



### Learning Objectives

- To understand the meaning, definition, objectives, benefits and drawbacks of internal audit.
- To identify the differences between internal check, internal control and internal audit.

#### POINTS TO RECALL



In the previous lesson, we have studied meaning and importance of internal Control, advantages and disadvantages, Principles of good internal control system, kinds of Internal Control, Methods of evaluating internal control system and Difference between Internal Check and Internal Control.

### 3.1 Introduction

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

Internal auditing is a catalyst for improving an organization's governance, risk management and management controls by providing insight and recommendations based on analysis and assessments of data and business processes with commitment to integrity and accountability.

Internal auditing provides value to governing bodies and senior management as an objective source of independent advice. The auditor's appointed to perform the internal audit activity are called as Internal auditor's.

### 3.2 Meaning

It is an audit conducted on a continuous basis by the employees of the organization appointed specially for this purpose, to review the operations and to offer suggestions to improve the efficiency. Audit which is conducted internally, i.e., within the organisation on behalf of the management is called as Internal Audit. The person who



### 3.4 Objectives of Internal Audit

The objectives of Internal Audit or the duties of an Internal auditor are as follows:



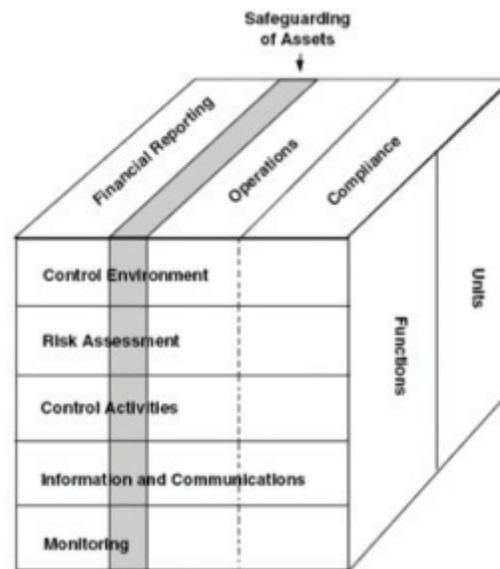
- 1. Verify the Accuracy of Accounts:** The primary aim of internal audit is to verify the correctness and accuracy of the financial records and accounts that are being presented to the management.
- 2. Detection of Errors and Frauds:** Internal auditor has to adopt suitable techniques and measures to detect errors and frauds, which are likely to be committed in the organization.
- 3. Review the Internal Check and Control System:** The auditor has to review and comment on the effective function of the internal check and internal control system within the organization. Any deviation in the function of the system should be reported to the management and the auditor should initiate suitable recommendations.
- 4. Verify the Assets of the Company:** Internal auditor should verify the existence of the assets in the company and should verify that proper measures are taken to protect or maintain the assets. He should also verify that assets are purchased or sold or replaced only with the approval of an authorized person.
- 5. Verify the Liabilities:** The internal auditor has to verify that the liabilities incurred by the organization are legitimate and they are likely to be incurred for the organizational activities.
- 6. Adherence to Accounting Standards:** Internal auditor has to ensure that the Accounting Standard practices are followed by the organization are strictly adhered.
- 7. Review the Managerial Functions:** Internal auditor has to review the managerial functions of an organization and has to report on them to the management.

### 3.5 Scope (or) Functions of Internal Auditor



1. **Evaluating of Accounting and Administrative Control:** Internal auditing ensures effective and efficient system of accounting control, standard costing, budgetary control and all other administrative controls.
2. **Protection of Assets:** Internal auditing besides ensuring proper accounting and custody of companies asset's it is concerned with the protection of the assets. It reports to the management about the utilization of the asset and the adequacy of return from the investment.

3. **Compliance with Established Policies and Procedures:** Internal auditing is concerned with reporting to the management about the compliance of the predetermined policies, procedures and standards of performance.
4. **Reliability and Validity of Reports:** Internal auditing ascertains the reliability of financial and operating reports prepared throughout the enterprise. It also provides assurance to the management of the validity of the reports and records. Internal auditing brings to light the inadequacies in the check and control system in operation to the management. Further, it provides advisory services to the management for the improvement of the system.



#### Comparison between Internal Audit and External Audit

##### Internal Audit

- Audit conducted internally i.e., by the management to ensure that the company complies with the policies, procedures and principles.
- The person who conducts internal audit is called as Internal Auditor, who is appointed by the management. The scope of work, powers and duties of internal auditor are determined by the management.
- Internal Auditor need not be a qualified Chartered Accountant and is remunerated in the form of salary as he is an employee of the company.
- Internal auditor has to submit an Internal Audit report to the management.

## External Audit

- Audit conducted externally i.e., by the shareholders to examine the accuracy of the books of accounts, records and financial statements.
- The person who conducts external audit is called as Statutory or External Auditor who is appointed by the shareholders of the company. The scope of work, powers and duties of statutory auditor are determined by the Companies Act.
- Statutory Auditor should be a qualified Chartered Accountant and is remunerated in the form of audit fees as he is an independent person.
- Statutory auditor submits Statutory Audit report to the shareholders of the company.

## 3.6 Advantages of Internal Audit

The advantages of conducting an Internal audit are as follows:



**1. Detection of Errors and Frauds:** Internal audit is a continuous and critical examination of books of accounts and records of the organization; hence errors and frauds can be easily detected and prevented.

**2. Quick Presentation of Accounts and Reports:** Transactions and postings in the books of accounts reviewed on a regular basis, which facilitates quick presentation of accounts and reports to the management. It also enables the external auditor to finalize the accounts quickly as the external auditor relies on the report submitted by the internal auditor.

**3. Advisory Services to Management:** Internal auditor who possess in depth knowledge of the business organization provides advisory services to the management like introduction of new product, improving the system of internal check and control to operations, etc.

**4. Proper Co-ordination and Control:** Internal audit coordinates the various operational or functional areas of business. It is the duty of the internal auditor to appraise and evaluate the efficiencies of the various control systems established in the organization. Hence, internal audit enables proper control and coordination in the organization.

### 3.7 Disadvantages of Internal Audit

The following are the limitations or disadvantages of Internal Audit:



1. **High Cost:** The cost of establishing and operating an internal audit in an organization is very expensive.
2. **Unsuitable for Small Organization:** Internal audit due to involvement of high cost is not suitable for small organizations.
3. **Unreliable Opinion:** Internal auditor's are employees of the organization and hence the report given by them may not be true and fair. Often, external auditor has reservations about the opinions expressed by the internal auditor.
4. **Ineffectiveness:** When the records of operations are not checked immediately after they are completed or when there is time lag between two audits, internal audit may become ineffective.
5. **Lack of Expertise:** Internal audit staff lacks the required skill and expertise as they are not professionally qualified chartered accountant.

### 3.8 Differences Between Internal Check and Internal Audit

S.No.	Basis	Internal Check	Internal Audit
1.	Meaning	Internal check is an arrangement of work in such a way that another person automatically checks the work of one person.	Internal audit is an independent appraisal of the operations of the company.
2.	Objects	The object of internal check is to prevent the occurrence of errors and frauds.	The object of internal audit is to detect errors and frauds.
3.	Scope of work	Internal check is considered as a device for doing the work.	Internal audit is a device for checking the work.
4.	Discovery of errors and frauds	In internal check errors and frauds are discovered during the course of doing the work.	In internal audit errors and frauds are discovered after the completion of the work.



S.No.	Basis	Internal Check	Internal Audit
5.	Commencement of work	Internal check is in operation during the course of transactions.	Internal audit commences only when accounting process is completed.
6.	Performance of work	In internal check no new staff is appointed to perform the work.	In internal audit the work is performed by a separate group of persons specifically appointed for this purpose.

### 3.9 Differences Between Internal Control and Internal Audit

S.No.	Basis	Internal Control	Internal Audit
1.	Meaning	Internal control is an arrangement of duties allocated in such a way that the work of one employee is automatically checked by another.	Internal audit is an independent review of operations and records undertaken by the staff specially appointed for this purpose.
2.	Objective	The system of internal control is devised in such a way that errors and frauds are minimized.	In internal audit errors and frauds already committed are discovered.
3.	Scope of work	In internal control the work is allocated to different employees in such a way that the work of one person is independently checked by other.	In internal audit the work of a clerk is checked by an internal auditor only after the former has completed his work.
4.	Work performance	In internal control there is no separate staff engaged to carry out the system.	In internal audit a separate staff is specially engaged for carrying out the work.
5.	Conduct	Internal control is a device for keeping a check on work.	Internal audit checks the work done in the light of policies and procedures as laid down by the management.





## STUDENTS ACTIVITY



1. Prepare a flow chart for accounting your family expenditure based on monthly income.
2. Visit a nearby large scale industry and discuss with internal auditor's regarding their appointment and their scope of work.
3. Arrange for a guest lecture with an internal auditor of a company and discuss the control over accounts and reporting to the management.

## SUMMARY

- **Internal Audit – Meaning:** Internal audit is an audit which is conducted on a continuous basis by the employees of the organization appointed specially for this purpose to review the operations and records of the organization and to offer suggestions to improve the efficiency.
- **Objects of Internal Audit:** The objects of internal audit are to check the accuracy of accounts, to review the internal control system, to protect the company assets, and to ensure that the company adheres to the accounting standards.
- **Advantages:** Internal audit helps in early detection of errors and frauds, quick presentation of accounts and reports, provides advisory services to management, benefits staff members and provides for proper co-ordination and control.



- **Disadvantages:** The draw backs of internal audit are it involves high cost, unsuitable for small organization, lack of expertise, conflicts between internal audit staff and other staff.
- **Difference between Internal Check, Internal Control and Internal Audit:** Internal Check, Internal Control and Internal Audit are complementary to each other as both are the two parts of the whole system of internal control. There exists a difference between the two systems.

## KEY TERMS

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



## EVALUATION



### I. Multiple Choice Questions:

1. The Internal Audit is conducted by \_\_\_\_\_
  - a. Government Auditor
  - b. External Auditor
  - c. Internal Auditor
  - d. Cost Auditor
2. The main objective of Internal Audit is \_\_\_\_\_
  - a. Detection of errors and frauds
  - b. Regular recording of business transactions
  - c. Preparation of financial statement
  - d. Preparation of audit report
3. Internal Auditor is appointed by \_\_\_\_\_
  - a. Board of directors
  - b. The business concern
  - c. Shareholders
  - d. Government
4. The internal audit is carried at \_\_\_\_\_
  - a. The end of the year
  - b. Throughout the year
  - c. Regular intervals
  - d. After the accounts are closed





5. The objective of internal audit is \_\_\_\_\_
  - a. To verify the accuracy of accounts
  - b. To review the internal control system
  - c. To detect errors and frauds
  - d. All the above
6. Which ensures the effective and efficient system of accounting control
  - a. Internal Audit
  - b. Internal Control
  - c. Internal Check
  - d. Computerised Accounting
7. Which audit ensures the reporting to the management about compliance of policies and standards of performance
  - a. Internal Audit
  - b. Internal Control
  - c. Internal Check
  - d. Annual Audit
8. Which provides advisory services to the management for its improvement
  - a. Internal Check
  - b. Internal Audit
  - c. Internal Control
  - d. Audit Report
9. Internal Audit is not suitable for
  - a. big organizations
  - b. small organisations
  - c. private Companies
  - d. Public Companies
10. Internal Audit is not suitable for small organisations because it is
  - a. Costly
  - b. Cheaper
  - c. Done by employee of the concern
  - d. none of the above

[Answers 1.(c), 2.(a), 3.(b), 4.(b), 5.(d), 6.(a), 7.(a), 8.(b), 9.(b), 10.(a)]

## II. Very Short Answer Questions

1. What do you mean by internal audit?
2. Define Internal Audit.
3. Who is an Internal Auditor?
4. How is an Internal auditor appointed?
5. Write a note on Internal Audit Report.

## III. Short Answer Questions

1. Briefly explain the scope of Internal Audit.
2. What are the Advantages of Internal Audit?
3. What are the Disadvantages of Internal Audit?
4. Write a short note on Internal Audit.





#### IV. Essay Type Questions

1. What are the advantages and disadvantages of internal Audit?
2. Explain the duties of an Internal Auditor.
3. Discuss the objectives of Internal Audit.
4. Differentiate Internal Check with Internal Audit.
5. Differentiate Internal Control with Internal Audit.

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