

# **Study on Co-ordination of Internal Auditor with Functional Heads**



**Internal Audit Standards Board**  
**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*  
New Delhi

© The Institute of Chartered Accountants of India

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic, mechanical, photocopying, recording, or otherwise without prior permission, in writing, from the publisher.

Edition : December, 2010

Committee/Department : Internal Audit Standards Board

E-mail : [cia@icai.org](mailto:cia@icai.org)

Website : [www.icai.org](http://www.icai.org)

Price : ₹ 100/- (*including CD*)

ISBN No. : 978-81-8441-418-9

Published by : The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi - 110 002.

Printed by : Sahitya Bhawan Publications, Hospital Road, Agra - 282 003.  
December/2010/1,000 Copies

## Foreword

---

The forces shaping our world today are immense, complex, surprising and challenging. More than ever, our prosperity — as organizations, societies and individuals — depends on the extent to which we can adapt to these forces and deploy them to our advantage. In these challenging times if internal audit is to demonstrate value then it must begin with a fresh look at the organisation's internal audit strategy and a reassessment of its own processes. A forward looking approach demands that the internal auditors should recognize the need to redefine the function's value proposition and seek to increase its value by learning to operate more efficiently, intelligently, and quickly.

I am happy to note that Internal Audit Standards Board of the Institute is issuing this “Study on Co-ordination of Internal Auditor with Functional Heads” that throws light on crucial aspects, essential for working of successful internal audit departments, for meeting the evolving needs and expectations of their key stakeholders.

At this juncture, I congratulate CA. Rajkumar S. Adukia, Chairman, Internal Audit Standards Board and other members of the Board for bringing out this innovative publication which guides the internal auditors to be well positioned and to demonstrate their function's real value.

I am sure that the members and other interested readers would benefit from this contemporary publication.

December 16, 2010  
New Delhi

**CA. Amarjit Chopra**  
*President, ICAI*



## Preface

---

In today's challenging times, organisations need professionals who generate results by being both technically strong and having great interpersonal skills. This is also a pre-requisite for internal auditors who should not only be well-equipped with traditional audit skills, but also acquire professional skills needed most as internal auditing moves forward as competitive and dynamic profession.

Internal audit function must be the catalyst for constructive changes in the organisation. Internal auditor should strive to be the partner to the organisation's various functions and instrumental to their success. To achieve this, it is necessary to approach internal audit with series of discussion with various functional heads about purpose, objectives and success factors. Internal auditor's role should be viewed as a partner and trusted advisor for functional heads as well as for the Board of Directors and Audit Committee.

The Internal Audit Standards Board has brought out "Study on Co-ordination of Internal Auditor with Functional Heads" with a view to provide guidance on the way co-ordination and co-operation between internal auditor and functional heads can be achieved while respecting distinctive functions and professional requirements of both. The Study provides an overview of the essential qualities an internal auditor must possess for effective co-ordination and discusses various basic tenets of internal audit which should not be compromised in the co-ordination process. It also provides an insight about various types of hurdles an internal auditor faces in the co-ordination process and the methodology to overcome these constraints with case studies.

At this juncture, I am grateful to CA. K.S. Sundara Raman and his study group members viz. Shri Kannan Rajagopalan, Shri Sridharan

Sadagopan, Shri Shyamal Budhdev, Shri Sumit Mantri and Shri Pinaki Saha, for sharing their experience and knowledge with us and preparing the draft of the Study.

I also wish to thank CA. Amarjit Chopra, President and CA. G. Ramaswamy, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, viz., CA. Naveen N. D. Gupta, CA. Nilesh Vikamsey, CA. Atul C. Bheda, CA. K. Raghu, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhyay, CA. Ravindra Holani, CA. Charanjot Singh Nanda, Ms. Usha Sankar, Shri Prithvi Haldea and Shri Sidharth Birla for their vision and support. I also wish to place on record my gratitude for the co-opted members on the Board, viz., CA. Sushil Gupta, CA. Smita Satish Gune, CA. Nagesh Dinkar Pinge, CA. Sumant Chadha and CA. Deepak Wadhawan for their devotion in terms of time as well as views and opinions to the cause of the professional development. I also appreciate efforts put in by CA. Jyoti Singh, Secretary, Internal Audit Standards Board and her team of officers, viz., CA. Arti Aggarwal and CA. Gurpreet Singh, Senior Executive Officers, for their inputs in giving final shape to the publication.

I am confident that this publication would achieve its objective by helping the internal auditors conduct effective internal audit through refining their techniques and methodologies to maintain balanced relationship with the functional heads.

December 28, 2010  
Mumbai

**CA. Rajkumar S. Adukia**  
*Chairman*  
*Internal Audit Standards Board*

# Contents

---

<b>Foreword .....</b>	<b>iii</b>
<b>Preface .....</b>	<b>v</b>
<b>Chapter 1:</b>	
<b>Role of Internal Audit .....</b>	<b>1-4</b>
<b>Chapter 2:</b>	
<b>Areas of Co-ordination .....</b>	<b>5-8</b>
Procurement (Revenue and CAPEX) .....	5
Material Management .....	5
Accounts Receivable .....	6
Treasury and Banking .....	6
Insurance .....	6
Production .....	7
Plant Maintenance .....	7
Health, Safety and Environment .....	7
Human Resources .....	7
<b>Chapter 3:</b>	
<b>Essential Qualities for Effective Co-ordination .....</b>	<b>9-12</b>
Knowledge .....	9
Business Understanding .....	10
Professionalism .....	11
Excellent Communication Skills .....	11

Perspective Reporting .....	11
Effective Presentation Skills .....	12
<b>Chapter 4:</b>	
<b>Co-ordination – Not a Compromise to</b>	
<b>Tenets of Internal Audit .....</b>	<b>13-16</b>
<b>Chapter 5:</b>	
<b>Co-ordination Aspects in Various Types</b>	
<b>of Internal Audit .....</b>	<b>17-21</b>
Operational Audit .....	17
Financial Audit .....	17
Compliance Audit .....	18
Information Systems (IS) Audit.....	19
Investigative Audit .....	20
Management Audit .....	21
<b>Chapter 6:</b>	
<b>Importance of Communication/ Co-ordination</b>	
<b>with Functional Heads .....</b>	<b>22-23</b>
<b>Chapter 7:</b>	
<b>Traditional and Modern Approach of</b>	
<b>Co-ordination with Functional Heads .....</b>	<b>24-26</b>
Traditional Approach .....	24
Modern Approach .....	25
<b>Chapter 8:</b>	
<b>Hurdles of Co-ordination and Methodology</b>	
<b>to Overcome .....</b>	<b>27-49</b>
Over Cautious and Defensive Approach of the	
Process Owner .....	27
Methodology to Overcome .....	27
<i>Case Study 1</i> .....	29
<i>Case Study 2</i> .....	30



Reservation on Technical Expertise of Internal Auditor .....	30
Methodology to Overcome .....	31
<i>Case Study 1</i> .....	31
<i>Case Study 2</i> .....	32
<i>Case Study 3</i> .....	33
<i>Case Study 4</i> .....	33
Non-supportive Stand .....	34
Methodology to Overcome .....	34
<i>Case Study 1</i> .....	35
<i>Case Study 2</i> .....	36
Resistance to Changes Recommended by Internal Audit .....	37
Methodology to Overcome .....	37
<i>Case Study</i> .....	38
Differing Views of Functional Heads on the Relevance of Audit Scope .....	39
Methodology to Overcome .....	39
<i>Case Study</i> .....	39
Confrontation on Prioritizing Audit Schedule .....	40
Methodology to Overcome .....	40
<i>Case Study</i> .....	41
Reluctance on Evaluating the Audit Issues .....	41
Methodology to Overcome .....	41
<i>Case Study</i> .....	42
Lack of Visibility of Best Practices .....	42
Methodology to Overcome .....	43

<i>Case Study 1</i> .....	43
<i>Case Study 2</i> .....	44
Conflict Arising due to Weak Interface Linkages between Process Owners .....	45
Methodology to Overcome .....	46
<i>Case Study 1</i> .....	47
<i>Case Study 2</i> .....	47
Discomfort on Findings which are based on Apprehensions .....	48
Methodology to Overcome .....	48
<i>Case Study 1</i> .....	49
<i>Case Study 2</i> .....	49
<b>Chapter 9:</b>	
<b>Conclusion</b> .....	<b>50-51</b>

## CHAPTER 1

# Role of Internal Audit

---

1.1 “*Preface to the Standards on Internal Audit*”, issued by the Institute of Chartered Accountants of India defines “Internal Audit” as follows:

*“Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance”.*

The above definition amply reflects the current thinking as to what is an internal audit and highlights its important facets. Internal audit is a management function, thus, it has the high-level objective of serving management’s needs through constructive recommendations in areas such as, internal control, risk, utilization of resources, compliance with laws, management information system, etc. Thus, internal audit’s role should be a dynamic one, continually changing to meet the needs of the organization.

1.2 Internal audit activity is an essential component of the governance mechanism of the Board of Directors and Senior Management. Internal auditor furnishes analysis, appraisals, recommendations, counsel and information concerning the activities reviewed. Internal auditor can suggest ways of reducing costs, enhancing revenues, and improving profits.

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

Internal auditor's role encompasses close co-ordination of various functions of the organization and provides assurance to the Board, Audit Committee and Senior Management on risk management and the strength of corporate governance. They contribute in the organization's need for sustained success and growth. A dedicated, independent and effective internal audit activity assists both functional management and the governing management (e.g., the Board, Audit Committee) in fulfilling their responsibilities by bringing a systematic and disciplined approach in assessing the effectiveness of the design and execution of the system of internal controls and risk management processes.

1.3 The value addition role will be effective only if Internal auditor's co-ordination with the process owners of various functions is done more objectively.

The Internal auditor has a larger responsibility towards Audit Committee as they rely on the Internal auditor as an objective source of information on what is going on within the organization. Hence, the Internal auditor has to ensure that all his findings are accurate and fully backed up with responses of concerned Functional Heads.

1.4 Internal audit is a highly interactive process which is aimed to help organizations accomplish their objectives. Internal audit is not, in anyway, a desk research activity. Essentially, their role is based on review, analysis and conclusions culminating from their co-ordination with Functional Heads.

***Effective co-ordination with Functional Heads enables the Internal auditor in meeting the Management Expectation of providing independent and objective assurance 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.***

### ***Role of Internal Audit***

1.5 Internal auditor helps Audit Committee by:

- (i) Conducting an objective evaluation of risk management and internal control systems;
- (ii) Conducting a systematic analysis of business processes and associated controls;
  - i. Being a source of information on frauds/ other irregularities;
  - ii. Conducting a review of operational and financial performance;
  - iii. Making recommendations on effective and efficient use of resources; and
  - iv. Making an assessment of accomplishment of corporate goals and objectives.

1.6 Internal audit head has to report its findings to the Audit Committee highlighting any deficiencies that have been detected, and the Audit Committee also has to enquire in depth from the Internal auditor about any complex issues involved. There should be an open flow of communication and information between the Internal auditor, Audit Committee and Statutory auditor. This helps to avoid mistakes and miscommunications and also considerably improves the work quality of the auditors.

1.7 Co-ordination of internal audit efforts involves the following:

- (i) Periodic meetings with Audit Committee and Statutory auditors regarding the company's internal audit universe, scope of the areas proposed to be covered, risk assessment updates, audit plans and the internal audit annual schedule.
- (ii) Periodic meetings between Internal audit head, Audit Committee and Statutory auditors with respect to statutory audit schedule, coverage and the desired level of direct or indirect assistance required and available.

***Study on Co-ordination of Internal Auditor with Functional Heads***

This also includes coverage through internal audit of concerns raised by statutory auditors.

- (iii) Access to statutory auditors of internal control documentation and reports. Common understanding of audit techniques, methods, audit approach and terminology to effectively co-ordinate work and rely on the work of one another.
- (iv) Communication regarding announcements when audits are scheduled to begin and the specific audit objectives that have been established.
- (v) Exchange of audit reports and management letters through the Audit Committee.
- (vi) Exchange of information to be reported to the Company's Audit Committee to affect a mutual understanding of audit issues and to present a consolidated view of audit efforts.

## CHAPTER 2

### Areas of Co-ordination

---

2.1 Internal auditors have to interact with functional heads of various functions and the following are some important areas of co-ordination:

#### **(i) Procurement (Revenue and CAPEX)**

Revenue procurement has well governed internal control procedures, policies on authorisation and budgetary controls. On the other hand, in CAPEX procurement value of commitment is very high and it is cleared by the top management. In many well established corporates, capital budgets are approved by the Board of Directors. Since, the CAPEX goes to the highest level of approval; the process followed will be extensively detailed, and technically justified to present a schedule of commitment and completion. All issues related to CAPEX procurement should preferably be addressed to the top management for effective communication. However, revenue related issues may be discussed and closed with lead buyers.

#### **(ii) Material Management**

Material Management, broadly, includes correct classification and management of inventory at optimum level so as to avoid carrying cost of inventory as well as stock out of critical items, with a view to ensure effective utilisation of inventory. It is essential that recommendations for minimizing inventory cost like, Just in Time Inventory, Vendor Managed Inventory (VMI), etc., should be discussed with the top management at site. Internal auditors need to include in their communication to the management the benefits

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

to the organisation by making these policy changes, and also the implications of not making these changes. However, routine inventory related issues on preservation, binning, etc., can be taken up with the Materials Head.

### **(iii) Accounts Receivable**

Issues on Accounts Receivable may arise out of many sub-functions like, Banking and Collection; Credit/ Debit Notes consequent of allowing discounts and rebate; Credit Management, etc. These are usually handled by separate functional heads. Each such issue need to be identified and properly linked to the respective sub-functions and co-ordinated with them for getting proper response so that processes relating to these are understood before raising audit issues. This will not only avoid making any wrong conclusions on audit findings but also will make the process owners accountable for audit responses to make corrective or preventive actions, if recommended by the Internal auditors.

### **(iv) Treasury and Banking**

Internal auditor needs to make a clear distinction between CAPEX funding and Working Capital Fund Management. CAPEX funding comes mainly from corporate objectives of investments in various projects and any issues relating to such activities can be addressed at appropriate decision making level in functional hierarchy instead of Fund Manager level. Internal auditor should have technical understanding of FOREX so that he can effectively communicate with the FOREX department.

### **(v) Insurance**

Insurance involves two separate segments, viz., coverage of insurable assets (risks) and the premium. For issues relating to the coverage of a particular risk, the Internal auditor needs to discuss and co-ordinate with the technical Functional Heads as this is a policy decision by the Management. However, issues relating to correctness of premium computation and inclusion of



### ***Areas of Co-ordination***

assets should be discussed with the concerned operational level heads.

### **(vi) Production**

Process knowledge and critical observation on input and output analysis will be of great advantage in communication with the Production Head.

### **(vii) Plant Maintenance**

Issues arising out of transaction recording of routine maintenance can be discussed with the Operation head but issues like, buy or repair, deferment of preventive maintenance, etc. should be discussed with the top management at site for getting the correct response.

### **(viii) Health, Safety and Environment**

Effective implementation of Health, Safety and Environment (HSE) policy is critical from both statutory compliance and corporate social responsibility view point. Since this function is mostly guided by the company policy, the Internal auditor needs to interact with the top management.

### **(ix) Human Resources**

Human Resources head guides and manages the overall Human Resources policies and programs for the entire company. Since this function is mostly guided by the Company policy, the Internal auditor needs to interact with the top management.

2.2 Strong knowledge of statute, good interpretation skills and well updated information on recent circulars/ notifications/ case laws will help in co-ordinating with functional heads in the following areas:

- Export and Import
- Indirect Taxation

***Study on Co-ordination of Internal Auditor with Functional Heads***

- Direct Taxation
- Secretarial
- Legal Services.

2.3 Other than areas listed above, an Internal auditor has also to co-ordinate skillfully and competently with various Functional heads in the following areas also:

- Accounts Payable
- Accounts
- Security Services
- Logistics and Supply Chain Management
- Project
- Asset Management
- Administration
- Payroll and Retirement Benefits
- Information Technology
- Marketing & Sales
- Customer Care
- Corporate Communications/ Public Relations.

Co-ordination efforts of Internal auditor for different functions demand relevant knowledge and skill sets to command respect and acceptance. In addition, Internal auditor's overall understanding of inter-functional linkages help in his discussion with different Functional heads on communicating the wider implication of the audit findings.

## CHAPTER 3

# Essential Qualities for Effective Co-ordination

---

3.1 In order to effectively discharge professional responsibilities, the Internal auditor needs to focus on many different skills in three major areas – general technical knowledge, audit process knowledge and professional skills. Standard on Internal Audit (SIA) 2, “*Basic Principles Governing Internal Audit*” lays down following with respect to skills and competence of internal auditor:

***“7. The internal auditor should either have or obtain such skills and competence, acquired through general education, technical knowledge obtained through study and formal courses, as are necessary for the purpose of discharging his responsibilities.*”**

***8. The internal auditor also has a continuing responsibility to maintain professional knowledge and skills at a level required to ensure that the client or employer receives the advantage of competent professional service based on the latest developments in the profession, the economy, the relevant industry and legislation.”***

3.2 The essential qualities that an internal auditor is required to have for effective co-ordination with functional heads are as follows:

### **(i) Knowledge**

Internal auditor should have a comprehensive and multi-faceted knowledge of various areas like, operations, systems, processes, audit standards, regulatory and statutory provisions, etc. Internal

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

auditor needs to update himself on developments in regulatory pronouncements, technology and new audit tools and procedures. Tools and technologies implemented by internal auditor typically support work papers, audit planning, reporting, report writing, tracking findings through remediation and knowledge sharing.

## **(ii) Business Understanding**

The demanding timelines for management's reporting imposes severe pressure on internal auditor to complete the internal audit process, without compromising the quality, at the shortest time. Hence, his grasp and understanding of business processes has to be sharp and quick. An internal auditor must develop a strong understanding of the organisation. Levels of experience, training and education help the internal auditor to assess business situations for better evaluation. He should obtain the required knowledge at the commencement of the engagement and as the internal audit progresses, the information should be assessed, enhanced, updated, refined and validated as he obtains more knowledge about the entity's business. Further, in case of continuing engagements, the internal auditor should update and re-evaluate information gathered previously including identification of any significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

Internal auditor can use the information obtained from understanding of business in following areas:

- Assessing risks and identifying key focus areas.
- Planning and performing the internal audit effectively and efficiently.
- Evaluating audit evidence.
- Providing better quality of service to the client.

### **(iii) Professionalism**

As internal auditor is viewed as an internal consultant to the management, he should exercise high degree of professionalism in his interaction with all levels of process owners.

### **(iv) Excellent Communication Skills**

The communication skills, both written and oral, play a paramount role in their relationship with the operating and executive management. Many a times improper communication by the internal auditor creates disharmony, anguish and conflict with the operating process owners and the functional heads. Besides, this improper communication may also tend to mislead the management on complex issues. The golden rule for successful communication is that the sender and the receiver understand the same information.

### **(v) Perspective Reporting**

Any functional head would appreciate Audit Reports that are presented in right perspective, besides being timely, factual, accurate and complete. While writing the report it is necessary that each observation be constructed in such a manner that it represents the true facts of the issue, its financial or other impact, the causes for the situation and also the recommendations to rectify it.

Within the management, there are different levels, and so the audit report has to be designed to suit the interest, needs and requirements of different levels of the management. All the levels need to know as to what is happening in the areas of their concern and internal audit report can serve as one of the vehicles of information. However, the degree of detail required by each level will be different and the internal auditor should take care of the same while drafting the report.

## **(vi) Effective Presentation Skills**

An internal auditor should have effective presentation skills which involve selecting major issues that warrant functional head's attention and presenting the same in a lucid and easy to understand manner.

In addition, internal auditor's analytical ability and good interpersonal relationship makes the co-ordination with functional heads more rewarding.

## CHAPTER 4

# Co-ordination – Not a Compromise to Tenets of Internal Audit

---

4.1 In the zeal of cordial relationship, internal auditor should not lose sight of the basic tenets of internal audit. The basic tenets of internal audit as stipulated in Standards on Internal Audit, issued by the Institute, reinforce the importance of the principles with reference to co-ordination aspect and some such important aspects have been discussed in below paragraphs.

4.2 The following paragraphs of SIA 2 “*Basic Principles Governing Internal Audit*” guide the internal auditor on crucial aspects:

### ***“Integrity, Objectivity and Independence***

4. ***The internal auditor should be straight-forward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude. He should not only be independent in fact but also appear to be independent. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity. For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities***

### **Study on Co-ordination of Internal Auditor with Functional Heads**

*independently and also report his findings without any management interference. For example, in case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. **The internal auditor should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.***

#### **Confidentiality**

*5. **The internal auditor should maintain the confidentiality of the information acquired in the course of his work and should not disclose any such information to a third party, including the employees of the entity, without the specific authority of the management/ client unless there is a legal or a professional responsibility to do so.** The internal auditor, therefore, needs to ensure that there are well laid out policies and controls to protect confidentiality of the information.*

#### **Due Professional Care, Skills and Competence**

*6. **The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit.** Due professional care signifies that the internal auditor exercise reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit, assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement.”*

4.3 Due to the very nature of internal audit function, it has a serious potential of creating behavioral issues within an entity.



### **Co-ordination — Not a Compromise to Tenets of Internal Audit**

Recognizing this, SIA 4, “Reporting”, issued by the Institute of Chartered Accountants of India, requires that ***to facilitate effective communication and ensure that the recommendations presented in the final report are practical from the point of view of implementation, the internal auditor should discuss the draft with the entity’s management prior to issuing the final report.***

4.4 According to SIA 4, ***the different stages of communication and discussion should be as under:***

- (i) ***Discussion Draft – At the conclusion of fieldwork, the internal auditor should draft the report after thoroughly reviewing his working papers. The discussion draft so prepared should also be carefully reviewed before it is presented to the entity’s management for auditee’s comments. This discussion draft should be submitted to the entity’s management for review before the exit meeting.***
- (ii) ***Exit Meeting – The internal auditor should discuss with the management of the entity regarding his findings, observations, recommendations, and text of the discussion draft. At this meeting, the entity’s management should comment on the draft and the internal audit team should work to achieve consensus and reach an agreement on the internal audit findings.***
- (iii) ***Formal Draft – The internal auditor should then prepare a formal draft, taking into account any revision or modification resulting from the exit meeting and other discussions. When the changes have been reviewed by the internal auditor and the entity management, the final report should be issued.***
- (iv) ***Final Report – The internal auditor should submit the final report to the appointing authority or such members of management, as directed. The Final***

***Study on Co-ordination of Internal Auditor with Functional Heads***

***Report should include an executive summary clearly indicating the highlights of the internal audit findings, key issues and observations of concern, significant control lapses, failures and weaknesses in the systems or processes. The periodicity of the Report should be as agreed in the scope of the internal audit engagement. The internal audit should mention in the Report, the dates of discussion draft, exit meeting, Formal Draft and Final Report.***

## **CHAPTER 5**

# **Co-ordination Aspects in Various Types of Internal Audit**

---

### **Operational Audit**

5.1 Operational audit examines the use of resources to determine if resources are being used in the most effective and efficient manner to fulfill the organization's mission and objectives. It involves measuring the operations and processes of any entity against established operational standards and suggesting ways and means to improve adherence to standards. The most difficult co-ordination in this type of audit is dealing in technical issues with technical experts. Their pre-conceived notion of internal auditor having financial background lacking technical knowledge warrants a more convincing skill on the impact of the findings. Internal auditor has to drive home the point that everything has financial implication. He should, therefore, demonstrate the commercial/ financial implication in his conclusions.

### **Financial Audit**

5.2 Financial audit reviews accounting and financial transactions to determine if commitments, authorizations, receipt and disbursement of funds are properly and accurately recorded and reported. Further, coverage of non-financial matters is limited to only those aspects that provide additional information to stakeholders who are mainly interested in the financial status of the entity. It is conducted keeping in mind the objective of issuing an opinion on the state of financial affairs. This type of audit also determines if there are sufficient controls over case and other

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

assets and that adequate process controls exist over the acquisition and use of resources. It should be noted that any findings on transaction audit should be factual and not opinion based. All factual based audit exceptions will always be accepted by functional heads.

## **Compliance Audit**

5.3 Compliance audit determines if the organization is complying with applicable laws, regulations, policies and procedures. Compliance audit entails:

- Gathering information about all applicable laws, regulations, and other compliance requirements.
- Understanding limitations of auditing in detecting deviations and non-compliance.
- Assessing the risk that significant illegal acts could occur.

5.4 Internal auditor would design and perform procedures based on risk assessment that would provide reasonable assurance of detecting significant deviations. Interpretation skills of internal auditor play an important role in co-ordination with functional heads of compliance and regulatory department. Unbiased interpretation of statutes, rules and regulations will help functional heads in appreciating the compliance requirement better. Any non-compliance, if reported with its implications to the functional head makes communication effective.

5.5 In order to obtain a general understanding of such a legal and regulatory framework, and how the organization complies with that framework, the internal auditor may, for example:

- Use the internal auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;

### ***Co-ordination Aspects in Various Types of Internal Audit***

- Inquire of management as to other laws or regulations that may be expected to have a significant effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity; and
- Inquire of management regarding the policies and procedures adopted for identifying, evaluating and accounting for litigation claims.

## **Information Systems (IS) Audit**

5.6 Information Systems Audit reviews the internal control environment of automated information processing systems and how people use these systems. This audit usually evaluates system input, output; processing controls; backup and recovery plans; system security; and computer facilities. These audits may review existing, as well as, developing systems. Information System Audit is also known as Automated Data Processing (ADP) Audit or Computer Audit. Internal auditor should obtain an understanding of the systems, processes, control environment, risk-response activities and internal control systems and should also obtain an understanding of the significance and complexity of the IT activities.

5.7 Information System reviews include the following:

- Review of existing or new systems, before and after implementation, to ensure their security and that they meet the needs of users.
- Project management reviews to ensure controls are in place to mitigate project risks or to identify the strengths and improvements required for future projects.
- Organizational or operational reviews to ensure that the organization's goals and objectives will be achieved.

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

- Specific technology reviews to ensure security and controls are in place.

Internal auditor's communication with functional head of IS department should focus on deviations to organisation's policies and procedures. Internal auditor should effectively persuade the functional head on the importance of alignment to organization's objectives to systems and software policies.

## **Investigative Audit**

5.8 Investigative assignments scrutinize allegations of wrongdoing or breaches of standards of conduct. Allegations may be internal or external to the organization and may examine the records of individuals, organizations and firms with agreements between them and the organization. While a financial audit samples the financial system and verifies that the sampled transactions add up according to basic accounting principles, an investigative audit goes deeper into the financial infrastructure investigating the bookkeeping, the transactions, the payments and the entities behind them, questioning their correctness validity and legality and exposing the truth behind the numbers.

5.9 Reasons for conducting investigation are as follows:

- internal theft
- misappropriation of assets
- conflicts of interest

Co-ordination for this audit is usually at the highest level in the organization like, with Senior Management. Investigative audits differ from other audits because they are, normally, conducted without first notifying the personnel who may be affected by the findings.

## **Management Audit**

5.10 Management audit focuses on results, evaluating the effectiveness and suitability of controls by challenging underlying rules, procedures and methods. Management audits, which are, generally, performed in-house, are compliance audits plus cause-and-effect analysis. When performed correctly, they are potentially the most useful of the evaluation methods, because they result in change.

Since Management audit aims to bring in change management, change in processes and highlights revenue enhancement and cost optimisation, care should be taken that the co-ordination is done more professionally and the exercise is carried out diligently without offending process owner's conviction on the existing process.

## **CHAPTER 6**

# **Importance of Communication/ Co-ordination with Functional Heads**

---

6.1 Maintaining a balanced relationship with the functional heads is the most crucial and challenging task for the internal auditor. For internal audit to be effective, the communication with the executive management has to be constructive. The relationship has to be based on mutual confidence but it should not be too friendly. Findings should not be treated as deficiencies but as practices that can be improved by the process owners.

6.2 Traditionally, internal auditor is the least preferred customer since it is seen as a fault finding machinery reporting on errors and mistakes. Functional head becomes very defensive in their interaction with internal auditor and justifies their actions to resist internal audit's observations.

6.3 In this dynamic business environment, function of internal audit is not restricted to doing post facto transactional audit/ processes and issuing a report on what went wrong. In the present context, internal auditor assumes his role as an internal consultant to various functions and assists the organization in:

- (i) Identifying all risks inherent to that function.
- (ii) Managing risk by optimizing processes.
- (iii) Developing simple work flow for processes.
- (iv) Suggesting steps to improve and make corrections.



***Importance of Communication/ Co-ordination with Functional Heads***

In this new role, the internal auditor has to co-ordinate with the functional heads for their risk management. The most important aspect of it is how efficiently and effectively the internal auditor is able to interact with the functional heads.

## CHAPTER 7

# Traditional and Modern Approach of Co-ordination with Functional Heads

---

### Traditional Approach

7.1 Traditionally, the process of co-ordination with the functional heads includes the following:

- (i) Discussion of audit scope with the functional heads and taking his/ her inputs for making it comprehensive.
- (ii) Issuing query sheets based on the initial observation of transactions/ processes.
- (iii) Validating replies given for each query.
- (iv) Issuing draft report to the functional heads based on response given for all queries.
- (v) Discussion of draft report with the functional heads to understand each others perspective.
- (vi) Release of final report to the management.

7.2 This approach is more impersonal and non-collaborative. This always leaves an impression on the minds of the functional heads that the whole approach is not appreciative of the good work done by the function but only highlights faults. They also carry a strong belief that the internal audit is not appreciating the

### ***Traditional and Modern Approach of Co-ordination with Functional Heads***

constraints which the auditee faces while carrying out day-to-day operations of the organisations. Many a times, postmortem audit gives a different view on hindsight. These lacunas in traditional approach necessitate embarking on to modern approach which has been discussed in paragraphs given below.

## **Modern Approach**

7.3 Both the internal audit and the functional heads work towards the common objective of saving cost, implementing better controls and preventing revenue leakages. Internal audit is involved in Root Cause Analysis (RCA) of the problem and helps the functional heads in mitigating the same. Moreover, the internal auditor is also required to interface with other cross functional process owners to help in streamlining the processes in an integrated and seamless manner.

7.4 Modern approach of co-ordination with the functional heads is detailed as below:

- (i) Understanding the broad processes of the function.
- (ii) Proactive discussion of critical processes with the functional heads and identifying risks associated with these processes.
- (iii) Understanding system controls and manual checks exercised by the department in managing the above risks.
- (iv) Defining audit scope based on the above discussions and understandings.
- (v) Conduct transactional and process audit based on the scope.
- (vi) RCA of exceptions which may be because of input or internal processes of the function.

***Study on Co-ordination of Internal Auditor with Functional Heads***

- (vii) Recommend process improvement through system controls/ manual checks to the functional head if exception is due to internal processes.
- (viii) Discuss processes of other function with the respective functional head if exception is because of input given by that function and suggest ways to streamline it.
- (ix) Measure and provide facts with all analysis to substantiate impact of finding.
- (x) Constructive discussion of draft audit report with the functional heads and structure auditee reply into – cause, corrective action, preventive action and target date.
- (xi) Release audit report to all the stakeholders.
- (xii) Follow-up for compliance till the issue is resolved.

## **CHAPTER 8**

# **Hurdles of Co-ordination and Methodology to Overcome**

---

8.1 The major constraints in the co-ordination process between the internal auditor and the functional head and the methodology/ requisite to overcome these constraints have been discussed in the following paragraphs. Different types of situations like, over cautious and defensive approach of the process owner, reservation on technical expertise of auditor, non-supportive stand, resistance to changes recommended by internal audit have been discussed with the help of case studies.

### **Over Cautious and Defensive Approach of the Process Owner**

8.2 Many a times an over cautious functional head builds a fence around him fearing audit exposures, lapses and weaknesses. This makes the co-ordination and communication of the internal auditor with the functional head difficult.

### **Methodology to Overcome**

8.3 If the observation is factually correct and the problem genuinely requires resolution, the functional head has to be made aware of his action towards solution. This will sound more as his achievement than as a lapse which is being reported by the internal auditor. This is because management always looks forward to a solution provider than to a person who reports only problem. The most important part of internal audit is to convince the functional

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

head on audit observation. More often, the functional head is of the mindset that he or his department has done nothing wrong.

8.4 In this case, the requirement for winning strategy for successful co-ordination is as follows:

- (i) Provide facts with all analysis to substantiate impact of findings.
- (ii) Give detailed explanation of lacuna in the existing system.
- (iii) Draw attention to better control practices within the organization and of other organizations in the industry.
- (iv) Highlight the potential revenue loss that may occur to the organization, if current system is not strengthened soon.
- (v) Project the internal audit findings to the management with corrective action plan of the process owner.
- (vi) Once the new system is in force, provide the review results along with the process owners and project the same to the management as adoption of best practice.
- (vii) Internal auditor has to explain all dimensions of the observation. He may also bring to the notice of the functional head that specified process executed by the department may be right on stand alone basis but is not best from over all organisation's perspective.
- (viii) The next big step is to structure auditee response so that the management gets assurance on closure of audit issue. If auditee response is structured into cause, corrective action and preventive action then resolution process becomes clear to all. Target date gives definite timeline to close the issue.

### ***Hurdles of Co-ordination and Methodology to Overcome***

8.5 The following illustrative case studies clarify the situation discussed in above paragraphs:

#### **(i) Case Study 1**

Company X was manufacturer of PVC. The finished product is in powder form and is sold in standard packaging of 25 kg bags. The bags are filled through an automated packing line and the quantity filled in bags is controlled through an online check weigher installed in the packaging line itself. In addition, tolerance limits were fixed for short/ excess filling in terms of number of grams per 25 kg bag.

During the process review, the internal auditor carried out weighment of bags on a standalone weighing scale, selecting adequate sample and observed that in a large percentage of bags comprised in the sample, the actual quantity filled far exceeded the defined tolerance limits, i.e., 50 gms per 25 kg. On being presented with the findings, the functional head's response was more of defensive nature, bringing out that firstly that this was only a statistical aberration and then stated that any such excess giveaways would get detected through other compensatory controls (manual) available like, random weighment of bags in a stand alone mode.

The internal auditor then co-ordinated with the commercial head and the warehouse in charge and took larger samples for study and validation of quantity bagged. In addition, the samples were taken at different points of time. In all cases the results were consistent with the initial findings. By extrapolating the findings for over one year period, the quantity giveaways and cost implications (factoring both negative and positive variations) were demonstrated to the functional head, along with live instances where the compensatory controls had failed to detect excess giveaways.

These findings were accepted by the functional head. Accordingly, system based control viz., installation of check weighers in the conveyer, after filling level in the load cell, was introduced. This

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

has resulted in to:

- (i) Reduction of dependency to manual checking.
- (ii) Increased accuracy level, since all bags are weighed after filling in load cell.
- (iii) Reduction of labour in the filling and weighing section in the plant.

### **(ii) Case Study 2**

Company Y was in the business of manufacturing polyester fibre. The finished product was wound in bobbins having standard weights. In case the weight of the bobbin is different from the standard size, the bobbin was downgraded to a lower grade (grade B) even though it conformed to all other quality parameters of prime grade material. In addition, there was no visibility of the reasons for classification as lower grade in the system. Internal auditor suggested introducing an intermediate grade for prime grade material wound in bobbins having non-standard weights.

This suggestion was initially rejected on the ground that almost the entire quantity manufactured was for the export market and non-standard material (in case the weight of the bobbin is different from the standard size) was not acceptable to customers. Internal auditor coordinated with marketing personnel, who concurred that it was possible to get a higher realization for prime grade material wound in non-standard sized than grade B. This suggestion was then accepted by the functional head and a new grade was introduced with the higher price than the B grade material.

## **Reservation on Technical Expertise of Internal Auditor**

8.6 Functional heads who have a stronger knowledge of their processes of systems and expertise in their field always believe that the internal auditor lacks technical skill and knowledge to understand and analyse the technical aspects of the process.



### ***Hurdles of Co-ordination and Methodology to Overcome***

## **Methodology to Overcome**

8.7 A good understanding of business processes of functions that are taken up for internal audit helps the communication with functional head more effective. This also makes the enquiry process effective, i.e., asking pertinent question, in an appropriate manner. The following may be considered by the internal auditor in such a situation:

- (i) Internal auditor should always analyze issues from the outcome or end result of a control/ system lapse rather than procedural lapse in all cases of technical functions. This approach gives a better visibility and acceptance in the co-ordination process. Any functional head will appreciate the audit concern better if it is not sounded too procedural and bureaucratic.
- (ii) Understand the broad processes and acquaint with controls, governing policies, Standard Operating Procedures (SOPs), Management directives, etc.
- (iii) In most of the cases, the internal auditor who has better understanding of the processes commands more respect from the functional head while dealing with complex audit issues.

8.8 The following case studies give examples of situation discussed above:

### **(i) Case Study 1**

Company Z was a multi-location/ multi-plant manufacturing company. All the processes, viz., manufacturing, plant maintenance, materials management and finance were integrated by deployment of an ERP Package.

The ERP system provided a functionality to create a purchase requisition for engineering spares through the Plant Maintenance Module. However, on detailed study of the Plant Maintenance Module and the built in controls, the internal auditor observed that

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

certain monitoring controls such as, linking of spares with particular equipment, were not configured in the system. The internal auditor demonstrated with data that the probability of an unlinked spare becoming a non-moving/ surplus inventory was much higher than spares which were linked to particular equipment in the system.

The internal audit findings were accepted by the management and necessary system based controls were configured in the ERP Package.

### **(ii) Case Study 2**

Company C started a Special Grade Fibre Manufacturing Plant for the first time in the country using imported technology. The products did not meet the quality parameters and were not accepted by the market, hence, the plant was closed down. The fiber intermediaries were left unused and not disposed for many years along with the imported chemicals and catalyst purchased for the manufacture of this product.

Internal auditors pointed out the situation with the suggestion that:

- (i) the intermediary product may have market for fibre manufacturer and, therefore, classify as special product and dispose off,
- (ii) the purchase orders for chemicals and catalyst should have the buy back clause so that the failed chemicals will be re-exported to the supplier at the pre-determined prices.

The process owners did not want to make any attempt to dispose off the intermediaries and the unutilised chemicals catalyst, stating that these materials do not have ready market. On follow-ups and persuasion with Research and Development Team of the company, it was established that the intermediaries can be sold to fibre manufacturers by sending sample and explaining the properties of the intermediaries. The foreign vendors who supplied the chemical and catalyst were given the left over chemicals sample and re-exported at 75% price of the original price.

### **(iii) Case Study 3**

Company D manufactured polyester fibres. In manufacture of one grade of fibres, the company used old PET Bottles as a raw material. The PET bottles were procured in bulk and payment was made on the basis of weight stated in the invoice.

On review of weight bridge data, the internal auditor observed major difference between the invoice weight and actual weight of material delivered. The process owners explained that the weight difference was on account of the moisture content in the material, which varies over time and evaporates during transit. The internal auditor highlighted the weight difference together with the annualized financial implication to the management and insisted for fixing a tolerance limit of moisture content and to fix variable price based on the moisture content. The findings of the internal auditor were accepted by the management and tolerance limits for moisture was defined in the Purchase Order, and lower price was fixed in the Purchase Order for the product exceeding the tolerance limit.

### **(iv) Case Study 4**

Y Company was involved in the manufacturing of chemicals for which certain outsourced rental tools were used. These rental tools consisted of a large number of small items/ parts which were to be assembled before being put to use and this whole activity used to take a few hours. The rental tool was then at the time of usage lowered into the manufacturing process. As per the finalized contract, whenever the rental tools were actually used in the manufacturing process, "operating rate" was payable and for the other period "rental rate" was payable which was lower than the "operating rate". The contractor used to charge "operating rate" for the time spent on assembling the tool.

Internal auditor brought out this issue to the functional head. Initially, it was brushed aside by the functional head stating that unless the tool is prepared/ assembled, it cannot be used. Secondly, it was an important activity forming part of the operations and, hence,

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

the operating rate certified was correct. Internal auditor agreed with the functional head's views that assembling activity was an integral and important part of the operations but "operating rate" was not payable as this was not an "operating activity" in line with the contract terms. Internal auditor also pointed out that such similar instances of the peer group companies which were being audited and had similar contracts. The functional head discussed the issue with the Procurement and Contracts team who concurred with the internal auditors' views. Accordingly, the excess payment made for the time certified for assembling the tool was recovered.

## **Non-supportive Stand**

8.9 In many organizations, there exists a strong tendency of auditees delaying the internal audit process as long as possible. This is more due to non-assigning of priority to internal audit function with reference to their operational target. This leaves the internal auditor very little time to collect, assimilate, analyse and conclude.

## **Methodology to Overcome**

8.10 The following are some important aspects which would help the internal auditor in such a situation:

- (i) Every function has some processes which are either having high financial impact and/ or are vital for the operations of the organisation. A collaborative approach with the functional head in flagging such critical processes by the internal auditor aids in his effort of "buying in" the auditee on the purpose and gain.
- (ii) Active participation by the internal auditor in discussing critical processes with the functional head brings sincerity in audit approach. This helps the internal auditor in presenting himself as a partner to business rather than fault finding reporter. Once this new role is understood, the functional head opens to audit and seeks internal auditor's guidance on control issues raised by the audit.

### ***Hurdles of Co-ordination and Methodology to Overcome***

- (iii) Internal auditor should persuade functional head to take corrective action within reasonable time. Functional head should be made to believe that taking corrective action is his achievement and not a closure of an audit issue.
- (iv) The end game is to see complete resolution of the issue. Internal auditor has to communicate periodically with the functional head to monitor compliance status. Once the target date given by the auditee expires, internal auditor must verify whether the issue is resolved or not.
- (v) Management is interested in comprehensive closure of issue. If auditee faces any bottleneck in resolving the issue, internal auditor may help him in closing the issue.

8.11 The following case studies illustrate certain situations which internal auditor may have to resolve:

#### **(i) Case Study 1**

A company B was involved in manufacturing and selling of “paints”. As per the routine procedure, physical verification of finished products was taken by the internal auditors in the mid of March so that the final report can be submitted before the year end. If any discrepancy is noticed it can be suitably adjusted in the books to give the correct financial statements.

During the physical verification, certain discrepancies were noticed by the internal auditor and a draft report was submitted to the concerned functional head stating the differences noticed in the various ranges of the paint. On seeing the draft report, the functional head told his deputy to look into it and come back on the queries after completing his routine job. The deputy, therefore, gave last priority to the draft report.

Internal auditor after 7 days of the issue of draft called upon the functional head to have a meeting so as to close out the report. Functional head during the telephonic discussion stated, “I have a lot of priority work to attend, for me sales is the most important

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

activity. If we do not achieve our target the company is going to be under trouble and I do not want to inform the top management that I have been busy replying the Internal Audit Report. Any way what you are going to inform me has already happened isn't it? Audit is merely a post mortem job."

After patiently hearing the functional head's views the internal auditor replied, "Very true Sir, sales has to be accorded top priority, but if you come to know after taking the order that the actual stock is less you will not be able to honour your commitment and the customer will lose faith in you. Hence, I request you to look at the actual stock figures and report". The auditor had broken the barrier and got the ears of the functional head. Internal auditor further went on "also certain big paint cans have started getting disfigured due to excessive heat at the warehouse. These cans may not be acceptable to the customers and the company might lose its reputation of selling old paint stock". This was the last straw on the functional head, his tone mellowed down completely and he immediately understood the importance of the physical verification process and the draft report. He immediately gave a suitable priority to the draft report and ensured its closure at the earliest.

### **(ii) Case Study 2**

Company S was involved in production and selling of large number of perishable confectionary items. The process plants would send the finished products to the warehouse on the basis of the requirement sent by the marketing offices located at the various regional capitals. Quarterly Physical verification of all the warehouses (cold & dry) was undertaken by the internal auditors along with the warehouse in charge.

Internal auditor in order to ensure that all the boxes were counted used to make a coloured mark on the counted cartons. During one of the verification exercise the auditors noticed that a few of the boxes had the earlier coloured ticks also. Though, the Material count tallied and the internal auditors were satisfied with the physical verification, at the time of preparing the report one of the junior inquisitively informed this matter to their senior auditor. The senior

### ***Hurdles of Co-ordination and Methodology to Overcome***

auditor in order to confirm his doubt requested the junior to accompany him to the warehouse and show him the lot. During the re-verification of the stocks and comparing with the other lots it was noticed by the auditor that the old lot lying had a different MRP than the new lots. Further, they also noted that the expiry date of the old lot was fast approaching.

Internal auditor immediately issued an “interim report” to the Marketing Manager stating the facts of the old lot, and added that if immediate corrective actions were not taken, not only the stocks would become stale but would also have to be thrown out/ destroyed at an additional cost with a lot of statutory formalities being eatable item. Functional head appreciated the findings of the auditor, as “partner” to business rather than fault finding reporter and immediately took the necessary corrective action.

## **Resistance to Changes Recommended by Internal Audit**

8.12 The functional heads are generally averse to internal auditor’s recommendation as they are always comfortable with simple and flexible processes. This may lead to resistance to changes recommended by the internal auditor in his report.

### **Methodology to Overcome**

8.13 The following aspects may be kept in mind by the internal auditor while dealing with such a situation:

- (i) Internal auditor should take efforts to demonstrate the trade off between simplicity and rigid controls. Risk associated with critical processes lies in its execution. Internal auditor should deliberate on the need and relevance of built-in system controls. Internal auditor should also properly articulate the risks associated with flexible processes and the benefit of stringent controls which acts as effective risk cover.

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

- (ii) Internal auditor should discuss efficacy of manual controls vis-à-vis system controls. He must understand from functional heads compensating checks to strengthen the process. He may discuss with functional heads whether these manual checks are in line with management policies and whether these manual checks can be substituted with system controls.

8.14 The following case study gives an example of the abovementioned situation:

### **Case Study**

E Ltd was a manufacturing company. All functions including production processes and plant maintenance were configured in the ERP System. As per the design of the Plant Maintenance Module, all engineering spares must be drawn against Plant Maintenance Orders (PMO). In addition, the system provided a functionality whereby excess spares drawn could be returned against the same Plant Maintenance Order. These functionalities had been provided to determine the actual cost for each maintenance job.

On detailed review of the system, the internal auditor observed the following weaknesses in the module:

- (i) There was no system lock to ensure that same materials which were originally drawn are returned back. This means that it was possible to return materials not originally drawn against the PMO.
- (ii) It was possible to return materials in excess of the quantities drawn against the PMO.

As a result large number of cases was observed where the material was being drawn and returned against different PMOs. Hence, it was not possible to accurately determine the quantity of maintenance spares required for each job as well as the cost of the job. These findings were accepted by the management as result of which system locks were introduced in the system. An



### ***Hurdles of Co-ordination and Methodology to Overcome***

additional benefit which resulted from the system was the timely return of maintenance spares to stores.

## **Differing Views of Functional Heads on the Relevance of Audit Scope**

8.15 Many a times the functional heads do not accept the relevance of audit scope as it is not in line with his view point. This situation may cause hindrance to the internal auditor in carrying out effective internal audit.

### **Methodology to Overcome**

8.16 The following aspects would help the internal auditor to overcome such a situation:

- (i) Internal auditor should walk through the major processes in general and critical processes in particular. This exercise will enable the internal auditor to convince the functional head on the comprehensiveness and relevance of the internal audit scope.
- (ii) Internal audit scope must reflect cognizance of functional head's views. If the functional head can relate his department's process to audit scope then acceptance of internal audit recommendations is instantaneous.

8.17 The following case study reflects the abovementioned situation:

### **Case Study**

Internal auditor carried out a physical verification of Fixed Deposit Receipts on a surprise basis and tallied it with the Ledger balance. Finding no discrepancy the auditor submitted an assurance report.

Finance head expressed the view that since this exercise was always carried out by the statutory auditors at the end of the year,

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

this was a redundant exercise. Internal auditor explained that the physical verification was done on a surprise basis to test that the controls are in place for custody of the Fixed Deposit Receipts and traceability rather than as a mere physical verification exercise. Since the controls were found to be in place an assurance report was issued by the internal auditor.

## **Confrontation on Prioritizing Audit Schedule**

8.18 The Functional Head, generally, prefers to postpone / defer audit schedules in view of his routine work pressures. This would lead to delay in completion of internal audit and as a result delay in timely issuance of internal audit report.

## **Methodology to Overcome**

8.19 The following points would be helpful to internal auditor in dealing with such a situation:

- (i) Internal Auditor should go with clear management mandate to complete the audit within the agreed timelines. He should clearly communicate that there is no preferential concession permitted by the management for the auditees to choose their priorities on matters of audit.
- (ii) Internal auditor should discuss priorities and periodicity based on risk with functional heads. Complete coverage of audit scope in phased manner for both transactions and processes is essential to give assurance to management about working of the department.
- (iii) Internal auditor must inform auditee that his department is subject to surprise checks during the course of audit. If relevance of such surprise checks is explained properly to the functional head then he will appreciate its importance.

### ***Hurdles of Co-ordination and Methodology to Overcome***

8.20 The following case study illustrates a situation of confrontation on prioritizing internal audit schedule:

#### **Case Study**

The auditee initially deferred the internal audit under the pretext of being busy with the month end closing activities. Internal auditor convinced the auditee that the queries would be discussed after the month end activities. Further, if any major issues are surfaced during this audit, all necessary rectification entries can be carried out which will thereby ensure the quality of the financial statements.

#### **Reluctance on Evaluating the Audit Issues**

8.21 In some situations, the functional head may not merit the audit issues in the right perspective and finds it immaterial and of insignificant consequence.

#### **Methodology to Overcome**

8.22 Internal auditor should cautiously deal with the abovementioned situation and take care of the following aspects:

- (i) The modern approach is to facilitate functional head in resolving the issue rather than pointing out mistakes. This can be done by carrying out Root Cause Analysis (RCA) of the issue. It is a class of problem solving methods aimed at identifying the root causes of problems or incidents. RCA is considered to be an iterative process, and viewed as a tool of continuous improvement.
- (ii) Internal auditor should communicate clearly whether root cause is because of internal process weakness or because of input provided by the other department.

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

8.23 The following case study shows the abovementioned challenge faced by the internal auditor:

#### **Case Study**

While carrying out an internal audit of stores inventory of a manufacturing unit, the internal auditor observed that a substantial inventory comprised of surplus and obsolete spares. The initial observation was submitted to the materials department, who stated that the materials were procured at the instance of maintenance department.

On further analysis and discussion with the operating personnel, the internal auditor observed that most of the obsolete inventory comprised of spares which were not linked in the Plant Maintenance System with specific items of equipment through a Bill of Material (BOM). Since the association of the spares was not visible the same were never used.

The results were accepted by the management and an organizational level exercise for updating the equipment Bill of Material was undertaken. After complete updation of BoMs substantial reduction in unwanted procurements and surplus/obsolete inventory was achieved.

#### **Lack of Visibility of Best Practices**

8.24 The functional head, generally, presumes that the process undertaken at his units are best while internal auditors may provide certain benchmark parameters for evaluation. The three main barriers to adoption of a best practice are a lack of knowledge about current best practices, lack of motivation to make changes involved in their adoption and a lack of knowledge and skills required to do so.

### ***Hurdles of Co-ordination and Methodology to Overcome***

## **Methodology to Overcome**

8.25 The following aspects would help the internal auditor in dealing with such a situation:

- (i) Having exposure to a large number of companies, internal auditor has the visibility of various processes. He can suggest benchmark practices of system controls and manual checks in mitigating process weaknesses.
- (ii) Discussion on benchmark practices with functional head should suit to organisational operational convenience. A well evaluated and properly demonstrated actionable recommendation is easily accepted by the functional head.

8.26 The following case studies describe such a situation and also provide a correct solution to the internal auditor:

### **(i) Case Study 1**

Internal auditor evaluated various commercial terms and conditions of the Procurement Orders and Contracts at the auditee unit with the peers in the industry. They also evaluated the commercial terms and conditions for similar contracts at other sites of the auditee's company.

In one of the case, while auditing the scrap disposal process, the internal auditor observed that all metal scrap was mixed together and was sold under one category viz., metal scrap. The practice was contradictory to the practice followed in other companies whereby the metal scrap was segregated into SS/Bearing Scrap/ MS, etc, and then sold at differential rates based on categories. The realization by segregation far exceeded the realization in case of mixed scrap.

Internal auditor not only demonstrated/ brought out the strong points of the peers/ leaders in the industry but also suggested the ways and means of improving the terms in light of the best practices and country scenario. The scrap segregation and disposal

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

procedure was immediately accepted and the same led to significantly higher realizations.

## **(ii) Case Study 2**

A leading company “S” was into steel production business. The company had large number of plants at various geographical locations.

Internal auditor was assigned the job of ensuring that there were no revenue leakages and the payments at all the plants were made as per the Purchase/ Work Order terms and conditions. While reviewing the payments, the internal auditor noticed that the terms and conditions were quite different from one plant to another. Internal auditor came up with an innovative idea, “let me make a small report comparing the various terms and conditions followed at the specific plant vis-à-vis other plants and also the best practices followed in the industry also”.

Internal auditor made the draft comparative statement and submitted it to the functional head for his review and comments. Functional head boasted, “I bet, Mr Internal auditor, we should be the best in the Industry, not only in India but also internationally. If it was not so, do you think the company would have hired me? I have been in this industry for last 30 years and I know ins and outs of this business”.

Internal auditor smiled, trying to guess what would happen after seeing the report. The Functional head started reading the report which covered the following major points:

- (a) Advance Bank Guarantee and percentage of the contract value
- (b) Delivery period – Lead time
- (c) Freight terms
- (d) Other Warranties and Guarantees
- (e) Performance Bank Guarantee terms and percentage of the contract value

### ***Hurdles of Co-ordination and Methodology to Overcome***

- (f) Payment terms. (15/ 30/ 45/ 60 days)
- (g) Liquidated damages
- (h) Liability in case of termination of contract
- (i) Repair charges for damaged equipment
- (j) Restocking charges in case of chemicals
- (k) Rates and Price Validity.

As the Functional head went on reading the report his face went from white to red knowing what peers at the other units were doing and how far they were lagging behind the leaders in the industry.

On reading the full draft report his outlook towards the Internal auditor changed. He not only praised the Internal auditor for his efforts but also requested him to revisit his plant with such findings in other areas as well, which will help him in proving to the top management that their unit is the best.

## **Conflict Arising due to Weak Interface Linkages between Process Owners**

8.27 At times, the functional heads work in an island approach and often miss out discussion/ deliberation on the interdependent processes for optimization. It is necessary that process owners work together to eliminate constraints and identify additional opportunities for improvement.

The process owners can evaluate each process by answering these process questions:

- What:
  - o is there to do?
  - o is being done?

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

- o should be done?
  - o can be done?
  - o constraints keep us from doing it?
- Who:
  - o does this job?
  - o should do this job?
  - o knows how to do it?
  - o should know how to do it?
- Where:
  - o is this job done?
  - o should it be done?
  - o can it be done?
- When:
  - o is this job done?
  - o should it be done?
  - o can it be done?

### **Methodology to Overcome**

8.28 Internal auditor should take care of the following aspects in such a situation:

- (i) Sometimes, the issue arises because of internal process weakness of other function. Proactively, internal auditor should involve in discussion with all interdependent functional heads in bringing clarity on the need for streamlining the process.



### ***Hurdles of Co-ordination and Methodology to Overcome***

- (ii) Many a times, problem lies in communication gap between two departments. Internal auditor may help in setting co-ordination between various departments. Since he is unbiased, acceptance of his view by respective departments and management is greater.

8.29 The following case studies describe situations of conflict between process owners:

#### **(i) Case Study 1**

Company XYZ is engaged in the manufacture of various grades of polymer. There are certain chemicals which are specific to a particular grade only and the composition of chemical changes with the change in the grade.

In one of the instance, direct charge material procured but remained unconsumed due to change in production plan. The reason being the breakdown of communication between the Business Group and the Procurement Department. While the production plan was dynamically changed as per change in the Business Plan, the same was not communicated on time to the Procurement Group resulting in receipt of material which will never be used in the near future. This thereby resulted into negative contribution for the alternate grade which was planned to be produced in place of the original grade, as the inventory built up of chemical for the original grade had significant financial implication.

A proper internal control system of Plant Changes and the Order Management System would have stopped the unwanted delivery or an agreeable deferred procurement plan with the vendor. Internal auditor brought this fact to the notice of business/ production/ procurement department and gave recommendation to streamline the process of communication of change in sales/ production plan.

#### **(ii) Case Study 2**

As per the procurement practice followed at XYZ Company, the yearly requirement of major direct charge chemicals was anticipated

### ***Study on Co-ordination of Internal Auditor with Functional Heads***

based on the Annual Production plan. Procurement action was initiated by the Central Procurement Department based on the yearly requirement submitted by the Production Department. The deliveries of the chemical used to be staggered over the period of production on monthly/ quarterly/ as is required basis.

In an instance, change in quantity of chemical requirement due to change in the production schedule as per change in Business Plan was not timely communicated to Central Procurement Department which had agreed for aggressive shipment schedule at a higher cost for a long lead time material. The material was thereafter received and was in stock for more than 12 months.

Internal auditor advised on the process improvement which was made standard operating procedure for control effectiveness. Thus, any change in the production plan by the Marketing Group, is now submitted concurrently to the Procurement Department along with the Production Department. Also, the procurement department now verifies the stock on monthly basis for proper deferment of supplies in case of excess stocked chemicals.

## **Discomfort on Findings which are based on Apprehensions**

8.30 Functional heads never appreciate opinionated observations based on certain hypothetical assumptions. An assumption is a statement or condition which is presumed or assumed to be true and from which a conclusion can be drawn. A hypothetical condition is an assumption made contrary to fact, but which is assumed for the purpose of discussion, analysis, or formulation of opininons.

## **Methodology to Overcome**

8.31 Internal auditor's findings based on apprehensions annoys functional heads. If findings are based on facts and provided with complete analysis, then functional heads would appreciate the dimension given in the report. Generally, internal audit remarks based on exaggerated apprehensions are met with hostile counters. Proper knowledge of process saves the Internal auditor from such

### ***Hurdles of Co-ordination and Methodology to Overcome***

embarrassing encounters. It also saves from embarrassment in pointing non-issue as observation. Moreover, this helps internal auditors in taking right approach to audit.

8.32 The following case studies describe situations mentioned above:

#### **(i) Case Study 1**

Report on delay in counterparty confirmation for closed forex transactions is immaterial to functional head. If internal auditor demonstrates the risk associated with it by giving examples of financial losses happened else where because of this control lapses then only functional head will appreciate internal auditor's point and strengthen counterparty confirmation process of front office and its monitoring process by back office.

#### **(ii) Case Study 2**

Internal auditor pointed out that equipments (cranes) are hired by the various sites, in spite of the fact that many such company owned equipments (cranes) are lying idle at one of the other site, after completion of a major capex at that site. This led to payment of rental charges which otherwise would have been avoided.

Internal auditor made a cost comparison and pointed out the effective cost savings which can be achieved by using own equipments. Also, the methodology and the authority level for approval in case of hired equipments (cranes) was reframed to allow hiring only if crane movements from one site to other is non-commercially viable, i.e., hiring only up to a particular amount for a job was introduced. The Functional Head appreciated and implemented his suggestion.

## CHAPTER 9

# Conclusion

---

9.1 When the internal auditor addresses the operational efficiency objectives articulating his methods for identifying and evaluating the redundant activities, process constraints, etc., the co-ordination will naturally be effective. Using risk based and value-for-money approach, the internal auditors' "Constructive Tone" helps the functional heads to focus on control exceptions and process irregularities. This approach significantly changes the internal auditor's image from a simple "**Fault-finder**" to an useful "**Internal Consultant**".

9.2 To summarize, the benefits of the modern approach detailed in earlier chapter achieves the following:

- (i) Achieve cordial relationship with functional heads.
- (ii) Instill confidence that internal audit is constructive internal support service instead of fault finding department.
- (iii) Greater assurance to management that internal audit and functional heads work together to enhance controls, resolve deficiencies and optimize processes.
- (iv) Functional heads institutionalize control systems in their areas based on the constructive process of internal audit.

9.3 It is expected that using the techniques and skills presented in this study, internal audit professionals will confidently leverage

### ***Conclusion***

their position to carry out their tasks with high professional pride. The ultimate effect of effective co-ordination would be converting the most skeptical auditees into a staunch advocate of controls by making them realise **“controls are everybody’s business”**.

9.4 To conclude, this Study would achieve its purpose when Functional Head accepts that –

***“The value of Internal Audit is undeniable and ..... the value they add is unmistakable”.***

