An Empirical Study on the Contemporary Approaches in Internal Control Audit

***Vaijanath Sagaramath.** **Assistant Professor of Commerce, CNR Govt First Grade College, Sriramanagar.**

Abstract

This paper attempts to study on contemporary issues on the internal audit. Risk management to financial aspect and employs internal control as the instrument to manage firm's risk. The context of risk management builds on the framework where the organization wide risk appetite is formulated and the risk management environment of the organization is defined. The context looks at laws, regulations, economy, market, culture, technology, natural environment, stakeholders' needs, issues and concerns (Simkins and Fraser, 2010). The main output of context is to determine criteria for the acceptability of the risks. The criteria are used to evaluate the significance of risk by comparisons against the risk with existing controls or the risk with proposed treatments. The second output of the context may be the specification of the other risk management activities, such as communication and consultation and risk assessment. Corporate governance has been recognized as an indispensable factor in ensuring sound financial reporting and deterring misappropriations of capital in an organization. The growth of corporate governance has been of immense help to the internal audit function and has raised it to a professional status by emphasizing the benefits of independent judgment and objectivity in reporting. Internal auditing serves as a monitoring device, the organizational policeman and watchdog, thus, an integral component of corporate governance. The aim of this research is to examine the role of internal auditing in enhancing good corporate governance practice in the corporate sector with focus on performance and to possibly provide guidance on strengthening the internal audit function in corporate governance.

Key words: Risk factors, Enterprise internal control, Qualitative research, IT governance.

Introduction

The role of internal control in preventing corruption in public organisations is also recognised in international conventions against corruption. 1 Internal control and internal audit, no matter how well conceived and operated, can provide only reasonable – but not absolute – assurance to decision makers and public managers about the integrity of their organisation's operations. Implementing a risk-based approach to internal control purports to ensure that management is responsive to the potential vulnerabilities facing their respective public organisations and functions. Rather than simply regulating internal practices and procedures, management must put in place a systematic process and adequate capability (i.e. knowledge, resources, etc.) to assess and use assessment results to adjust management systems in a cost-effective manner to prevent risks from (re-)occurring. It also necessitates an ex post assessment of risk mitigating actions, recognising that earlier diagnosis and actions may not always have the desired effect. This requires leadership to create a culture that encourages risk management as a strategic and continuous action supporting prevention rather than as means of assigning blame to individuals and identify system vulnerabilities. Although internal auditors can play a valuable advisory service on internal control, the internal auditor should not be a substitute for a risk-based approach to internal control. Finally, to be effective, internal control and internal audit need to be integrated with other organisational systems that feed directly into management frameworks and decision-making processes as a means of strengthening public governance. Brazil's systems of internal control have historically been characterised by a strong compliance culture reflecting a combination of administrative and historical developments. Civil law countries, such as Brazil, are characterised by a high degree of formalisation of administrative decision-making processes, often spelled out in great procedural detail in primary and secondary legislation. Brazil's rules-based approach also reflects, in part, the historical influence of military leadership and the need to address asymmetric capabilities across the federal public administration. The modernisation of internal control in Brazil has been driven by a number of factors including increased federal spending (see Figure 3.1), innovations in service delivery and a push towards performance and accountability during the 1990s and 2000s. Innovation in service delivery has, in particular, been recognised as a driving force for reinforcing internal control in OECD member countries (see, e.g. Blöndal, 2005; Laking, 2005; Ruffner and Sevilla, 2004; Sevilla, 2005).

Objective:

This paper intends to explore and analyze (1) the critical risk factors that influence the governance of enterprise internal control in an technology driven environment, and (2) classify the risk factors and study their importance in such an environment.

Contemporary Approaches in Internal Control Audit

The separation of ownership from control produces a condition where the interests of owners and ultimate managers may, and often do diverge, and where many checks which formerly operated to limit the use of power disappear. It carries the risk to investors that management will misuse the resources entrusted to them and act in their own self-interest, even if it is detrimental to the shareholders. These risks are better managed within the framework of corporate governance through accountability mechanisms such as financial reporting, internal control and auditing. The relevance of corporate governance in curbing financial malfeasance and ensuring probity in reporting cannot be overemphasized. Board of Directors and Audit committees are directly responsible for internal control framework and this governance responsibility is carried out via the help of internal auditors. Since the beginning of the 21st century, the corporate world has witnessed series of failures (Enron, WorldCom, RBS, Northern Rock; Oceanic bank, Intercontinental bank), which brought about a heightened public awareness to corporate governance issues. The global economic crunch which began in 2007 added further strands to corporate governance practices and policies.

Recent trends in risk based internal controls

These developments witnessed in the corporate sector have intensified investors' involvements. And with that trend, have come more and more demand for high corporate governance standards, to ensure the efficient and effective use of capital, which provides good returns on investments in a manner responsible for society's interest; and is protected from malfeasance and misappropriation. Corporate governance is about the procedures and processes according to which an organization is directed and controlled

Corporate governance tends to encourage the efficient use of scarce resources as well as ensure accountability for the stewardship of those resources. Good corporate governance is a sine- qua -non for the success of any organization. Its relevance was further stressed in a 2002 Mckinsey survey which stated that 'corporate governance is at the heart of investment decisions'.

And investors tend to put corporate governance at par with financial indicators when evaluating investment decisions. Corporate governance is not an end in itself but a means to an end. As such, there are different factors that may lead to the accomplishment of its objectives. One of those factors is effective internal audit function (IAF). The concept of internal auditing has been central in the debate on corporate governance and regulating financial reporting; its activities play an important part in the effective governance and risk and control framework. Internal auditing is an independent appraisal function established by management for the review of operations.

Furthermore, after the major accounting scandals and the alarming number of earnings misstatements, there were calls for major reforms in the responsibilities and oversight of management, external auditors and corporate governance. In addition, the widespread failure in financial reporting has been largely blamed on weak internal control [5]. Since then, internal auditing has enjoyed a level of prominence and attention like never before. Consequently, due to the corporate failures, corporate governance codes now explicitly require disclosures by Companies on the soundness in their internal control system. Section 404 of the Sarbanes Oxley Act (SOX) made it compulsory for annual reports to contain a statement that management is responsible for internal controls and an assessment of the effectiveness of the internal control structure and procedure for financial reporting. Again, in 2003, the US Securities and Exchange Commission approved final version of the revised New York Stock Exchange (NYSE) and NASDAQ requirements. The NYSE now requires listed companies to have an internal audit function. The Institute of Internal Auditors (IIA) has also clarified roles and responsibilities by affirming the importance of risk management and corporate governance. According to IIA, internal auditing helps an organization accomplish its objective by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and corporate governance. However, in Nigeria, a survey by the Securities and Exchange Commission (SEC) reported in a publication in April 2003, showed that corporate governance was at a rudimentary stage, as only about 40% of quoted companies, including banks had recognized codes of corporate governance in place. Specifically for the financial sector, poor corporate governance was identified as one of the major factors in virtually all known instances of a financial institution's distress in the country. And one of those factors identified in poor corporate governance was weak internal control which is the primary area of the internal audit function.

The role of internal auditors

• Internal auditors should be largely independent, highly competent and people of integrity.

• The head of internal audit should not be below the rank of assistant general manager (AGM) and should be a member of a relevant professional body.

• He should report directly to the board audit committee but forward a copy of the report to the MD/CEO of the bank. Quarterly reports of audit must be made to the audit committee and made available to examiners on field visits.

• Internal audit unit should be adequately staffed. Necessity for corporate governance practice The central idea common to all regulators across different sectors is recognition of the need to incorporate a value system with potential for a comprehensive achievement of societal and corporate goals. Interests in corporate governance go beyond that of shareholders in the performance of individual companies in today's economies.

showed that an overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14% in North America and Western Europe, 20-25% in Asia and Latin America; and over 30% in Eastern Europe and Africa. More than 60% of the respondents stated they would avoid companies with poor corporate governance controls, and about 33% said they would completely avoid countries corporate governance rules and regulations are not strictly adhered to. In summary, adherence to corporate governance practices help improve confidence of domestic investors, reduce cost of capital, underpin the proper functioning of financial markets and ultimately induce more stable sources of financing

The relationship between corporate governance and internal auditing

Virtually all guidelines on sound corporate governance practice, includes recommendations for risk management through internal control and audit as a critical part of the governance mosaic. This relationship can be seen as an intricate part of the stewardship model of corporate governance. Internal controls and audit has been a central concept in the debate on regulating corporate governance and financial reporting since the Cohen Report on the auditor's responsibilities and especially the Tread way report on fraudulent reporting.

Power in dealing with "the audit explosion" claims that, the new corporate governance guidelines, such as the combined code in the UK, represents a new style of regulating an entity. Power predicted that "for such a style to succeed, the inside of organization and their internal control system (ICS) must be re-conceptualized as a potential regulatory space" .

As a consequence, the researcher has identified the concept of internal auditing and its relationship with corporate governance, an issue of main concern and a topic for closer examination. The internal audit profession has gone through a significant revolution and has received renewed emphasis internationally. There is also a growing recognition of the role internal auditing can or should perform in contributing to improved corporate governance and reporting, as organizations perceive and respond to risks associated with non-financial disclosures. For instance in the US and Nigeria, under the new SOX and CBN requirements, management is required to provide an assessment on the effectiveness of the internal controls and the external auditors are also required to conduct an audit on the internal controls and certify that management has carried out an assessment of those controls. Even though effective controls may not totally eliminate all potential accounting errors (both intentional and unintentional); it can limit the probability of financial misstatements. Greater risk of financial misreporting can result from ineffective internal controls. In addition, based on the findings from a global internal audit survey, it has been reported that internal audit practitioners expect that in the near future, less emphasis would be placed on operational and compliance audits and audit of financial risks, while corporate governance, enterprise risk management, strategic reviews; social and sustainability audits and ethics audit are set to become major focus areas

Conclusion

Corporate governance of banks has gone through a significant revolution and has even received renewed emphasis since the introduction of the corporate governance code for banks in 2000s. There is also a growing recognition of the role internal auditing in contributing to improved corporate governance and reporting, as banks perceive and respond to risks associated with banking operations, thus, an integral part of the corporate governance mosaic. The need for improved internal control and auditing mechanisms is one of the most important issues in public debate regarding corporate governance. In the aftermath of the financial crisis, many companies have implemented extensive risk management procedures. Additionally, internal audit has increasingly attracted the attention of managers as it constitutes the core of modern corporate governance.

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