Reporting under Internal Audit

November 22, 2014

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Internal Audit-Definition

"**Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.** "

The Institute of Internal Auditors
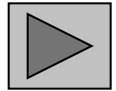
Internal Audit-Definition

Internal Audit is **an independent appraisal activity** which helps organizations to achieve their stated objectives by:

- Reviewing the policies, procedures, operations and proposing improvements

- Reviewing the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations that could have a significant impact on operations.

- Reviewing the application and effectiveness of risk management procedures and risk assessment methodologies of various operations and activities.
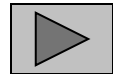
Internal Audit-Definition

- **Evaluating the internal controls in various business processes, procedures and operations**

- **Reporting results of the evaluation of controls, recommending stronger controls and also following up of action taken for recommendations made in previous reports**

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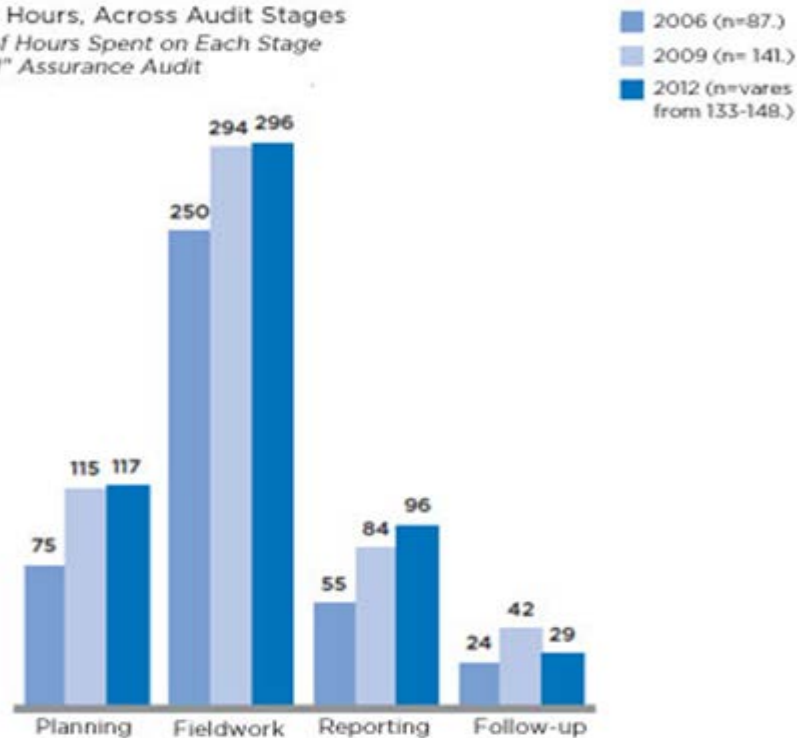
Reporting Mechanism

Audit Reporting Process

- Executives struggle to both streamline the audit reporting process and improve the audit team's ability to draft clear and concise audit findings. Many audit departments end up spending more time than desired in the audit reporting stage and are looking for ways to generate reports faster

- Prior to issuing the draft report, it is better to engage management in advance by communicating interim findings in a written format, enabling management to immediately begin remediation efforts

- Also, focusing your communication on severe findings and avoiding rating of audit issues often results in a better collaboration with management, reducing the time spent reporting

Audit Reporting Process

Fieldwork Consumes the Most Audit Time

Time Spent, in Hours, Across Audit Stages
Mean Number of Hours Spent on Each Stage
of a "Traditional" Assurance Audit

- 2006 (n=87.)
- 2009 (n= 141.)
- 2012 (n=vares from 133-148.)

Planning: 75, 115, 117
Fieldwork: 250, 294, 296
Reporting: 55, 84, 96
Follow-up: 24, 42, 29

Source-CEB

Audit Reporting Process

- **Raise Issues Earlier to Avoid Management Pushback**

  – Communicating findings earlier decreases the amount of time spent on iterations and discussions with management in the reporting stage. Prior to issuing a draft report, secure early agreement on the validity of findings by requiring written signoff from management. Early involvement enables management to immediately begin remediation efforts and transforms audit report issuance into a formality rather than a point of contention

    - Issue written documentation of findings for management sign-off to eliminate disagreement

    - Use an interim report or an audit issue and recommendation worksheet (AIR) during fieldwork to raise issues to management

Audit Reporting Process

- **Focus on Resolving the Issue Rather Than Giving a Grade**

  – **Issuing ratings for individual findings and/or the overall audit report might lead to more pushback from management throughout the audit. By focusing on resolving the issue rather than giving a grade, business leaders are better able to prevent unnecessary management pushback due to sensitivity issues.**

    - **Research indicates that 23% of companies do not grade individual findings and 22% do not use ratings for overall findings.**

    - **Remove audit ratings to reduce distraction from the audit finding and instead prioritize findings by level of notification required.**

Audit Reporting Process

- **Tailor Communications to Highlight Severe Findings**

    - **Tailoring audit communications to stakeholder expectations ensures maximum attention on the most important issues. Prioritize audit reports so that severe findings critical to business unit or process performance get attention at the highest level. Use potential impact and severity in order to center Audit Committee discussions on the most important issues from the enterprise perspective.**

        - **Prioritize audit findings to focus line management's remediation efforts on severe findings rather than "easy to fix" issues**

        - **Include a summary of audits in the report for the Audit Committee**

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Current Practice

Rating systems for audit findings (Individual findings & Overall findings) have **changed** little.

- The three-point scale for individual findings is still the dominant method for issuing grades.
  - Of the three-point scale, **High/Medium/Low** is preferred over Red/Yellow/ Green.
  - Respondents apply a range of measures from a simple three-point rating scale to other relatively complex rating scales to rate audits.
    - Respondents believe that rating audits **helps top management** directly address problems, establish priorities and focus on remediation plans.
    - That being said, these ratings also tend to **trigger frequent debates** and can shift the focus from the root cause of the problem.

Current Practice

Methods for Communicating Grades of Individual Audit Findings (Percentage of Respondents)
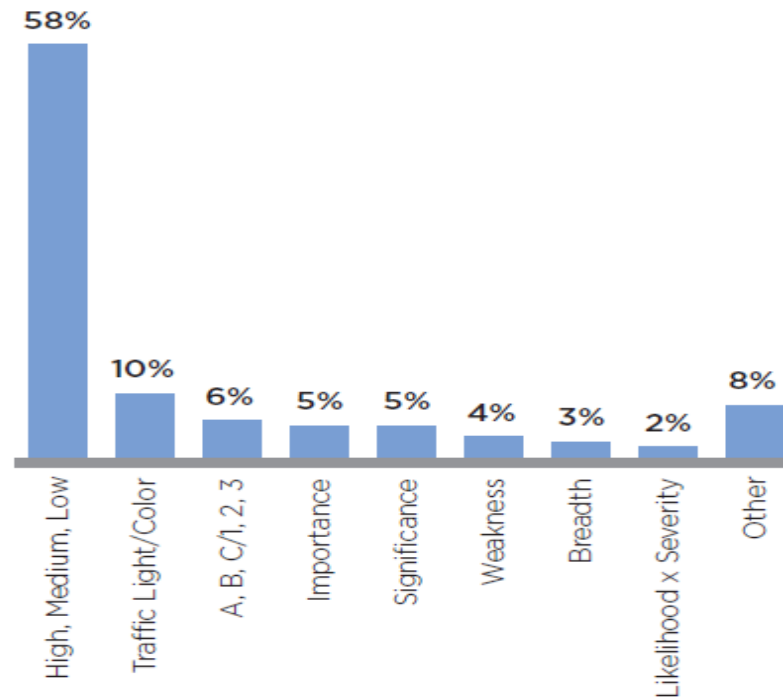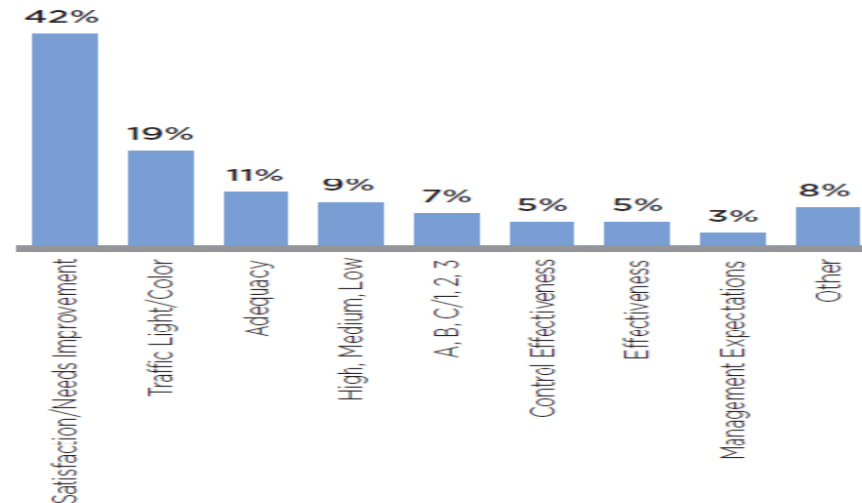

n = 137.

Source-CEB

Current Practice

- **Similarly, the three-point scale for overall findings is still the dominant method for issuing grades. Satisfied/Needs Improvement/Not Satisfied is the most common method for sharing overall findings.**

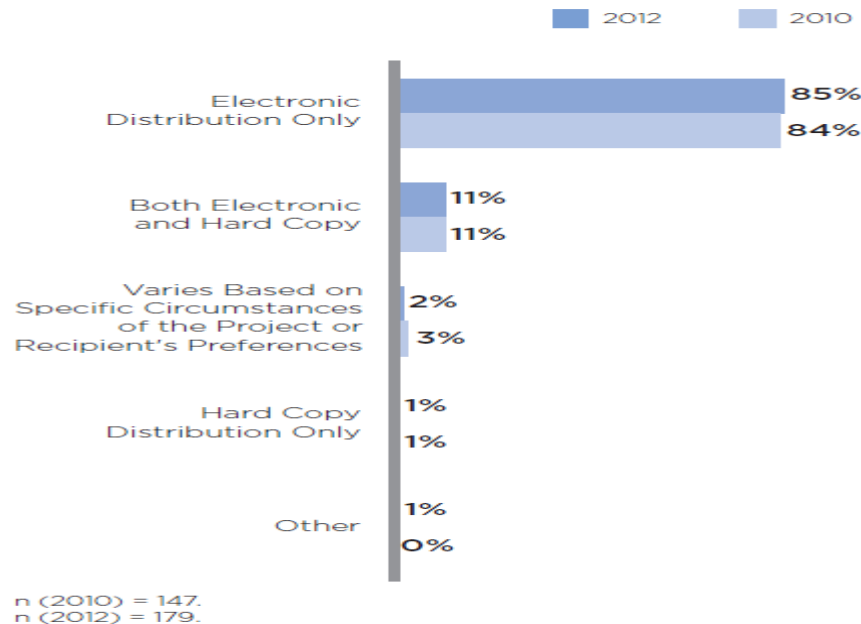**Methods for Communicating Grades of Overall Audit Findings (Percentage of Respondents)**

Source-CEB

Current Practice

- **Most companies use periodic summarization to communicate with the audit committee. The average number of pages in audit reports has increased from 9 to 12 pages (2010 to 2012). Internal Audit continues to distribute Audit Findings electronically**

  Distribution Method of Final Audit Reports to Recipients

  (Percentage of Respondents)

Legend: 2012 | 2010

Distribution Method	2012	2010
Electronic Distribution Only	85%	84%
Both Electronic and Hard Copy	11%	11%
Varies Based on Specific Circumstances of the Project or Recipient's Preferences	2%	3%
Hard Copy Distribution Only	1%	1%
Other	1%	0%

Source-CEB

n (2010) = 147.
n (2012) = 179.

Current Practice

**Reports to Audit Committee
(Percentage of Total Responses, Multiple Responses Allowed)**
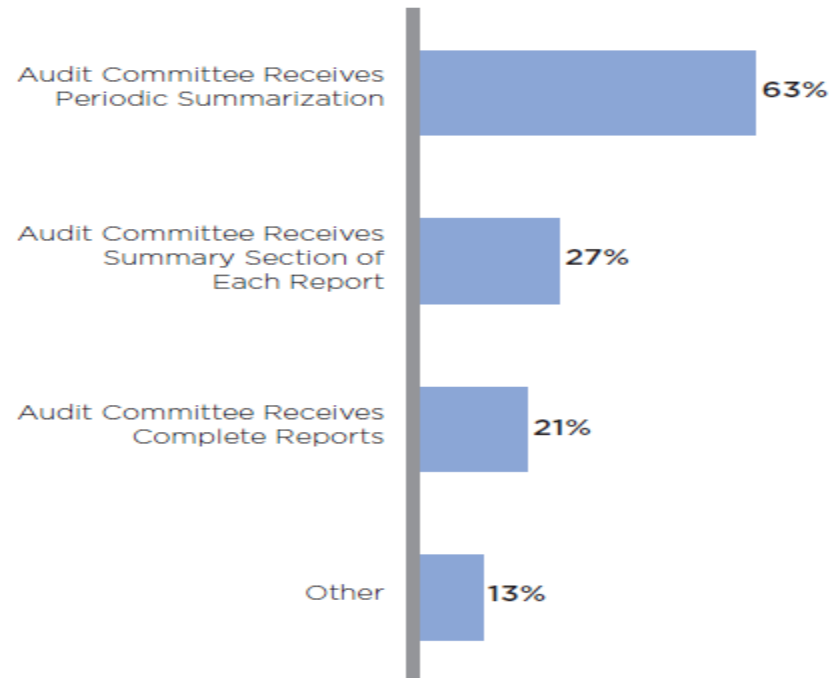
Source-CEB

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The primary focus of the risk-based internal audit shall be to provide assurance to the Audit Committee of the Board and top management of the organization about the **adequacy and effectiveness** of the Bank's risk management, control and governance processes. As such, after completion of field work, an audit report is prepared which should contain the following

- A brief overview of the unit being audited, objective and scope of audit, scope limitations/exclusions, sampling methodology, audit methodology, trend of risk and an audit opinion.

- Observations/Deficiencies observed during audit and categorization of same on the basis of the potential impact of the control Weakness **(High/Medium/Low)**

Contents of Audit Report

- **Root cause analysis of the issues observed (e.g. Process related deficiency, System related deficiency, Operational deficiencies)**

- **Risks involved**

- **Remedial action/Recommendations**

- **Responsibility and Response (action plan) – who, when and how**

- **Timelines for compliance**

- **Status of issues identified during previous audit, if any**

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Reporting Mechanism

Reporting to Management, Compliance Committee and Audit Committee:

- **Key audit issues and ratings, wherever applicable, on a periodical basis.**

- **Status on compliance with the recommendations made by the Committee**

- **Exposure to sensitive sectors i.e. capital market & real estate**

- **Review of compliance with various regulations e.g KYC/AML in case of banking sector etc.**

- **Review of Frauds.**

Reporting Mechanism

- **Review of information on violations by various functionaries in the exercise of discretionary powers**

- **Reporting of Revenue leakage detected during audits and status of recovery thereof - reasons for undercharges and steps taken to prevent revenue leakage.**

- **All risks identified should be addressed separately to ascertain whether they are applicable from a financial materiality and misreporting standpoint.**

Thank you

Internal Controls

Internal Controls are important checks instituted by management to have reasonable assurance that:

- **Operations are carried out in an efficient & effective manner**

- **Transactions are recorded accurately & completely**

- **Assets are properly recorded & safeguarded**

- **Laws are complied with**

- **Reliable reports are generated**

Risk Management

- **Focus on risk of occurrences that could prevent the project from achieving its goals**

- **Identification of inherent risks and the trend of risks.**

- **There are many types of risk – Credit, Market, operational, legal & Compliance, Reputation, Information Technology risks etc.**

- **Focus on areas with high risk & high probability that controls are not in place or are weak**

Add value by eliminating unnecessary controls, if underlying risks are minimal/within project's risk appetite!

Pointers for Risk Assessment

While reporting the risk impact of an issue, following pointers need to be taken into consideration:

- **Financial Risk:**
  - What is the estimated potential for direct operating loss?
  - What is the potential for a material balance-sheet misstatement?
  - What is the value of the items processed?
  - What is the financial history of past incidents?

- **Reputational:**
  - How will this instance get publicized?
  - What is the possibility of negative publicity? and to what degree would there be such publicity?
  - What is the previous history of such an incident in the industry?

Pointers for Risk Assessment

- **Regulatory:**
  - How has the regulator addressed similar (or the same) matter earlier? How the matter could be dealt with by the regulator, in this instance.
  - What are the views of Compliance and Legal regarding the possible/likely reaction from the regulator?
  - What is the precedent in the industry for such an instance?

- **Information Technology:**
  - How critical was the business process supported by the information system which was impacted?
  - How many number of transactions were processed by the information system?
  - In how many areas, the information system was not in compliance with the information security policy?
  - Whether the breach in information security has led to compromise in customer/confidential data?