Management
- Section 302 requires management (principal executive and financial officers) to certify the effectiveness of disclosure controls and procedures with respect to the quarterly and annual reports.
- Section 404 of Sarbanes-Oxley requires management to document and evaluate the design and operation, and report on the effectiveness, of its **internal control over financial reporting**.

Role of IA in Sarbanes Oxley Era

- External Auditors
- Section 404 of Sarbanes-Oxley requires an issuer's external auditors to evaluate management's assessment of internal controls and to issue a report thereon.
- Section 201 makes it unlawful for an issuer's external auditor to provide certain types of non-audit services to an issuer concurrent with the audit.
- Section 203 requires the external auditor to rotate every five years the lead audit or coordinating partner and the reviewing partner on the engagement.

Role of IA in Sarbanes Oxley Era

- Role for IA:
- It is the management's responsibility to ensure the organization is in compliance with the requirements of Sections 302 and 404 and other requirements of the Act, and this responsibility cannot be delegated or abdicated.
- Support for management in the discharge of these responsibilities is a legitimate role for internal auditors.
- The internal auditors role in their organization's Sarbanes-Oxley compliance can be significant, but also must be compatible with the overall mission and charter of the internal audit function.

Role of IA in Sarbanes Oxley Era

- Role for IA:
- Internal auditors should consider Sarbanes-Oxley noncompliance as a risk to the organization, along with all other risks, in their risk assessment process.

SOX activities for IA

(1/4)

- Potential activities IA can do for SOX implementation
- IA activity as consultants
 - may assist the organization in identifying, evaluating, and implementing risk and control assessment methodologies
 - recommend controls to address related risks.
- However, decisions to adopt or implement recommendations made as a result of an internal audit advisory service should be made by management.

SOX activities for IA

(2/4)

- Potential activities IA can do for SOX implementation
- IA help in Documentation and/or Testing:
 - If management has not documented their control environment and does not have adequate resources needed to do so within the time period required, then internal auditors may aid management in documenting their internal controls.
- However IA should be careful while doing the documentation role, IA should not slide into a decision making role (e.g., implementing internal controls during the documentation process).

SOX activities for IA

(3/4)

- Potential activities IA can do for SOX implementation
- IA help in Training or Information about Controls
 - Internal auditors may provide training and/or information on internal control identification and assessment, risk assessment, and test plan development without impairment to objectivity. As the organization's control experts, this would be a natural role.

SOX activities for IA

(4/4)

- Potential activities IA can do for SOX implementation
- IA help for Control Self-assessment
 - The internal audit activity is often the source for expertise regarding control self assessment (CSA) and for skilled facilitators. CSA may be used as an effective and efficient means for management to document and/or assess controls.
- Internal auditor may provide information, training, and/or facilitates a CSA. However, if during the CSA the internal auditor owns the assessment or is the main source of the documentation, then IA's objectivity is impaired.

Difference between IA and SOX testing

- SOX only covers internal control over financial reporting. It does not cover:
 - Operational Efficiency
 - Improvement Opportunity
 - Benchmarking of best practices
 - Wastages and inefficiencies
 - Fraud which may not have material financial impact

Difference between IA and SOX testing

- Examples
- Inventory Review
- Control: Old, slow, non moving inventory is reviewed by CFO and provisions are made for all inventory that are old, slow & non moving in excess of 180 days.
- Treatment in SOX: In SOX, you will see the evidence of review and whether adequate provision is made
- Treatment in IA: ???????

Difference between IA and SOX testing

- Treatment in IA:
- Root cause analysis to identify why inventory became slow and non moving
- Identify the method by which it can be avoided in future. E.g. define maximum inventory levels
- Suggest the alternate ways to liquidate the materials
 - Use of materials by other locations in case of multiple plant environment
 - Possibility to liquidate the materials if these are not customized products
 - Reprocess the materials. For e.g. plastic and metal can be extracted from residual
- Suggest on keeping slow and non-moving materials separately and regular reporting

Difference between IA and SOX testing

- Control: Receipt of goods worth Rs. 100/- has been recorded accurately and completely.
- SOX: Check the entry is recorded that you have purchased the above goods for Rs. 100/-.
- What if goods could be purchased for Rs. 80/-.
- No impact with respect to SOX

- IA treatment:
- Vendor selection process needs to be questioned.
- Quality of the goods could be commented upon
- Provision could be created
- Comparative quoted from the other vendors

Difference between IA and SOX testing

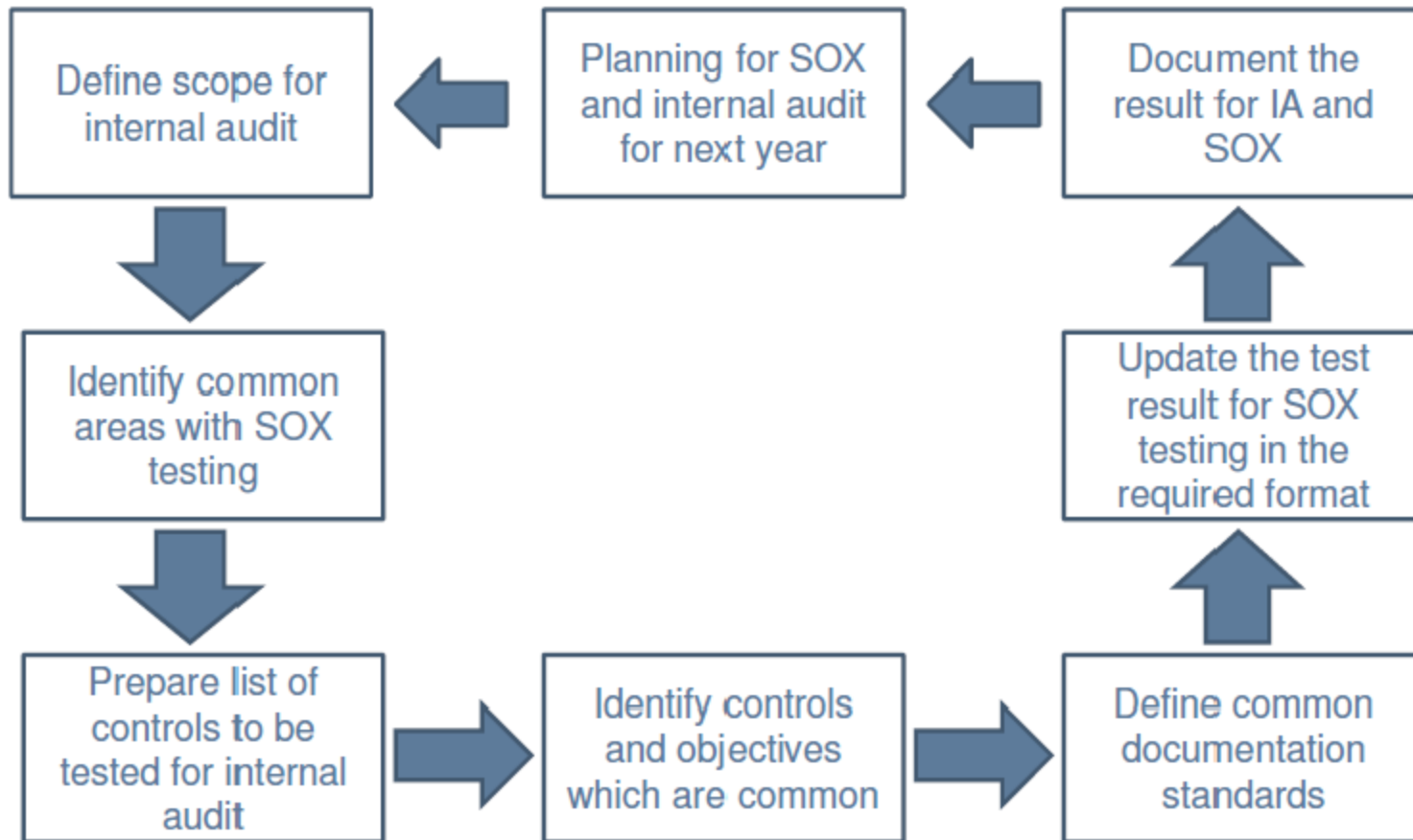
- Description: Fraud in company where there is theft of Rs 1,500,000 lakhs by cashier
- SOX Treatment: ensure that Fraud is detected, accounted as loss and reported in Financial Statement (if material)
- IA Treatment:
 - Identify root cause for fraud
 - Understand if it is process related gap or individual instance
 - Understand if there is any Segregation of Duty issue
 - Understand if there has been any collusion resulting in fraud

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Synergy between IA and SOX testing

Synergy between SOX and Internal Audit



How SOX certification testing can be done

- Three levels of assessment of effectiveness of internal control over financial reporting can be done in the SOX certification process. These are :
 - Control self assessment by process owners: Quarterly walkthroughs of all processes and controls or Semi-annual testing of Critical/Key controls
 - Overall supervision and sample verification of control self assessment exercise by process owners. Group Head to certify the effectiveness of the internal control report based on the aforesaid reports
 - Independent testing by the **Internal Audit** of the above activities



Thank You

arihant.jain@icicibank.com