

Evaluation of Internal Auditing in Business in General
and in Trading Companies in Particular



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By

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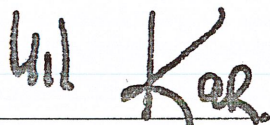
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DEDICATION

To my dearest wife Shaikha for all the support through my whole life

To my daughter Dalal and sons, Mohamed, Abdulrahman, Abdulla for
their love and support

To my parents and family for their encouragement

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ABSTRACT

The main objective of the research is to evaluate the internal audit performance in business in general and in trading companies (as case study in Kingdom of Bahrain) in particular, to investigate the main problem and the obstacles encountering the internal audit function in trading companies, to highlight on the other area related to internal audit such as risk management in order to evaluate and develop the overall company's strategies through an effective audit program to come out with a conclusion based on certain recommendations whereby the culture of internal audit be developed and be supported by its shareholders and the organization as a whole .

The reason of carrying this research arises from the following facts:

- The importance role of internal audit as an emerging profession in business activities is being neglected and marginalized.
- The scope of internal audit is limited to merely verifying accounting transactions, prevention and detection of fraud and errors and in some cases safe guard assets and properties of assets rather it concerned more with assisting management in all its activities.
- Nowadays the scope of the company's business has been expanded and growing with each passing day to survive from being collapsed, in such a difficult climate, research shows that the assurance provided by a professional internal audit function is becoming more valuable than ever.

Hence, the above – mentioned facts were the main impetus to select this topic.

To achieve the above objectives, data selected randomly consisting of 37 companies comprising of different business. These companies include small, medium and large size. Questionnaires, interviews and field visit were conducted. The sources of the data include directors, managers, manager's assistance, and senior and junior staff.

Main finding emerged from this thesis:

- Organizationally the status of an internal audit manager is below the grade of other departmental managers.
- There is no strength awareness from top management and other departments to the role of internal audit department, rather the Companies should look at the internal audit department as one of the most influential and value- based services available to the board, with the power to make a tangible contribution to the stewardship, efficiency and profitability of the organization.
- Internal audit department reporting to other than audit committee, rather it should report to audit committee as an independent committee for evaluating the effectiveness and the quality of an internal audit.
- It was found in some companies, that the internal audit staff is below the university degree and with inadequate practical experience in auditing, and also with no written policies, procedures and ethical standards governing the business organization.

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CHAPTER ONE

Introduction:

Fundamentals of the Research:

- The importance of internal auditing
- Statement of the problem.
- The importance of the research.
- Objectives of the research
- Assumptions of the reach
- The techniques of the research
- The methodology of the research
- The terminology of the research
- The constraint of the research
- The previous researches

INTRODUCTION

The need of the internal audit has appeared in the very beginning to those who are engaged with auditing the financial operation in various systems such as routine checking of stock records, purchase invoices, cash and other similar records and documents. Such need was in response to some factors represented in the enlargement of the size of systems of various branches, further to the need for particular means to avoid mistakes, frauds and detect the errors at the time.

The detachments of ownership from the administration, and emergence of huge companies, have lead to creation of the internal audit profession for accounts audit to avoid fraud and mistakes. Furthermore, the development in the administration field such as specialization, job distribution, and non centralization of the accounting activity in the companies branches, have lead to increasing acknowledge to the need for the internal audit services.

Through time, the top administration assures its utility to a better service by specifying an independent department for internal audit.

On the other hand, the administration started to realize that it is possible to get the assistance of the internal auditor in other scopes of work apart from accounting and financial tasks, and such internal auditor considered to be as constructive as well as a protective tool.

The internal auditors started to assess the internal supervision in its broad understanding including its administrative sides represented in its operational efficiency, and achievement of objectives and planned policies.

It is to say that the increasing understanding of the administration for the benefits of the proper internal supervision, and the complications required by the proper system of the internal supervision in the huge entities, have lead to the development and growth of the internal audit as a tool for control on all type of other internal control.

Accordingly, the profession and its aspects and objectives have developed.

The internal audit nowadays with its modern understanding, has broadened and included the activities of assessing extend of effectiveness of various control means, and extended more to include the comprehensive assessment for the regulative performance in various units.

Risk Management is an area that becoming increasingly important in which internal Audit has always been concerned about risks.

Internal Auditor role in risk Management area would concern on evaluating the business risk Management such as reducing business risk i.e. possibility in business value from any source and achieving the objectives of the organization in terms of increase business value to the shareholders.

Role of internal auditor on assessing, evaluating and ultimately come out with recommendation for the purpose of increasing the value of the organization.

The important role of internal auditor in evaluating the unexpected changes in expected future net cash flows, which represent the major source of fluctuation in business value.

The important role of internal auditor in business risk in terms of evaluating is the effectiveness of these business risks such as price risks, credit risks, and pure risks.

Role of internal auditor in analyzing business risks in terms of variations in cash flows and business value and to ensure that it comply with the organizations loss prevention policies and procedures manual.

The role of internal auditor would focus on how the process of these specific types of risks such as price risk, credit risk, pure risk and recommend the best alternatives ways, which probably would reduce the risk of reducing the value of the organization in future.

The role of internal auditor in developing methods of managing risk in order to increase business to shareholders

The role of internal auditor in evaluating the performance of the firm's risk management and its strategies on an ongoing basis

Internal auditor role in how the risk management functions is structured and the exact responsibilities of the units devoted to risk management.

Internal auditor role in evaluating risk management decision

Fundamentals of the Research:

The importance of internal auditing:

It is vast and it cannot be confined in this introduction but it is necessary to refer to the following main points:

- Internal auditor evaluates the effectiveness and adequacy of an organization's system of internal control and the quality of performance in carrying out assigned responsibilities so as to meet the organization's requirements and minimize the risk of loss. Besides, the auditor's primary concern when reviewing the adequacy of an organization's system of control is whether the key controls are designed into the system to prevent, detect, or correct materials errors and irregularities and to assure that the organization's objectives and goals will be met.
- Internal auditors may not possess all round expertise. Nevertheless, because of their experience and expertise in auditing the system of internal control they develop with an objective attitude towards the efficient and economical use of an organization's resources, internal auditors identify, and report inefficiencies.
- Internal auditors can provide advice and assistance to managers in developing and evaluating goals, objectives and systems by determining whether underlying assumptions are appropriate, information is current, accurate and relevant and suitable controls are incorporated. Internal auditors should ascertain whether such objectives and goals conform to the organizational goals and objectives.

- The main impetus in the growth of internal auditing appears to have been associated with the time factor of economic restraint when management while having less opportunity to increase profits by increasing sales, try to over come such problem by controlling costs. It is probable that internal auditing has to be considered as an effective tool for such purpose.
- It services the organization and appraises policies, procedures, plans and records for the purpose of informing and advising management.
- Internal auditors assist management by determining the reliability and integrity of information. Information systems provide data for decision-making, control and compliance with external requirements.
- It also assists management by reviewing the means used to safe guard assets from various types of losses such as those resulting from theft, fire, and improper or illegal activities.
- Internal auditors make recommendations and suggestions for improvements when the auditor finds differences between actual conditions and expected results.
- The chief of the internal auditing can ensure appropriate actions on the basis of recommendations by instituting a follow up routine which includes a time bound frame with in which a positive response is required about implementation of suggested remedial measures for removing the deficiencies.
- Internal auditors make special investigations for management. The internal auditor must always be available for any type of investigation that management requires.
- There are many ways in which the internal auditor can service management. To sum up, it is the duty of internal auditor to safe guards the funds, earning power and good will of the organization. By drawing the attention of management to any circumstances, which if allowed to continue, would impair efficient or otherwise will result in diminution of profits.

- Many companies use the internal auditing department as training ground for future executives. As compared to the training in any other department, executives will have better training opportunity to study all operations of the company.

Statement of the Problem:

If we discuss the nature of internal auditing, the concept of the profession seems to be traditional. It is primarily concerned with accounting and financial matters. A significant emphasis is placed on financial records and detection of frauds. The internal auditor is mostly engaged in conducting routine checking of stock records, purchase invoices, cash, sales bills and other similar records and documents. It is basically concerned with safeguarding of the assets of the organization. Many business activities being unaware about the contribution of the profession internal auditing neglect its importance. Management of organizations frequently considers internal auditing merely routine work. With such a perspective, management frequently introduces unqualified, incompetent people into internal auditing. The profession of internal auditing is inadequate and ineffective. Most of the organizations have not written policies, procedures, plans and audit programs. There is a misconception of the role of internal auditing by other departments. In addition to that management does not provide the necessary facilities and capabilities for internal auditors to fulfill their objective.

I reached to the aforementioned remarks on internal audit function after a considerable experience in a trading business firm.

These were the main impetuses that motivated me to select the following topic:

A critical appraisal of internal audit function in business in general and in trading companies in particular in Kingdom of Bahrain

Case Study: Trading Companies in Kingdom of Bahrain :

I hope to achieve the following general internal audit objectives in Kingdom of Bahrain business:

- To examine the objectives of the internal auditing
- To evaluate the internal audit performance
- To understand the main problems and obstacles encountering the internal audit function
- To suggest and recommend the suitable solution.

We will also focus on the actual situation of the internal audit function in the trading business company determining the overall objectives, problems and obstacles facing the internal audit performance in our research.

Hopping to conclude it with significant recommendations and suggestions that will assist in solving these problems and obstacles and improving the internal audit function in the Trading Company under study

The Importance of the research:

The importance of this research arises from the importance of the internal auditing and its role in business activities, In addition to that according to my awareness that this topic wa not dealt with. I feel that those in charge of internal audit department lacks competence, qualifications and many business activities neglect the importance of internal audit.

I reached the aforementioned conclusion after an experience in auditing and contracts with various internal audit departments in general and in trading companies in particular in Kingdom of Bahrain.

The question of the research:

I will attempt to respond to the following principal question:

- What is the actual situation of internal auditing in the trading business company?

To respond to this question, we have to answer the following sub-questions:

- (a) What is internal auditing?
- (b) What is Risk Management?
- (c) How we identified the key risks to our business?
- (d) What is the role of internal auditor in risk management?
- (e) How good are our processes to identify and analyze threats to our business?
- (f) Do we have controls in place to cover all our really big risks, or are there any gaps?
- (g) Do we have a culture where people take risk control seriously?
- (h) Can we trust our financial reporting?
- (i) How well does executive management direct and control the business?
- (j) How reliable is our management information?
- (k) Do we comply with relevant legislation?
- (l) Are we doing enough to safeguard our assets?
- (m) How do we control change and system development initiatives?
- (n) What is the importance of internal auditing in a modern managerial function and in the light of technological and other advancement?
- (o) What is the nature and spread of internal auditing in trading business?
- (p) What are the objectives of the internal auditing in the Trading business company?
- (q) What is the scope of internal auditing in the business?
- (r) What is the importance of internal auditing to Trading company management's?
- (s) What are the objectives of the internal audit department in the trading company?
- (t) What is the scope of the internal audit department in the Organization?
- (u) What are the training courses and programs of continued education received by the audit staff of the organization?
- (v) What is the procedure for the recruiting process of an audit staff in the organization?

- (w) What is the internal audit plan of the Trading business?
- (x) What is the actual situation of the internal audit function in the trading business?
- (y) What are the problems and obstacles encountering the internal audit function in business and in trading company in Kingdom of Bahrain?
- (z) What are the appropriate recommendations and suggestions for improving the internal audit performance in Kingdom of Bahrain and the trading business?

What are the objectives of the research?

I will attempt to accomplish the following principal objective:

- To investigate the nature of internal auditing in business depending on the above principal objective emerges other objectives. The research attempts to fulfill them.

These objectives are:

- (a) Examine what is internal auditing.
- (b) To analyze the importance of internal auditing to modern managerial function.
- (c) To understand the objectives of the internal auditing in business.
- (d) To study the organizational structure and level of report.
- (e) To determine how important is this function to the management.
- (f) To evaluate the internal audit performance in business.
- (g) To understand the objectives of the internal audit department in the trading company.
- (h) To know the scope of the internal audit department.
- (i) To investigate the training courses and programs of continued education offered to the audit staff.
- (j) To understand the procedures followed for the recruiting process of an audit staff.
- (k) To examine the internal audit plan.
- (l) To discover the actual situation of the internal audit function scheme.
- (m) To understand the problems and obstacles encountered the internal audit function.

- (n) To provide recommendations and suggestions for improving the internal audit function in Kingdom of Bahrain in general and Trading company in particular.

The Assumption of the Research:

I regard the following points as assumptions of the research:

- (a) The importance of an internal audit function is neglected. In certain organizations, the internal audit department is not regarded as a critical department.
- (b) The limitation of the financial capabilities resulted in the weakness of internal audit performance.
- (c) The inadequacy of competent, qualified and experienced staff resulted in the weakness of internal auditing and as such, staffing the department with experience and qualified staff is not a priority.
- (d) The procedures for selecting and developing internal audit staff are unscientific. Internal auditors are often generalists and accordingly, may not have the required expertise and experience to audit the specialized areas.
- (e) The organizational structure and reporting system is not appropriate.
- (f) Due to the limitation of the internal audit scope in accounting and financial area, the internal audit department became ineffective. Lack of the required qualification or training especially in areas of risk management, information technology, corporate governance and treasury.
- (g) Lack of scientific criteria for the evaluation of internal audit staff weakened the internal audit performance. Fairly young and inexperienced internal auditors staff some internal audit departments.

- (h) Inadequate human and material resources of the internal audit department undermined the internal audit function.
- (i) Due to lack of formal internal audit plan, the functions and activities of the scheme could not be covered efficiently in accomplishing the objectives of the project.

The Scope of the Research:

The scope of this research is confined to the internal auditing function in Trading in Kingdom of Bahrain case study of the research.

The Techniques of the Research:

I will use the following tools as techniques of the research:

- (a) References
- (b) Periodical publications
- (c) Questionnaires
- (d) Interviews
- (e) Observations

The Methodology of the Research:

As I will follow the descriptive methodology, it is essential to mention the main features and characteristics of this method as follows:

The descriptive methodology enables the researcher to study a case more than other methods.

The descriptive method is fit to focus on a great area of the research population and it is also suitable for a case study.

In descriptive methodologies we can use more than one tool for collecting data such as a questionnaire, an interview and observation. The importance of these tools differs one from the other in their usage. We can depend on one technique and the other tools can be used to confirm and backup the results.

I will emphasis on the questionnaire and will use the interview and the observation as supplementary tools.

Based on the above aforementioned we shall follow the descriptive methodology (the survey and case study method) to describe, analyze and evaluate the actual situation of the internal audit function in Kingdom of Bahrain business and Trading company as a case study.

Hoping to come out with findings and recommendations that contribute to the development and improvement of the internal audit performance in business

The Terminology of the Research:

It is essential to understand the precise meaning of the terminologies frequently used at any stage of this research. The important terminology's used are:

- (a) Internal auditing.
- (b) Board
- (c) Director, manager or chief.
- (d) Compliance
- (e) Management
- (f) Trading Organization.
- (g) Audit Programs
- (h) Risk
- (i) Risk Management.
- (j) Code of Ethics

(k) Add Value

(l) Charter

(m) Governance

(n) Independence

(o) Objectivity

(p) Standard

- (a) Internal auditing: Refers to “an independent appraisal function established within an organization to examine and evaluate its activities as service to the organization.
- (b) Board: Aboard is an organization's governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a non profit organization, or any other designated body of the organization, including the audit committee, to whom the chief audit executive may functionally report.
- (c) Director, manager or chief: Is the head of the internal audit department
- (d) Compliance: Refers to the extent to which policies, procedures, rules, governmental regulations, and laws. Good business practices, and generally accepted accounting principles are followed.
- (e) Management: is defined as “any one in an organization with responsibilities for setting and/ or achieving objectives.
- (f) Trading: is the oldest and largest business in Kingdom of Bahrain. 75% of the populations deal in trading in Kingdom of Bahrain
- (g) Audit Programs: An audit program is like a road map. It show the route the internal auditor intends to take and the requirements for each individual audit program to be tailored to the particular assignment and to determine

operating objectives and related controls; and show the detail with which the programs shall be prepared

- (h) Risk: The possibility of an event occurring that will have an impact on the achievement of objectives.
- (i) Risk Management: A process to identify, assess, manage, and control potential events or situations, to provide reasonable assurance regarding the achievement of the organization's objectives.
- (j) Code of Ethics: is defined as the guidance and moral principles followed by members of The Institute of Internal Auditors, Inc. The code applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.
- (k) Add Value: Value is provided by improving opportunities to achieve organizational objectives, identifying operational improvement, and/ or reducing risk exposure through both assurance and consulting services.
- (l) Charter: The charter of the internal audit activity is a formal written document that defines the activity's purpose, authority, and responsibility. The charter should (a) establish the internal audit activity's position within the organization; (b) authorize access to record, personnel, and physical properties relevant to the performance of engagements; and (c) define the scope of internal audit activities.
- (m) Governance: The combination of process and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.

- (n) Independence: The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels.
- (o) Objectivity: An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others.
- (p) Standards : A professional pronouncement promulgated by the Internal Auditing Standards Board that delineates the requirements for performing a broad range of internal audit activities, and for evaluating internal audit performance.

Constraints of the Research:

The internal audit departments of the 37 organizations were remote. Thus their visits were costly in terms of time, money and efforts.

The publications that dealt with the internal auditing are limited, especially in their practical aspect. Due to this, the research will depend on questionnaires, interviews, observations and reports of the internal auditor submitted to the top management. Besides I will depend on references on its theoretical aspect

Previous Researches:

According to my awareness there have been no past researches about internal auditing in general and trading companies in particular in Kingdom of Bahrain.

I will refer to publications on internal auditing profession. I shall mention samples of these books and I shall come into brief conclusions and remarks.

CHAPTER TWO

This chapter will include the theoretical aspect of the research

- Concept and ethics.
- Origin and development.
- Nature and scope.
- Objective and goals.

of internal auditing in general and in trading companies in particular and practices as related to the businesses and trading companies in the Kingdom of Bahrain

This is introductory theoretical part of the internal auditing. We shall deal with the practical one in the next chapter.

PART ONE

Concept and Ethics:

With reference to the definitions of internal auditing in general and trading companies in Kingdom of Bahrain, the research shows that all the definitions of internal auditing in these organizations in Kingdom of Bahrain are with in the limits of these two definitions.

(A) "An internal audit can be defined as a systematic examination of the ways and means of the internal control. A review of the accounting information reflected in the books and financial lists of the establishment, aiming at investigating the accuracy and obtaining a neutral technical opinion". (1)

(B) "An internal audit is an examination and an independent internal evaluation of the establishment activities for the benefit and aims of the management" (2).

This is a traditional concept of internal auditing. It is primarily concerned with a systematic examination of the internal control to reduce opportunities in committing errors with a significant emphasis on detection of frauds and accuracy of financial records.

(1) Conference for the development of the internal audit in Saudi Arabia operations in 1999.

(2) The institute of internal auditors, Opcit p.1.

The internal auditor is mostly engaged in reviewing the accounting information reflected in the books and financial lists by conducting routine checking of stock records, purchase invoices, cash, sales bills and other similar records and documents. It is a mere routine review of financial and other records by specially assigned staff. It deals also for the benefit and aims of the management such as adequate safeguard of the assets of the organization.

The modern concept of internal auditing goes far beyond the traditional limits.

Internal auditing is no longer considered as a mere routine review of financial and other records & detection of frauds by specially assigned staff. 'As the institute of internal auditors USA' defines it, "internal auditing is an independent appraisal function established with in an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist member of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analysis, appraisals, recommendations, counsel and information concerning the activities reviewed".

In June 1999, the Institute of Internal Auditors (IIA) officially adopted a new definition of the internal auditing function .The new definition was developed by the Guidance Task Force (GFT) and defined the internal audit function as:

"An independent, objective assurance and consulting activity designed to add value and improve an organization's operations". It helps an organization accomplish its objectives by bringing a system; disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA 2000). The new definition shifts the focus of internal audit function from one of assurance to that of value added and attempts to move the profession to toward a standard s-driven

approach with a heightened identity (Bou-Raad, 2000; Krogstad et al., 1999). (1)

The above definition can be analyzed in detail by examining each of the material concepts: (2)

Internal auditing

The service is provided within the organization and is distinct from the external audit role. Years ago the IIA considered changing the name of internal auditing to reflect the modern and increasingly professional approach. No alternative was forthcoming and the idea was dropped.

Independent

The concepts of independence are fundamental. Internal auditing cannot survive if it is not objective. All definitions of internal audit feature an element of independence, although its extent, and how it is achieved, is a topic in its own right. The audit function must have sufficient status and be able to stand back from the operation under review for it to be of use. If this is not achieved, then this forms a fundamental flaw in the audit service and some internal audit functions may not be able to subscribe to the standards.

Assurance and consultancy

This refers to the fundamental shift in the role of internal audit. The shift makes clear that the past tinkering with the advice and consulting aspect of auditing is now a full-blown additional consultancy arm of the function. Internal audit may provide advice and assistance to management in a way that best suits each manager's needs.

(1) Albert L.Nagy, William J. Cenker, *Managerial Auditing Journal* Volume 17 Number 3 2002
pp.130-137, MCB University Press

(2) K.H.Spencer Pickett, *the Essential Handbook of Internal Auditing*, John Wiley & Sons Ltd,
England, 2005, pp 100-111

Even consulting work should take on board the impact of risks and IIA Implementation Standard 2110.CI

says that: ‘during consulting engagements, internal auditors should address risk consistent with the engagement’s objectives and should be alert to the existence of other significant risks’. Meanwhile the primary role of internal audit is to provide independent assurances that the organization is, or is not, managing risk well. Internal audit can provide assurance on the extent to which controls are able to address risks but cannot give any absolute guarantees. There is help at hand and an implementation standard 1220 A3 clarifies this point by saying that: ‘The internal auditors should be alert to the significant risks that might affect objectives, operations, or resources. However assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified’.

Activity

The fact that internal audit function is an activity is important. This means it is a defined service, although not necessarily located within the organization (e.g. it may be outsourced).

Designed to add value

As a service, auditing has to form a client base and understand the needs of the organization. Here the service role should lead to a defined benefit to the organization rather than internal audit working for its own mysterious goals. Adding value should be uppermost in the minds of chief audit executives (CAE) and this feature should derive the entire audit process.

And improve an organization's operations

This brings into play the notion of continuous improvement. The auditors are really there to make things better and not inspect and catch people out. In one sense, if the CAE cannot demonstrate how the auditors improve the business, there is less reason to resource the service.

It helps an organization accomplish its objectives

The task of internal audit is set firmly around the organization's corporate objectives. Making an organization successful is the key driver for corporate governance (a badly governed organization will not be successful), for risk management (where risks to achieving objectives are the main focus) and internal controls (that seek to ensure objectives are realized). Moreover, it is the search for long-term corporate success that must steer the internal audit shop, or there is little point setting up the team.

Systematic, disciplined approach

Internal audit is now a full-blown profession. This means it has a clear set of professional standards and is able to work to best practice guidelines in delivering a quality service. One measure of this professionalism is that the organization can expect its auditors to apply a systematic and disciplined approach to its work. Be it consulting or assurance work, IIA Performance Standard 20040 requires that: 'The CAE should establish policies and procedures to guide the internal audit activity'.

Evaluate and improve

It was mentioned the need to focus on making improvements in the organization and part of this search for improvement entails making evaluations. Internal audit set what is found during an audit against what should be present to ensure good control. This necessarily entails the use of evaluation techniques that are applied in a professional and impartial manner to give reliable results. Many review terms leave out the

evaluation aspect of review work and simply ask a few questions or check a few records and their

results are not robust. Internal audit, on the other hand built into its definition the formal use of evaluation procedures to support steps to improve operations.

Effectiveness

Effectiveness is a bottom-line concept based on the notion that management is able to set objectives and control resources in such a way as to ensure that these goals are in fact achieved. The link between controls and objectives becomes clear, and audit must be able to understand the fundamental needs of management as it works to its goals. The complexities behind the concept of effectiveness are great, and by building this into the audit definition, the audit scope becomes potentially very wide.

Risk management, control and governance process

Organizations that have not developed vigorous systems for these matters will fail in the long run and fall foul of regulators in the short term. The internal auditors are the only professionals who have these dimensions of corporate life as a living and breathing component of their role. They should therefore be the first port of call for anyone who needs to get to grip with corporate governance and IIA Performance Standard 2130 makes it clear that the internal audit activity should assess and make appropriate recommendations for improving the governance process in its

Accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organization.
- Ensuring effective organizational performance management and accountability.
- Effectively communicating risk and control information to appropriate areas of the organization.
- Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.

The assurance role of internal auditing needs to be understood. Assurance implies a form of guarantee that what appears to be the case is in fact the case, based on a reliable source of conformation that all is well. The more impartial and professional the source of these assurances, the more reliable they become (1).

(1) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005, pp 100-111

Ethics: -

Purpose of Code of Ethics is to promote a successful gaining of an ethics culture, as every successful professional knows in the profession of internal auditing. It is based on the vision, values, attitudes and beliefs of profession of internal auditing. A code of ethics is necessary and appropriate for the profession of internal auditing, which reflects the ability of the auditing organization to perform competently, professionally based on a grounded of management support, acceptance and on imaginative service to the organization. The code of ethics culture should be encouraged among all employees to add value to the organization.

A code of ethics is founded as it is on the trust placed in its objective assurance about risk management. (1)

Ethics are an important consideration in the practice of internal auditing that concerns with the standards of professional behavior for the guidance of internal auditors and covering basic principles in the various disciplines of internal auditing practice. (2)

(1) Institute of internal audit Opcitp

(2) James A.Cashin Handbook for Auditors 1982 Reissue p.7-6.

Internal auditors are expected to apply and uphold the following principles:

1- Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

2- Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

3- Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

4- Confidentiality

Internal auditors respect the value and the ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so. (1)

(1) Code of Ethics adopted by the IIA, Board of directors, June 17, 2000.

PART TWO

Origin and Development

Ancient Times

Internal auditing has its roots in antiquity. Only recently the tree began to blossom. The story of modern internal auditing bespeaks a painfully slow growth since its ancient beginnings. The buds did not begin to show until 1941 when the Institute of Internal Auditors, Inc., was formed; then a distinctive discipline began to flower.

Evidence of verification of transactions- now only one of the internal Auditing's activities- goes back over 5,500 years. The records of a Mesopotamian civilization about 3600 B.C. show tiny marks at the side of numbers relating to financial transactions. The dots, checks, and tick marks portray a system of verification. One scribe prepared summaries of transactions; another verified them. It was probably here that the control system of verification and division of duties oriented. Early Egyptian, Persian, and Hebrew records show similar system. The Greeks were strong believers in control over finances. Their records show that transactions required authorization and verification.

Ancient Rome employed with the "hearing of accounts." One official would compare his records with those of another. This oral verification was designed to keep officials in charge of monies from committing fraudulent acts. Indeed the task of hearing accounts gave rise to the term audit; from the Latin *auditus* ("a hearing"). *Quaestors* ("one who inquires") would examine the accounts of provincial governor, seeking to detect fraud and the misuse of funds.

The middle Ages

When Rome fell, so did monetary system and controls. Not until the end of the Dark Ages did rulers demand proof that they were obtaining the revenues owed them. Barons and justices made the first audits; appointed officials made them later.

An expanding Italian commerce during the 13th century demanded more sophisticated record keeping. Thus was born the double-entry system of bookkeeping- an answer to an essential need. This system helped merchants control transactions with customers and suppliers and check on the work of employees. Auditing was taken seriously. An auditor representing Queen Isabella accompanied Columbus to the New World.

The Industrial Revolution

Auditing, as we now know it, began during the industrial revolution in England. Companies hired accountants to check the records. Audit verification became less a matter of personal accountability and stewardship. It became more a matter of scrutinizing written records and comparing entries in the books of account with documentary evidence. The concern was with the records rather than with the people who prepared them.

Recent Times

Auditing crossed the seas to the United States during the 19th century along with British investments. Wealthy Englishmen invested substantial amounts in United States corporations, especially breweries. They wanted an independent check on their investments. The English auditors brought with them methods and procedures that the Colonials adapted to their own needs. The British requirements arose under the statutory dictates of the British Companies Act calling for accountability to investors.

The United States had no such dictates; hence, auditing served the needs of the entrepreneur. These needs gave rise to the balance-sheet audit, stressing a more analytical approach to accounts.

Auditing in the United States

After World War 1, the United States' economy escalated. Many corporations although not required to do so, published audited financial statements. But, By and large, auditing was for the benefit of the bankers who feared the overly optimistic balance sheets and needed an independent verification on which they could rely. The railroads were among the first to adopt a far-flung internal auditing program. Railroad executives needed assurances that their stationmaster across the country was handling receipts properly.

Congressional Action

Auditing received a great push forward when the united states congress enacted the securities act in 1933, the securities and exchange act in 1934, the public holding company act in 1935, and the investment company act in 1940 the purpose of this legislation was to regulate publicly traded securities and to use accounting and auditing as means toward that end. Corporations could not rely entirely on the external accountants because they needed in-depth analyses that those accountants were not always in a position to give. Therefore, they hired internal auditors to help in the verification of accounting records and to determine compliance with accounting controls.

The internal auditors struggle for identity

The outside auditors usually controlled the internal auditors. The latter were shadows of the former, shadows with little prestige or identity.

Modern internal auditing began to evolve in 1941 when The Institute of Internal Auditors, Inc., was formed. Only then did the hackles that bound it to the books of account start to break down. Only then did it assume an upright posture, no longer genuflecting to the professional outside account.

The term internal auditor and internal auditing had a pettifogging, nitpicking connection to some of the founders of The Institute. They sought for a term or phrase that would better describe the expanding role of the internal auditor, but none emerged.

And so John B. Thurston, one of the Institute's founders, said in 1941

You will all recognize the unhappy inadequacy of the phrase 'internal auditor.'

Years ago it was probably satisfactorily descriptive of our earlier predecessors in the profession. But today, auditing, in the precise meaning of the word, is only one of the functions of the internal auditor. Your organization committee gave much thought to the possibility of using some other phrase or term, and finally reached the conclusion that we must bow to historical precedent.

The founders hoped that the actions rather than the description of the profession would help it achieve its separate identity. But 1941 did not give birth to an Athena springing fully formed from the brow of Zeus.

Rather it sparked the glint in the eyes of the founders who dreamed of a profession concerned more with assisting management in all its activities, not merely verifying accounting transactions. The glint presaged a lusty infant-management-oriented auditing-and the infant has made steady progress.

That progress is depicted in the various changes the Statement of Responsibilities of the Internal Auditor underwent from 1947 to 1976. (1)

The Evaluation of the Audit Function (2)

1. Extension of external audit

Internal audit developed as an extension of the external audit role in testing the reliability of accounting records that contribute to published financial statements.

The IIA.UK&Ireland have suggested this link between external and internal audit:

The nineteenth century saw the proliferation of owners who delegated the day-to-day management of the performance of their organizations. They were at greater risk of error, omissions or fraud in the business activities and in the reporting of the performance of these businesses than owner-managers. This first gave rise to the profession of external auditing. External auditors examine the accounting data and gave owners an opinion on the accuracy and reliability of this data. More slowly the need for internal auditing of business activities was recognized. Initially this activity focused on the accounting records. Gradually it has evolved as an assurance and consulting activity focused on risk management, control and governance processes. Both external audit and internal audit exist because owners cannot directly satisfy themselves on the performance and reporting of their business and their managers cannot give an independent view.

(1) Lawrence B. Sawyer, the Practice of Modern Internal Auditing, the Institute of Internal Auditors, Inc, Florida, second edition, 1981, pp.3-

(2) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005, pp 4-5

2. Internal check

The testing role progressed to cover non-financial areas, and this equated the internal audit function to a form of internal check. Vast numbers of transactions were double checked to provide assurance that they were correct and properly authorized by laid-down procedures. The infamous 'audit stamp' reigned supreme indicating that a document was deemed correct and above board.

3. Probity work

Probity work arrived next as an adaptation of checking accounting records where the auditors would arrive unannounced at various locations and local offices, and perform a detailed series of tests according to a preconceived audit programme. Management was presented with a list of errors and queries that were uncovered by the auditors. The auditors either worked as a small team based in accountancy or had dual posts where they had special audit duties in addition to their general accounting role.

4. Non- financial systems

The shift in low-level checking arose when audit acquired a degree of separation from the accounting function with internal audit sections being purposely established. This allowed a level of audit management to develop which in turn raised the status of the audit function away from a complement of junior staff completing standardized audit programmes.

5. Chief auditors

Another thrust towards a high profile, professional audit department was provided through employing chief internal auditors (or chief audit executives) with high organizational status.

6. Audit committees

Audit committees bring about the concept of the audit function reporting to the highest levels and this had a positive impact on perceived status. Securing the attention of the board, chief executive, managing director, non-executive and the most sensitive corporate issues.

7. Professionalism

The Institute of Internal Auditors (IIA) has some history going back over 50 Years. Brink's Modern Internal Auditing has outlined the development of the IIA: in 1942, IIA was launched. Its first membership was started in New York City, with Chicago soon to follow. The IIA was formed by people who were given the title internal auditors by their organizations and wanted to both share experiences and gain knowledge with others in this new professional field. A profession was born that has undergone many changes over subsequent years.

The Development of Internal Audit Services (1)

The developmental process outlined above highlights the way the function has progressed in assuming a higher profile and a greater degree of professionalism, and these developments over the last 20 years may likewise be traced:

1. Internal check procedures

Internal audit was seen as an integral component of the internal checking procedures designed to double-check accounting transactions.

(1) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005, pp 5-6

2. Transaction-based approach

The transactions approach came next, where a continuous programme of tests was used to isolate errors or frauds.

3. Statistical sampling

Statistical sampling was later applied to reduce the level of testing along with a move away from examining all available documents or book entries.

4. Probity-based work

Probity-based work developed next, again featuring the transaction approach where anything untoward was investigated.

5. Spot checks

It was then possible to reduce the level of probity visits by making unannounced spot checks so that the audit deterrent (the possibility of being audited) would reduce the risk of irregularity. Moreover, most internal auditors assumed a 'Gotha' mentality where their greatest achievements resided in the task of finding errors, abuse and / or neglect by managers and their staff.

6. Risk analysis

The transaction/probity approach could be restricted by applying a form of risk analysis to the defined audit areas so that only high risk ones would be visited. Each unit might then be ranked so that the high risk ones would be visited first and/or using greater resources.

7. Systems-based approach

Then came a move away from the regime of management by fear to a more helpful service. Systems-based audits (SBA) are used to advise management on the types of controls they should be using. Testing was directed more at the controls than to highlight errors for their own sake.

8. Operational audit

Attention to operational areas outside the financial arena provided an opportunity to perform work not done by the external auditor. The concepts of economy, efficiency and effectiveness were built into models that evaluated the value-for-money implications of an area under review.

9. Management audit

Management audit moves up a level to address control issues arising from managing an activity. It involves an appreciation of the finer points relating to the various managerial processes that move the organization towards its objectives.

10. Risk-based auditing

Many internal audit shops now moved into risk-based auditing where the audit service is driven by the way the organization perceives and manages risk. Rather than start with set controls and whether they are being applied throughout the organization properly, the audit process starts with understanding the risks that need to be addressed by these systems of internal control. This is no linear progression in audit services with many forces working to take the profession back to more traditional models of the audit role where compliance and fraud work (financial propriety) are the key services in demand.

PART THREE

Nature and Scope:

The scope of the internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality performance in carrying out assigned responsibilities (1).

Throughout the world, internal auditing is performed in many different types environments and within organizations that vary in purpose, size, and structure. In addition, the laws and customs within various countries differ from one another. These differences may affect the practice of internal auditing in each environment.

During the coming years, internal auditors can help to ensure that the Professional Practices Framework will continue to grow more robust through their active involvement in guidance development.

(1) The Institute of internal audit

Functions of Internal Auditing:

Internal auditors are required to perform the following functions: -

1. Reviewing and appraising the correct, adequacy and application of accounting, financial and other operating controls and promoting effective controls at reasonable costs.
2. Ascertaining the extent of the compliance with established policies and plans as well as procedures.
3. Ascertaining the extent to which company assets are accounted for and safeguarded from losses of all kinds.
4. Ascertaining the reliability of management data developed within the organization.
5. Appraising the quality of performance in carrying out assigned responsibilities.
6. Recommending operational improvements.

Internal auditing practitioners are charged with assisting the organization in the effective discharge of responsibilities, promoting the establishment of cost-effective controls, assessing risks, and recommending measures to mitigate those risks. Integral-part of the management team, internal auditors furnishes top management with analysis, appraisals, counsel, and information on the effectiveness the review, and monitor organizational ethics.

Evaluating emerging technologies, Analyzing opportunities, Assessing quality, economy efficiency, and Provide accurate timely communication. Such diversity gives internal auditors a board perspective on the organization. And that, in turn, makes them a valuable resource to executive management and the board of directors in accomplishing overall goals and objectives, as well as strengthening internal control and governance.

Internal audit is potentially one of the most influential and value-added services available to the board, with the power to make a tangible contribution to the stewardship, efficiency and profitability of the organization (1)

(1) The Institute of Internal Auditors – UK and Ireland, November 2003.

PART FOUR

Objective & Goals:

As a result, informed senior managers and boards are relying on internal auditors for advice and counsel for everything from analysis of operations and assessment of risk to recommendations for improved corporate governance.

Moreover, internal auditing practitioners are increasingly being challenged to apply their expertise in much broader ways than over before- such as evaluating emerging technologies, detecting and deterring fraud, analyzing the effectiveness of policies and procedures, and identifying opportunities to save you and your shareholders money.

When it comes to adding value across the board, there's no better source than internal auditing.

World- class internal audit shops speak out in the importance of internal Auditing's relationship with the audit committee: (1)

Internal audit is the primary resource of the audit committee in carrying out its duties and responsibilities. With those responsibilities increasing and continued pressure from the SEC for financial reporting integrity, a functioning partnership of the audit committee and internal audit is vital.

An active and informed audit committee provides the ultimate independent and objective oversight of the corporate control environment, including focus on emerging trends and risk. Internal auditing is the primary agent of the audit committee within the company.

(1) The Institute of Internal Auditors Standard for professional practice for internal audit

CHAPTER THREE

The practical part of the research:

Internal Auditing:

- Concepts and Ethics
- Origin and development
- Nature and scope
- Objectives and goals

PART ONE

Concepts and Ethics

Concepts:

Internal Auditing is defined as:

“An independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” To this end, internal auditing furnishes management with analysis, appraisals, recommendations, counsel and information concerning the activities reviewed. (1)

This definition clearly shifts the emphasis from serving management to serving the organization as a whole. The above definition refers that internal auditing should not confine itself to the routine checks of stock records, invoices, cash etc, but has to conduct an appraisal of various functions, providing advise and recommendations of the activities as well as operations reviewed. Internal auditor has to go beyond the traditional concept to internal auditing which was basically concerned with safe guarding of assets, books of account, accuracy of financial and accounting records and a significant stress on detection of frauds. Internal auditing should cover every phase and sector of the organization, emphasizing on new areas like reviewing the economic and efficient use of resources and organizational performance. (2)

(1) The institute of internal auditors, standards for professional practice for internal auditor, June 1999.

(2) Cook-Winkle, Auditing philosophy and technique, Houghton Mifflin Company, Boston, 1980, Second Edition, P. 385

The fundamental principles on which internal auditing should be based are:

- (a) The independent status.
- (b) Objectivity
- (c) Conducting a financial investigation on any phase of the organization's activities under any circumstances and at anytime.
- (d) An obvious understanding of the department's objectives,
- (e) Care in the selection of an internal audit staff (1)

The above principles are equally vital to the success of the work of the internal audit department

Objectivity means an independent mental attitude and an honest belief in work i.e. no subordination of judgment to others.

Thus internal auditors are precluded from:

- (a) Developing
- (b) Designing
- (c) Drafting or
- (d) Installing procedures or operating systems, because these activities are not auditing functions. Performing such activities is presumed to impair audit objectivity.

Internal auditors should be independent from the activities they audit. Internal auditors are independent when they can carry on their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through the organizational status and objectivity.

(1) E.H. Woolf (et al), Internal Auditing, HFL (publishers) Ltd, London, 1973, Fourth edition, pp. 7-8

The principal purposes of an internal audit can be summarized as follows:

- (1) Verification of the reliability and integrity of the financial, operational and accounting information.
- (2) To ensure that the standard accounting practice of the organization are adhered to.
- (3) To conduct an investigation for management.
- (4) To ascertain that the system is functioning as intended.
- (5) To evaluate the adequacy and effectiveness of controls.
- (6) To report audit findings and recommendations to a level within the organization.(1)

Information is a fundamental resource of an organization. It must be: relevant, understandable, reliable, complete, objective and timely. Taking decision, strategic or operational, requires information as the main input to the decision-making process. Thus it is essential to the managers of an organization (2)

The internal auditors review the established systems to ensure compliance with those policies, plans procedures, laws, and regulations that could have a significant impact on operations and reports.

(1) The institute of Internal Auditors, standards June 1999.

(2) Andrew D. Chambers and (et al), Internal Auditing, Pitman publishing, London, 1987, Second edition p. 309.

Ethics:

The purpose of code of Ethics is to promote an ethical culture in the profession of internal auditing. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objectives assurance about risk management, standards, as described within the PPF, are the criteria by which the operations of the an internal audit department are evaluated and measured. They are intended to represent the practice of internal auditing as it's should be. The standards are meant to serve the entire profession of internal auditing, in all types of organizations where internal auditors are found. (1)

The principal of ethics is important and essential for the profession of internal auditing same as such trust placed in its objectives to meet the risk management, control and governance processes. The management depends on the internal auditor to fulfill its stewardship obligations. The internal auditor must therefore, maintain high standards of conduct, honor, and character, and should behave himself so that his good faith and integrity is not open to question.

He will, therefore, subscribe to the code of Ethics of the institute of internal auditors and comply with the following principles:

- (a) Integrity
- (b) Objectivity
- (c) Confidentiality
- (d) Competency

(1) The Institute of Internal Auditors, www.theiia.org / ecm /print.ctm? Doc, 31/03/2002.

RULES OF CONDUCT

1. Integrity

Internal auditors:

- Shall perform their work with honesty, diligence, and responsibility.
- Shall observe the law and make disclosures expected by the law and the profession.
- Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. Objectivity

Internal auditors:

- Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
- Shall not accept anything that may impair or be presumed to impair their professional judgment.
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. Competency

- Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- Shall perform internal auditing services in accordance with the Standards for the Professional Practice of Internal Auditing.
- Shall continually improve their proficiency and the effectiveness and quality of their services.

4. Confidentiality

- Shall be prudent in the use and protection of information acquired in the course of their duties.
- Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.
- These are the basic guidelines to the internal auditors with regard to the moral issues and conflicts that they may face while carrying out internal audit assignment.(1)

Thus from the aforementioned discussion one can conclude that modern internal audit definition not only cover traditional activities but also extend to include the economic and efficient use of resources and performance of the organization. Internal auditors must maintain high standards of conduct in order to effectively discharge their responsibility and duties objectively.

(1) The institute of internal auditors: Code of Ethics (June 17, 2000)

PART TWO

Origin and Development:

Origin:

The need for internal audit arises due to the fact that in the recent past, business organization has grown enormously in size and operations. Many of them employ thousands of persons and conduct their operations from various locations. It has, therefore, become necessary for the managements of such organizations to have a team of specialist to review the procedures and operations of various units and report cases of non-compliance, inefficiency and lack of control, so that the necessary action can be taken. This task cannot obviously be left to the statutory auditors whose main objective is to report whether or not the financial statements reflect a true and fair view of the working results and financial condition of an enterprise. Internal auditing has, therefore, become a specialized service requiring not only expertise in accounting but also in organizational behavior and in functional areas of management (1)

Thus the principal factor in its emergence was the extended span of control faced by the management. The solution was to provide the required internal audit service.

(1) The institute of the Internal auditing, 1999 and Rick Hayes (et al) principal of auditing 1999

Development:

Contemporary professional practice of internal audit was born in 1941, when the first internal auditing book, Victor Z. Brink's modern internal audit, was published, and the institute of internal auditors was founded.

In five decades the institute has done much to enhance the profession of internal auditors, including approving a statement of responsibilities, developing a common body of knowledge, establishing continuing education, professional certification (certified internal auditors) programs and adopting standards for the professional practice of internal auditing.

Throughout the 1940's and 50's internal audit activities in many organizations focused upon financial auditing, and internal audit departments were heavily involved in the review of financial statements. Today however, internal auditing takes on a much broader perspective as suggested in the institute of internal auditor's statement of responsibilities of internal auditors. (1)

The main impetuses in the growth of internal auditing is appeared to be linked with times of economic restraint when management has a chance to increase profits by controlling costs only, as it failed to add profits by increasing sales.(2)

(1) David N. Richiute, Auditing concepts and standards. South Western publication co. Ohio, USA, 1982. p.29.

(2) Andrew D. Chambers and (et al), Opcit p, 4.

In 1981, the institute of internal auditors-uk offered the first professional qualification in the United Kingdom. People passing the examination are awarded the Member of the Institute of Internal Auditors (MIIA). Professional examinations in internal auditing are now well established with the certified internal auditor scheme in the USA. Accompanying its status within the enterprise, internal auditing is now much strongly established professionally.

A review of the progress of the profession of internal audit for the past fifty years during which the profession is in existence reveals that internal auditing continues to be an appraisal function operating over a broad area of operations including accounting and financial aspects. Independence of the audit chief based on his status in the organization, integrity, objectivity and honesty remained the same. What has changed dramatically is the practice of internal audit as a profession.

In its earliest form the internal audit function was basically, a quality control' functions, verifying, checking financial transactions and carrying out some fraud investigations. The internal auditing practice was well in accordance with the statement of responsibilities issued by the institute of internal auditors (USA) immediately after the World War II, which defined the function of internal auditing as below:

“Is an independent appraisal activity within an organization for the review of accounting, financial and other operations as a basis for protective and constructive service to management, It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature” (1947).

The subsequent elevation of the role of the internal auditors is reflected in the second revision (1957) which reiterated the internal auditor's association with accounting and financial information, but also linked the auditor with the evaluation and review of “other operations” by removing the element of discretion by eliminating the word

'may' (as far as involvement of auditors in operation function was concerned) appearing in the 1947 version indicated above. The relevant portion of the 1957 revision is given as follows:

Is an independent appraisal activity within an organization for the review of accounting, financial and other operations as of service to management (1957). (1)

The above definition becomes the foundation of internal auditing profession in its modern form and the 1971 version clearly define the role of internal auditing as "an independent appraisal activity within an organization for the review of operations as service to management"

(1) V.V. Naik, 'Practicing internal auditing in the changing scenario', the Chartered Accountant, January 1994.

It was realized that the various management levels could not derive full benefit from the internal audit service and after much deliberation the emphasis was shifted from “management” to “organization” in the 1990 revision by the institute of internal auditors which is so reproduced:

“An independent appraisal activity (established) within an organization to examine and evaluate its activities as service to organization” (1)

The scenario is dramatically changing with the collapse of USSR and the Eastern block, emergence of a Unified European market as a single entity and the prospect of increased mergers/take over and the impact on trade due to imbalances in trade deficits between the USA on one hand and Germany and Japan on the other hand etc.

(1) R.P.Maheshwari & B. Singh p112

PART THREE

Nature and Scope:

The Activities of Internal Auditing:

The scope of internal audit varies widely and depends on the size and structure of the entity and the requirements of its management. The scope of internal audit work as specified in the standard covers the examination and evaluation of adequacy and effectiveness of an organization's system of internal control and the quality of performance in carrying out assigned responsibilities. It is concerned with determining whether the systems established by the management are adequate and effective.

The scope includes examination of financial and operating information (1)

The Internal Audit Ensures:

- Reliability and integrity of financial and operational information
- Compliance with policies, plans, procedures, laws and regulations
- Safeguarding of assets
- Economical and efficient use of resources
- Accomplishment of established objective and goals (2)

Reliability and integrity of Information:

The internal auditor's role in examining the reliability and integrity of the information includes:

- (a) Checking of the operating records (both financial and non-financial) to ensure validity of documents and data generated. Information systems provide data for decision-making, control and compliance with external requirements.

(1) A.H. Millichamp. An introduction manual for accounting students, DP publications Ltd. London, Fourth edition, pp.548-551. (2) Andrew D. Chambers and (et al), Op cit P. 335 R.P.Maheshwari and B.S principles and practice of auditing pp 116

- (b) Ascertained that the information generated are accurate reliable, timely, complete and useful. Timeliness from the point of view of critically in decision – making, completeness from the point of view of correctness in decision-making and utility to ensure that unnecessary and time-wasting data are not generated.
- (c) Ensuring that the controls over record keeping and reporting are adequate and effective.
- (d) In the case of financial records to ensure that both internal management and external legal requirements are fulfilled. Internal auditor not only uses the information already developed and presented to him by the management, but also examines, in detail those areas for which the information is not covered or covered insufficiently. With the advent of advanced computer systems, evaluating the reliability and integrity of information from the internal audit point of view becomes more and more complex. This has result the introduction of new techniques for evaluation of information.

Compliance with policies, plans, procedures, laws etc:

Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations that have a significant impact on operations and reports and should determine whether the organization is in compliance with them. (1)

Policies and procedures form the basis of organizational control. Policies are the parameters within which a company should operate and also enable various management levels to take decisions that will be consistent with the objectives of the company.

Corporate plans provide a basis for translating company objectives into realities. The internal auditor is concerned with ensuring that there is a sufficient existing system that would provide smooth execution of these plans.

(1) Institute of internal auditor, Opcit P.3.

Safeguarding the Assets:

The internal auditor's role in safeguarding assets would fall under two categories:

- (1) Internal auditors should appraise the measures used to safeguard assets from various types of losses such as protection from theft, fire etc. This could possibly mean examination of the kinds of insurance scheme the company has taken and whether such schemes provide adequate coverage of the company's assets in case of theft or fire.
- (2) To ensure the existence of assets by proper verification procedures, Physical verification of fixed assets and inventories using appropriate audit procedures would also ensure that the assets are adequately safeguarded. (1)

Economic and Efficient use of Resources:

Internal auditors should appraise the economy and efficiency with which resources are employed. The internal auditor's role in reviewing the economical and efficient use of resources directly contributes to the improvement of organizational productivity. Internal auditor's review in this regard would result in his identifying areas where company facilities have not been fully utilized, areas in which organizational efforts are non productive and specific procedures and work methods are not economical. (2)

(1) H.J. Kerridge, Auditing for accounting technicians, Macdonald and Evans, 1983, pp. 103-114.

(2) James A. Cashin. Hand book for auditors, McGraw-Hill Book Company. P.50-3

The standards for professional practice define the internal auditor's role in measuring the economical and efficient use of resources to ensure that:

- (a) Operating standards have been established for measuring economy and efficiency.
- (b) Established operating standards are understood and are being met.
- (c) Deviations from operating standards are identified, analyzed and communicated to those responsible for corrective action.
- (d) Corrective action has been taken. (1)

While reviewing the operating standards, the internal auditor has to ensure that for every activity in the organization whether it is purchasing, storing, operating-standards have been established.

To ensure achievement of the standards, the internal auditor has to check whether there is a system for pointing out deviations from the standards to the concerned level of management for necessary action.

(1) The Institute of Internal Auditors, Opcit p, 4

Accomplishment of the Established Objectives and Goals for operations or Programs.

Internal auditors should review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

The Management is responsible for:

- (a) Establishing operating and program objectives and goals.
- (b) Developing and implementing control procedures.
- (c) Accomplishing desired operating and program results

Internal auditors:

- (a) Should ascertain conformity with organization goals and objectives
- (b) Can assist managers in developing and evaluating goals, objectives, and systems by determining whether:
 - (1) Their underlying assumptions are appropriate.
 - (2) Accurate, current and relevant information is being used. (1)

The activities of internal auditor include the benefits derived from an external auditor as the result of relation between them. This can be revealed by discussing the similarity, differences and assessment to rely on internal audit work.

There are some similarities in the areas of operation of the internal auditor and the statutory auditors; especially regarding accounting matters both of them have a common interest in ensuring that an effective system of internal control exists and that the accounting system is adequate to generate true and fair financial statements. Accordingly the nature of work carried out by both is similar as regards examination of the system of internal control, testing and checking of accounting books, records and statements and verification of assets and liabilities. Both of them examine the same set of accounting documents and carry out similar physical and other verificatory checks. (2)

Despite these similarities there are certain fundamental differences in the status, responsibility, approach and the scope of operations of an internal auditor and a statutory auditor. The internal auditor is a representative of the management.

(1) K. Purushotham, "Internal audit: measuring management control" the chartered Accountant, India, May 1994

(2) E.H.Woolf and (et al), PP. 171 -172

The nature and scope of his operations are determined by the management and may, therefore, differ from one organization to another according to the needs and perceptions of different management. The rights and duties of the statutory auditor, on the other hand, are defined by the statute. The statutory auditor is independent of the management, whereas the internal auditor being part of the organization does not enjoy a totally detached position. Thus the internal auditor's approach is to report on matters vital from the point of view of management, whereas the statutory auditor is primarily concerned with the truth and fairness of financial statements presented to the shareholders.

The internal and external audit work should be coordinated to ensure adequate audit coverage and to minimize duplicate efforts. Coordination of audit efforts involves:

- (a) Periodical meetings to discuss matters of mutual interest.
- (b) Access to each other's audit programs and working papers.
- (c) Exchange of audit reports and management letters.
- (d) Common understanding of audit techniques, methods and terminology. (1)

The role of internal audit is determined by management and its prime objectives differ from that of the external auditor who is appointed to report independently on the financial statements. Nevertheless some of the means of achieving their respective objectives are often similar and thus certain of the work of internal auditors may be useful in determining the nature, timing and extent of external audit procedures, (2)

(1) IFAC (the council of the international federation of accountants), "Proposal international standards on auditing "the chartered accountant, Feb. 1993"

(2) David N. Richiute, *Opcit* P. 36.

An internal audit function is part of the entity, irrespective of the degree of internal audit's autonomy and objectivity. It cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial statements. The external auditor has sole responsibility for the audit opinion expressed and that responsibility is not reduced by any use made of the internal audit work.

The external auditor should obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach.

An effective internal audit function will often support a modification in the nature and timing and a reduction in the extent of procedures performed by the external auditor but can not eliminate them entirely. In some cases however, having considered the activities of internal audit, the external auditor may decide that internal audit work will have no effect on external audit procedures.

The external auditor should perform a preliminary assessment of the internal audit function, when it appears that certain internal audit work is relevant to the external audit of the financial statement and may be considered in specific audit areas.

The external auditor's preliminary assessment of the internal audit function will influence the external auditor's judgment about the use which may be made of the work of internal audit in modifying the nature, timing and extent of external audit procedures (1) (2). Before placing any reliance on the work of an internal auditor, the external auditor must assess the internal auditor and his work in the following areas:

(1) Leslie R. Howard, Auditing, the English language book society and Macdonald and Evans, seventh edition, P.4. (2) Rick Hayes and Arnold Schilder and (et al), principles of auditing copyright 1999

- a) Organizational status: Internal audit's specific status in the entity and the effect this has on its ability to be objective. In the ideal situation, internal audit will report to the highest level of management and be free of any other operating responsibility.

(1) (2)

Any constraints or restrictions placed on internal audit work by management would need to be carefully considered. In particular, the internal auditor will need to be free to communicate fully with the external auditor.

- b) Scope and objectives of the internal audit function: The nature and extent of the assessments which internal audit performs. The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

- (c) Technical competence: whether the internal audit work is performed by persons having adequate technical training and proficiency as internal auditors, the external auditor may, for example review the policies for hiring and training the internal audit staff and their experience and professional qualifications. On going training in specialized areas such as computer is useful.

(1) Walter B. Meigs (et al), principles of auditing, Irwin-Dorsey Ltd, 1977 six edition P. 152.

(2) Rick Hayes and Arnold Schilder (et al) principles of auditing, 1999
Himalaya Publishing house, 1984, third reviser edition, P. 10.

- (d) Due professional care: whether internal audit work is properly planned, controlled, recorded, supervised, reviewed and documented. The existence of adequate audit manuals, work programs and working papers would be
- (e) Resource available: an internal audit department that is starved of resources will not be very useful to the external auditor. (1) (2)

(1) R.G. Saxena, principal of auditing (theory and practice), Himalaya Publishing house, 1984 third reviser edition, P. 10.

(2) Rick Hayes and Arnold Schilder (et al) principles of auditing, 1999 Himalaya Publishing house, 1984, third reviser edition, P. 10.

The extent of reliance depends on many factors including:

- (j) The materiality of the areas or items to be tested.
- (ii) The level of audit risk inherent in the areas or items. Value of the work in progress in a civil engineering company or the provision for doubtful debts in a hire purchase company is high risk areas that the external auditor must see.

If we wish to discuss the nature of an internal audit from the point view of independence, we must deal with:

- (a) The organizational status and
- (b) The administration of the internal audit dept.

The organizational Status:

The status of internal auditing must be sufficient to permit accomplishment of its objectives, proper organizational status enhances the independence and objectivity of internal auditing. The director of internal auditing should report directly to an official with sufficient authority to promote and ensure:

- (i) Internal auditing independence.
- (ii) Board audit coverage.
- (iii) Adequate audit coverage.
- (iv) Appropriate action on audit recommendations.

Without support of management and the board of directors, cooperation's of auditors may be lacking.

Internal auditors should be positioned in the organizational structure of a company so that they may extend without restrictions, their examination over all aspects of a company's operations.

Internal auditors report to an authorized person who is in a position to take action on the recommendations in their report is essential and important (1) (2).

(1) Cook/ Winkle, Opcit p. 389-390 R.P.Maheshwari & B.Singh,p 118
(2) R.P.Maheshwari and B.Singh principals and practice of auditing pp112-116

As long as internal auditors are company employees, complete independence is probably impossible to attain. However, auditors should have sufficient independence within a company's organization so that audit objectives will not be compromised. (1)

Management can do much to establish such an attitude of independence by allowing auditors ample freedom in selecting the particular operations for the study and also by informing those responsible for the operations under audit that the investigation is fully sanctioned.

The audit Charter (2)

The audit charter may be used in a position fashion to underpin the marketing task that is discharged by audit management. It can also be used to defend audit services in the even of a dispute or an awkward audit. The charter formally documents the raison of the audit function. It is important that all audit departments both develop and maintain a suitable charter. The Institute of Internal Auditors has issued a statement of responsibilities that cover the role of internal auditing and this document may be used to form the basis of such a charter. The audit charter constitutes a formal document that should be developed by the CAE and agreed by the highest level of the organization. If an audit committee exists then it should be agreed in this forum although the final document should be signed and dated by the chief executive officer.

(1) Cook/winkle, Opcit pp.389-39

(2) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005, pp 113

The audit charter establishes audit's position within the organization and will address several issues:

- The nature of internal auditing
- The audit objectives
- The scope of audit work
- Audit's responsibilities
- Audit's authority
- Outline of independence

Reasons for having a charter include:

- (a) Documenting a commitment by executive management to internal auditing.
- (b) Defining the authority or responsibilities of internal auditing.
- (c) Defining the organizational and reporting relationships between internal auditing and others within the organization.
- (d) Outlining the scope of internal auditing activities.
- (e) Providing basis for evaluating overall audit effectiveness.

Topics to be included in the charter are the:

- (a) Objectives and goals of internal auditing.
- (b) Approval of senior management or the audit committee.
- (c) Relations, internal and external, audit to others.
- (d) Responsibility to follow up audit findings and recommendations etc.

The Audit Committee has the responsibility for the internal audit function and will insure that:

Organization within the company are reviewed at appropriate intervals to determine whether they are effective carrying out their functions of planning accounting, custody, and control in accordance with management instructions, policies, and procedures; and in a manner that is consistent with company objectives and with high standards of administrative practice.

The results of the examinations made by the auditors, the opinions that they form, and the recommendations which they make, are promptly reported to the Audit Committee and to management members who should take appropriate action.

Any plans or actions taken to correct reported conditions are evaluated for satisfactory disposition of audit findings and, if the disposition is considered unsatisfactory, sees that further discussions are held to achieve satisfactory results

Director of Auditing

Authority:

The director of auditing is authorized to direct a broad, comprehensive program of internal auditing within the company.

Internal auditing examines and evaluates the adequacy and effectiveness of the management control system provided by the company to direct its activities toward the accomplishment of its objectives in accordance with company policies and plan. In accomplishing his activities, the director of auditing and his representatives have full, free, and unrestricted access to all company functions, records, property, and personnel.

The director is responsible for the entire internal audit function, including:

- (1) Development and accomplishment of audit objectives and goals.
- (2) Development of a program to select and develop audit personnel.
- (3) Development of written policies and procedures to guide audit staff.
- (4) Effective use of internal audit resources.

- (5) Establishment and maintenance of a quality assurance program.
- (6) Conformity of audit work with applicable standards.
- (7) Establishes policies for the auditing activity and directs its technical and administrative functions.
- (8) Develops and executes a comprehensive audit program for the evaluation of the management controls of all company activities.
- (9) Examines the effectiveness of all levels of management in their stewardship of the company resources and their compliance with established policies and procedures. (1).
- (10) Recommends improvement of management controls designed to safeguard company resources, promote company growth, and ensure compliance with government laws and regulations.
- (11) Reviews procedures and records for their adequacy in accomplishing intended objectives, and appraise policies and plans of the activity or functions under audit review.
- (12) Authorizes the adequacy of the action taken by operating management to correct reported deficient conditions; acknowledges adequate corrective action; continues to review with appropriate management personnel actions considered inadequate until there has been a satisfactory resolution of the matter.
- (13) Conducts special examinations at the request of management, including reviews of presentations made by persons outside the company.

(1) Rvin N. Glein, CIA, examination review. Vol 1,

(a) The administration of the internal audit department:

An internal audit job description for an audit manager, audit senior and audit associate can be set forth to include the following:

Audit Manager:

Purpose:

- ☐ To administer the internal auditing activities.
- ☐ To develop a comprehensive program of audit coverage for location.
- ☐ To obtain accomplishment of the program in accordance with audit standards.
- ☐ To maintain effective working relations with executive and operating management.

Authority and Responsibility:

- ☐ Prepares a comprehensive and long range of program of audit covered for location
- ☐ Establishes the departmental structure
- ☐ Obtains and maintains audit staff capable of accomplishing internal auditing
- ☐ Establishes and monitors accomplishment of objectives etc
- ☐ Identifies those activities subject to audit coverage, evaluates their significances, and assesses the degree of risk inherent in the activity in terms of cost, schedule, and quality.
- ☐ Assigns audit areas, staff, and budget to supervisory auditors.
- ☐ Develops a system of cost and schedule control over audit projects.
- ☐ Establishes standards of performance and reviews performance according to those standards.
- ☐ Provides reports to executive management within the assigned location concerning coverage and the results of the audit activity. Interprets those results to improve the audit program and its coverage.

Audit Senior:**Purpose:**

- ☐ To evaluate the adequacy and effectiveness of controls over those activities.
- ☐ To conduct reviews of assigned organizational & functional activities.
- ☐ To plan and execute audits in accordance with accepted standards.
- ☐ To perform special reviews at the request of management etc.

- ☐ To determine whether organizational units in the company are performing their planning, accounting, custodial, or control activities in compliance with management instructions, applicable statements of policies and procedures, and in a manner consistent with both company objectives and high standards of administrative practice.
- ☐ To report audit findings and make recommendations for correcting unsatisfactory conditions, improving operating and reducing cost.
- ☐ To direct the activities of assistants.

Authority and Responsibility:

- ☐ Plans the scope of the audit and prepares an audit program
- ☐ Determines the auditing procedures to be used
- ☐ Directs, counsels and instructs staff assistants
- ☐ Appraises the adequacy of the corrective action taken to improve deficient conditions etc
- ☐ Surveys functions and activities in assigned areas to determine the nature of operations and the adequacy of the system of control.

- ☐ Determine the direction and thrust of the proposed audit effort.
- ☐ Identifies the key control points of the system.
- ☐ Evaluates a system's effectiveness through the application of his knowledge of business system (including financial, engineering, purchasing, and other operations) and his understanding of audit techniques.
- ☐ Performs the audit in a professional manner and in accordance with the approved audit program.
- ☐ Obtains, analyzes, and appraises data to create an informed, objective opinion about the adequacy and effectiveness of the system, and the efficiency of the performance of activities under review.
- ☐ Make oral or written presentations to management during and at the conclusion of the examination. Discusses efficiencies and recommends corrective action to improve operations and reduce cost.
- ☐ Prepares formal written report, expressing opinions on the adequacy and the effectiveness of the system and the efficiency with which activities are carried out.

Audit associate:

Purpose:

- ☐ To conduct or assist in conducting reviews of activities.
- ☐ To evaluate the adequacy and effectiveness of controls over those activities.
- ☐ To plan and execute complete reviews of Limited audit assignments.
- ☐ To report audit findings and to make recommendations for the correction of unsatisfactory conditions, improvements in operations, and reduction in cost etc.
- ☐ To determine whether organizational units in the company are performing their planning , accounting , custodial , or control activities in compliance with management instructions, applicable statements of policies and procedures ,

- Obtain s, analyzes, appraises data to make an informed objective opinion about the adequacy and effectiveness of the system, and the efficiency of the performance of activities under review.
- Makes, or assist in making, oral or written presentations to management during and at the conclusion of the examination. Discusses deficiencies, recommends corrective actions, and suggests improvements in operations in cost.
- Prepares formal written report, as requested, expressing opinions on the adequacy and effectiveness of the system and the efficiency with which activities are carried out. (1) (2)

(1) Lawrence B. Sawyer, The Practice of Modern Internal Auditing, second edition, IIA, Florida , pp.549-553. (2) Internal Auditing: Key to Financial and operations improvement Modern Business Reports-1633 Broadway, New York, pp.19-24

Managing the Internal Audit Process

The internal audit department should give consideration to the following:

(A) Staffing:

The internal audit department should provide assurance that the technical proficiency and educational background of internal auditors are appropriate for the audits to be performed.

The director of internal auditing should establish suitable criteria of education and experience for filling internal auditing positions, giving due consideration to scope of work and level of responsibility.

Reasonable assurance should be obtained as to each prospective auditor's qualifications and proficiency. (1)

(B) Knowledge, skills and disciplines:

The internal audit department should possess or should obtain the knowledge, skills and disciplines needed to carry out its audit responsibilities.

The internal audit staff should collectively possess the knowledge and skills essential to the practice of the profession within the organization. These attributes include proficiency in applying internal auditing standards, procedures, and techniques.

(1) Institute auditors, of Internal Opcit P.4.

The internal audit department should have employees or use consultants who are qualified in such disciplines as accounting economics, finance, statistics, electronic data processing, engineering, taxation and law as needed to meet the audit responsibilities. Each member of the department, however, need not be qualified in all of these disciplines.

Supervision:

The internal audit department should provide assurance that the internal audits are properly supervised.

1. The director of internal auditing is responsible for providing appropriate audit supervision. Supervision is a continuing process, beginning with planning and ending with the conclusion of the audit assignment.
2. Supervision includes:
 - (a) Providing suitable instructions to subordinates at the out set of the auditing and approving the audit program.
 - (b) Seeing that the approved audit program is carried out unless deviations are justified and authorized.
 - (c) Determining that the audit work papers adequately support the audit findings, conclusions and reports. (1)
 - (d) Making sure that the audit reports are accurate, objective, clear, concise, constructive and timely.
 - (e) Determining that audit objectives are being met.
3. Appropriate evidence of supervision should be documented and retained.

(1) D.R. Carmichael and (et al). Auditing concepts and methods, A guide to current auditing theory and practice, McGraw-Hill Company, 1987, pp.276-285.

4. The extent of supervision required will depend on the proficiency of the internal auditors and the difficulty of the audit assignment.
5. All internal audit assignments whether performed by or for the internal audit department remains the responsibility of its director.

(D) Selecting and developing internal audit personnel

The program to select and develop human resources in the internal audit department includes:

- (a) Developing written job description for each level of the audit staff
- (b) Selecting qualified and competent individual.
- (c) Training and providing continuing development opportunities to each internal auditor
- (d) Appraising each internal auditor's performance
- (e) Providing counsel to internal auditors on their performance and professional development. (1)

Audit work should include planning the audit, examining and evaluating information, communications results and following up.

Planning the Audit:

Internal auditors should plan each audit. Planning should be documented and should include:

- (a) Establishing audit objectives and scope of work

(1) Ibid pp.285-292

- (b) Obtaining background information about the activities to be audited
- (c) Determining the resources necessary to perform the audit
- (d) Communicating with all who need to know about the audit
- (e) Performing as appropriate, an on-site survey to become familiar with the activities and controls to be audited, to identify areas for audit emphasis, and to invite auditee comments and suggestions
- (f) Writing the audit program
- (g) Determining how, when, and whom audit results will be communicated
- (h) Obtaining approval of the audit work plan .

Examining and Evaluating Information:

Internal auditors should collect, analyze, interpret and document information to support audit results.

The process of examining and evaluating information is as follows:

- (i) Information should be collected on all matters related to the audit objectives and scope of work.
- (ii) Information should be sufficient, competent, relevant and useful to provide a sound basis for audit findings and recommendations. Sufficient information is factual, adequate, and convincing so that a prudent, information person would reach the same conclusions as the auditor. Relevant information supports audit findings and recommendations and is consistent with the objectives for the audit. Useful information help the organization meet its goals.
- (iii) Audit procedures, including the testing and sampling techniques employed, should be selected in advance, where practicable, and expanded or altered if circumstances warrant.

Communicating Results:

Internal audit should report the results of their audit work.

- (a) A signed, written report should be issued after the audit examination is completed. Interim report may be written or oral and may be transmitted formally or informally.
- (b) The internal auditor should discuss conclusions and recommendations at appropriate levels of management before issuing final written reports.
- (c) Reports should be objective, clear, concise, constructive and timely.
- (d) Reports should present the purpose, scope and results of the audit, and where appropriate, reports should contain an expression of the auditor's opinion.
- (e) Reports may include recommendations for potential improvements and acknowledge satisfactory performance and corrective action.
- (f) The audit's view about audit conclusion or recommendations may be included in the audit report.
- (g) The director of internal auditing or designee should review and approve the final audit report before issuance and should decide to whom the report will be distributed.

Following up:

Internal auditor should follow up to ascertain that appropriate action is taken on the reported audit findings.

Internal auditors should determine that corrective action was taken and is achieving the desired results or that management or the board assumed the risk of not taking corrective action on reported findings.

Conclusion:

We can summarize that the nature and scope of the internal auditing provide reasonable assurance that the organization's objectives and goals will be efficiently and economically and that the system is functioning as intended based on wide and several implications :

- **Expertise:** Great expertise is required from auditors to enable them to provide advice on the wide range of key control objectives
- **Safeguarding assets:** It is necessary to establish who is responsible for investigating frauds since this is resource-intensive.
- **The compliance role:** Controls over compliance may include an inspection routine and audit's role in this should be clearly defined.
- **Information system:** The audit of management information system (MIS) is crucial since this may involve reviewing MIS as part of operational audits, or these systems can be audited separately.

- **Value for money:** The concept of economy, efficiency and effectiveness (or FFM) is another sensitive issue. Auditors can assist management's task in securing good arrangements for promoting VFM or alternatively undertake a continual search for waste and other poor VFM.
- **Management needs:** A wide scope requires a good understanding of the operations being reviewed and it is necessary to include management's needs in the terms of reference by adopting a more participative style.
- **Specialists:** The four elements of the key control objectives may require specialists in each of the defined areas and the level of expectation may place great demands on the audit service. (1)

(1) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005.pp112-113.

PART FOUR

Objectives and Goals:

In fact any profession has objectives to be realized. As a convenient summary of these objectives, it may be stated that the internal auditor is primarily concerned with evaluation, compliance, and verification. Verification is taken up first, in as much as activities, related to this objective have been most important historically in the development of internal auditing. Goals must be set with in resources constraints:

Financial budget, man power availability and other capabilities

Verification:

The internal auditor's activities related to verification involve two areas: The accounting records and reports, and the underlying assets and liabilities.

Typical internal audit activities in the area of verification of assets would include count of cash funds and deposited receipts, proof of bank reconciliation, confirmation of accounts received by correspondence with customers, comparison of inventory quantities as shown by detailed inventory records with actual quantities on hand as determined by physical count, examination of insurance policies in support of insurance coverage and prepaid insurance expenses, and comparison of plant asset records with the machinery, equipment or other items actually in use.

The matter of verification also extends company records and particularly the reports prepared from those records.

The verification activities of the internal auditor are closely related to the work of the independent auditor and it should be apparent that this form of internal control activity would add directly to the credibility of the client's accounting records, thus a reduction in the scope of the auditing work performed by the independent auditor. (1)

(1) H.J. Kerridge, *Opcit* pp. 103-114.

Records:

In order to ascertain the reliability of the financial and operating reports prepared throughout the company, it is necessary that some unit undertake to examine the underlying records.

Reports:

The internal auditor will review all reports to determine their general reliability. In many cases the auditor may trace that the presentation arrangements or grouping of data in reports contains significant obscure information.

The internal auditor determines that all statements are prepared and are in accordance with some uniform chart of accounts or other means of aiding proper account classifications.

Assets and Liabilities:

In addition to records and reports the internal auditor must verify that the assets and liabilities are properly stated. The internal auditor will determine that assets are being utilized efficiently and that they are being properly accounted for.

Evaluation:

The second internal audit objective to be discussed is that of evaluation. This is perhaps the broadest of the three objectives and the major developments and changes in the concept of internal auditing in recent years have occurred in relation to this objective. Entry of internal auditor into the area of evaluation followed locally from the verification activities that once occupied the major portion of the time of the typical internal auditor. Thus the evaluation of accounting procedures becomes the earliest type of activity pertaining to this objective.

The successful performance of such evaluation activities and the realization by management of the benefits to be derived led to gradual expansion so that now evaluation objective commonly includes all or most of the following activities by internal auditors in companies that have taken a progressive and forward looking approach to internal auditing.

Evaluation of internal control from standpoint of how well the accounting system provides for-

- Information that is adequate and accurate.
- Protection of business resources from losses due to theft embezzlement etc
- Control over all phases of operations
- Evaluation of clerical and accounting efficiency from stand point of such matters as
- Effectiveness of procedures
- Adequacy of personnel

Evaluation of over - all performance of various operating departments from the stand point of:

- Plan of organization
- Policies
- Individual performance (1).

(1) James A. Cashin, Op cit pp. 7 - 2. Handbook for Auditors, 1982 reissue. McGraw- Hill Book Company, USA

Compliance:

Superior policies, procedures or controls are of no value unless they are carefully and actually in practice. Thus once the internal auditor has evaluated a given plan of organization and operation, he will endeavor to ascertain whether the planned program is actually being carried out in practice.

The compliance activities of the internal auditor are particularly important in companies with extensive branch operations. (1) The procedures to be used in each branch will usually be carefully designed in the office and the internal auditor will thus concentrate on compliance, and of course, verification, in making his examination of branch operations.

In the absence of compliance the internal auditor determines:

- (a) The reasons for noncompliance
- (b) Procedures maybe faulty.
- (c) Better procedures may be available.
- (d) Conditions may have changed.
- (e) The cost of noncompliance
- (h) How to obtain compliance, if desirable

In addition to the aforementioned objectives and goals, there are other internal audit services that can be summarized as follows:

(1) H.J. Kerridge, Op cit pp. 117 - 120

(1) Identification of risk areas:

The internal auditors identify areas with high expected or suspected risk and notify management to determine if auditing procedures should be applied.

(2) Prevention and detecting of fraud:

Internal auditing is responsible for assisting in the deterrence of fraud by examining and evaluating the adequacy and the effectiveness of control commensurate with the extent of potential risk. (1)

Therefore it can be concluded that internal auditors should review operations or programs to ascertain whether results are consistent with established objectives and whether the operations or programs are being carried out as planned.

Types and Functions of Internal Auditing:

General Concept:

The opportunities for an internal auditor to expand the scope of examination beyond the financial and accounting activities of a company were recognized in the early development of internal auditing. For example the institute of internal auditors mentioned in its statement of responsibilities that internal auditing should deal primarily with accounting and financial matters but could deal also with matters of an operating nature.

(1) Irwin N. Glein, Opcit. p. 90.

Determining the extent to which company policies and procedures were followed, evaluating these policies and procedures developed into major aspect of the work of internal auditors.

The scope of internal auditing also extended to management auditing which concerns with many aspects of management performance and control. Thus internal auditing encompasses three types of auditing set forth below:

- (a) Internal financial auditing.
- (b) Internal operational auditing.
- (c) Internal management auditing. (1)

Internal Financial Auditing:

Many companies still insist that their internal audit departments concentrate on financial auditing, that is, (a) fraud and error prevention and (b) assets protection. Internal financial auditing is concerned essentially with the past, protection provided by existing controls and the accuracy of data reflected in the financial records. It deals with the financial and accounting aspects that remain essential internal auditing activities.

Internal Operational Auditing:

Operational auditing is a comprehensive examination and appraisal of business operations for the purpose of informing management whether or not various operations are performed in a manner that complies with established policies directed towards management's objectives. Included in the audit is an appraisal of the efficient use of both human and physical resources as well as appraisal of various procedures. The audit should also include recommendations of solutions to problems and of methods for increasing efficiency and profits.

(1) Cook/winkle, Opcit p. 385.

Operational auditing is the term widely used to describe the extension of the internal auditing function into almost all aspects of a company's operations.

The operational aspect of internal auditing is reflected in the scope of work section of the 1978 standards for the professional practice of internal auditing.

Generally the term "operational means the extension of internal auditing to all operations of a company

At present there is a growing trend to attempt to reduce the amount of internal audit time spent on financial auditing and to do more operational auditing (1).

Internal Management Auditing:

The widest definition for management audit is as follows:

A management audit is future-oriented, independent and systematic evaluation of the activities of all levels of management performed by the internal auditors for the purposes of improving organizational profitability and increasing the attainment of the other organizational objectives through improvements in the performance of the management function, achievement of program purposes, social objectives, and employee development. Financial data are some of the source of evidence. The primary sources of evidence are the operational policies and the management decisions as related to the organizational objectives. Included are an evaluation of the management control system in term of existence, compliance, and adequacy along with its decision - making process in terms of existence, compliance,

(1) Mary E. Richard D. Irwin Inc., N.D., p. 88.

and relevance to the attainment of organizational objectives and the quality of management. The resultant audit report both identify problems and recommends solutions. (1)

Auditing of management performance or management auditing is usually regarded as an extension of the more traditional financial auditing encompass audit of financial accounts, transactions and reports including related internal control procedures. The boundaries between these two broad categories of auditing are not definable, since comprehensive financial auditing requires the auditor to concern himself with many aspects of management performance and control. In fact it is often condensed that in as much as all activities and operations of an organization have financial aspects, the term financial auditing itself can properly embrace all that is contemplated by those who adopt the term “management auditing”. The term operational auditing is also often used to characterize auditing that extends beyond the conventional financial and accounting areas of auditing.

An effective functioning of internal audit:

Internal auditor today in any organization is perhaps the most misunderstood person. This is because the internal auditor has to work and communicate in an atmosphere where he may come across conflicts, frictions, resentment, mistrust and fear response of auditee and management. In this situation the most challenging task before him is to communicate through reports that justify his utility. This article does not deal with the cosmetic aspects of effective report writing but brings into focus some behavioral perspectives and implications arising out of the very unique position in which internal auditor is placed in, and suggests a strategy which can narrow down the areas of difference and enlarge areas of cooperation.

(1) Smith J.E.: An evaluation of selected current internal auditing terms, research report No. 19, Florida: IIA, Inc (1975)

Internal Auditor Vis-à-Vis management:

Internal audit is a function of management and for the management. Accordingly it is the prerogative of the management to give adequate teeth to this function. The management expects internal auditor to highlight those areas where the resources of the company have not been properly utilized and/or executives have exceeded their delegated authority. Internal auditor has to fulfill this role even though he earns the displeasure of his auditees temporarily. This is because internal auditor is a fact finder and he has to faithfully report all facts which may even reflect badly on the image of the concerned manager, even though not intended, otherwise, it is like swimming without getting wet. Internal auditor has to work in a manner that is acceptable to a management. Not only he has no direct authority over the person with whom he works but also he has to extract facts and constructively criticize them in clear terms. Internal auditor has no work of his/her own: the work of other divisions - is the work of internal auditor. (1)

Internal Auditor Vis- a Vis Auditee:

Internal auditor has to bring out certain facts into the knowledge of management and persuade the management to take corrective action wherever deemed necessary. Since the management uses internal audit reports to judge the performance of internal auditor, who also want to gain confidence of management. This desire more than activates him to report every thing, sometimes even without realizing its long - term implications on his relation with the auditees.

Bearing the above - mentioned relationship in mind, the emergence of some conflicts and two extreme view points emerge which are or follows:

(1) A.R. Khanna and N. Chopra. The charter accountant, December 1990.

(a) Internal auditor as consultant:

The modern internal auditor is like a business consultant. His job is to help others in carrying out their duties in efficient and economic manner. He possesses problems solving attitude and comes out with workable and realistic ideas for performing the jobs better and understands the limitations of auditee. His auditees, who are his follow employees, appreciate his understanding of the operational aspects and willingly accept his workable recommendations and implement them religiously.

(b) Internal auditor as a Nuisance:

The internal auditor is practically a nuisance for the auditee. His report submitted to the management contain criticism of certain procedures and systems which have been decide by management itself The reports may also contain instance of human errors and system failures so he is seen as a threatening force, intruder in other's work. He neither enjoys willing cooperation nor his suggestions are given due consideration.

A closes examination of above-mentioned two viewpoints may reveal there is some truth in both of them.

Very often we come across line managers who think internal auditors should stick to financial matters alone and leave the evaluation of functional areas to other line managers themselves. After all, they maintain that the auditors are not engineers, marketing specialists, physicist, and so on and so forth, and therefore, how can possibility they understand and evaluate such functions when they them selves have never handled any of them.

Although internal auditors have used a number of techniques to counter these obligations like training of audit staff, hiring technical experts, etc, functioning managers still carry the feeling that in the absence of actual management experience on the firing line, auditors agreeable to understand the pressures and limits in which decisions were taken and/or performed.

Very often internal audit reports are sent directly to management without first interacting with the auditee. This practice is bound to increase friction and resentment. Therefore need is strongly felt to adopt a new approach which will achieve common organizational objective. Under this approach internal audit reports will be more realistic and practical and they will become joint and collaborative efforts. Sometimes it is observed that even through auditees have worked closely and the report reflects a mutually agreed/accepted recommendation, the auditees may still later on respond with evasive comments. In some cases they may say that the auditors did not understand how to solve the problem. While in a number of cases these comments may be hyperbole; in other cases auditees may be right. Even if they are right and on the defensive side, they must disagree with an already developed recommendation presented by the auditors. In such situations rather than admitting that the auditees are right, the internal auditor stiffens his stand and support his staff as a result of which conflict emerge. The challenge before internal auditors is to transform this situation into one that will produce mutually beneficial results towards the common goal of the organization. (1)

It is also essential to tackle with internal auditing in the light of technological and other advancements. It is a truism that audit objectives remain the same when computers are in use, for computers are only toots which assist management to achieve its objectives but the approach to audit work will be differently marked.

(1) Andrew and (et al), Opcit p. 82

The need for internal auditors who are both technically competent (computer auditors) and are experienced as internal auditors, is essential to cope with the audit problems of advanced computer systems. So it is true to say that today internal audit departments require specialist audit competence to be capable of auditing systems that are computerized.

The importance of internal auditors in the light of technological and other advancements can be summarized as follows:

The scope of internal audit is interpreted as being concerned with compliance, efficiency, effectiveness and economy of all concern's activities and the computer center will become one of the operational audits along with other operations such as production and marketing. Internal auditors will be concerned to review the controls built into the computer programs of computer application.

Information is the organization's most valuable resource. Internal auditors reassure management that the information submitted to management is reliable for control purposes (ex. monitoring) is of high quality (correct, complete, accurate, timely, relevant, economy consistency clarity, conciseness and security) and in assisting them to meet their objectives. This is the primary purpose of all support activity, including computer auditing and all detailed work should be planned and implemented with this over all objectives in mind.

Information is of special significance for the other management activities of planning, organizing, and directing. (1)

(1) Andres D. Chambers and (et al), computer auditing, pitman publishing Ltd, Great Britain, 1986. Second edition p. 15.

The internal auditor has always had a special interest in safeguarding assets. It can be argued that a concern's information is part of its intellectual property, is its most valuable resource to be safeguarded. When the pyramids were built manpower was the resource that had to be commanded, at the time of the industrial revolution the key resource was capital. Now it is information, which is therefore of direct concern to the internal auditor. Computers are ideally suited to storing, processing and transferring the vast quantities of data that are a feature of today's business environment and they do this at high speed.

Internal auditors assist to prevent or detect computer crime and abuse in the following grounds:

- (a) Prevention or detection of misappropriation of assets and services using the computer systems. The most common forms of computer abuse is straight forward theft of physical assets, in particular cash.
- (b) Prevention or detection of the misappropriation of computer-based information which often involve the disposal of it for gain.
- (c) Prevention or detection of the deliberate manipulation of machinery or system resulting intentionally or incidentally, in partial or complete denial of use or some other disadvantages to the organization.
- (d) Prevention or detection of the manipulation of accounting or other data for malicious reasons. (1)

Hence recently internal auditing profession encompasses many aspects of activities:

Financial, operational and management performance, besides internal auditing requires specialist who are competent in handling computer systems. Collaborative attitude is also needed in internal auditing profession.

(1)The Institute of Internal Auditors

Part Five

Other issues related to Internal Auditing

Management and Internal Auditor

- **Planning and Internal Auditor**

Internal auditors should not spend all their time looking backwards at completed transactions. They should look forward with management and help in evaluating the overall planning process and to ensure whether plans, policies, and procedures meet certain standards.

- **Organizing and Internal Auditor**

Internal auditors should have no responsibility for deciding organization , but their knowledge of systems and controls can be of value to those who do have that responsibility, Internal auditors are expected to determine what managers are responsible for, what they are authorized to do , and how they should account for their accomplishments and results.

- **Directing and Internal Auditor**

Directing is people-oriented, not transaction-oriented; one approach to audits of directing can be the audit of the personnel department. Hence, management-oriented audits can be performed by focusing on the objectives of the department such as identify personnel needs, to train and develop manpower, and to administer personnel programs and benefits (1).

(1) Sawyer, L.B. (1981). The Practice of Modern Internal Auditing, IIA, pp 684 - 707

- **Controlling and the Internal Auditor**

Internal audit of control system to ensure that whether established objectives are met. Under another approach to controlling which would be useful to both management and the internal auditor, internal auditors determine how well managers exercise the principle of management control in handling their own operations.

Therefore, the role of internal auditors should go beyond verification and to assist managers in carrying out their functions economically, efficiently, and effectively and to be counselors of managers, and to be as conversant with the functions and the principles of management as any competent manager (1).

People and Internal Auditor

Modern internal auditors deal mainly with people. The research studies have proven that the difference between an effective and an ineffective audit may often lie in the way the auditee regards the auditor and therefore, poor relations defeat the audit purpose and that good relations promote it, internal auditors must develop and maintain good relations with auditees to gain information and to ensure corrective action on auditing findings. Relations between auditor and auditee may improve if the auditor, the expert on control, appreciates the difference between imposed control and self-control. Internal auditors who adopt a participative posture have a better chance of reaching their audit objectives than those do not (2).

(1) Sawyer, L.B. (1981). The Practice of Modern Internal Auditing, IIA, pp 684 - 707

(2) Sawyer, L.B. (1981). The Practice of Modern Internal Auditing, IIA, pp 747 - 762

Relationships with External Auditors

External auditors and internal auditors have different objectives, but they reach them by similar means. External auditors express an independent expert's opinion as to the fairness of their clients' financial statements. They serve a number of entities because their opinion is relied on by management, directors, shareholders, suppliers, creditors, and the government. Internal auditors serve the organization by measuring and evaluating its operations.

The need for coordination is becoming more important each day as the modern business is becoming more complex.

Reasons for the coordination can be summarized as follows:

- ✓ Financial reporting standards have stretched the time needed for financial audits.
- ✓ Inflationary trends have increased the personnel costs of public accounting firms.
- ✓ Fees have risen accordingly as this does not sit well with management.
- ✓ Rigorous requirements on organizations to ensure adequate system of internal accounting control.
- ✓ Well-coordinated effort by professional external and internal auditors can provide nervous board members with assurance of control system.
- ✓ Internal auditors can be a source of useful information to the external auditors.
- ✓ External auditors can be helpful to internal auditors by supplying an outsider's viewpoint by providing advice on current developments in accounting and financial auditing; by supporting internal audit recommendations; by supporting the internal auditor's need for a sufficient high status in the organization to ensure independence (1).

(1) Sawyer, L.B. (1981). The Practice of Modern Internal Auditing, IIA, pp 773 - 783

Relationships with Boards of Directors

Internal auditors should have a clear understanding of the philosophy and the functions of the audit committees in their organizations. There is a need for the Audit committee as the information provided by the external auditors is often not enough and therefore, the committees will have to turn to the internal auditors for information and for comfort, and internal auditors will have to meet their own increased responsibilities. Hence. Internal auditors can be one of the important instrument of control as well as a means of improving the quality of services provided to the board of directors of the organization (1).

Internal Auditing and Risk Management

Risk Management is an area that becoming increasingly important in which internal Audit has always been concerned about risks.

Internal Auditor role in risk Management area would concern on evaluating Business risk Management such as reducing business risk i.e. possibility in business value from any source and achieving the objectives of the organization in terms of increase business value to the shareholders.

Role of internal auditor on assessing, evaluating and ultimately come out with recommendation for the purpose of increasing the value of the organization.

(1) Sawyer, L.B. (1981). The Practice of Modern Internal Auditing, IIA, pp 787 - 803

Definition of Risk Management

Risk Management can be defined as the management of any situation where there is uncertainty about what outcome will occur in order to reduce the risk of the unexpected value and increase the business value and individual welfare (1).

- **Risk Management Process**

Risk management involves identification of potential direct and indirect losses, evaluating of their potential frequency and severity, development and selection of methods for managing risk to maximize business value, implementation of these methods and ongoing monitoring (2).

- **Risk Management Organization**

In general, the views of the senior management concerning the need for, scope, and importance of risk management and the possible administrative efficiencies determine how the risk management function is structured and the exact responsibilities of units devoted to risk management. Most large companies have a specific department responsible for managing pure risk that is headed by the risk manager (or director of risk management).However, given that losses can arise from numerous sources, the overall risk management process ideally reflects a coordinated effort between all of the corporation's major departments and business units, including production, marketing, finance, and human resources (2).

(1) Harrington, S. E. and G. R. Niehaus (1999). Risk Management and Insurance. United State, the Mc Graw-Hill Companies, Inc, pp 3, (2) pp 14 -15.

Risk Management Staff

Depending on a company's size, a typical risk management department includes various staff specializing in areas such as property-liability insurance, workers' compensation, safety and environmental hazards, claims management, and, in many cases, employee benefits. Given the complexity of modern risk management, most firms with significant exposure to price risk related to the cost of raw materials, interest rate changes, or changes in foreign exchange rates have separate departments or staff members that deal with these risks. Whether there will be more movement in the future toward combining the management of these risks with pure risk management within a unified risk management department is uncertain (1).

- **Reporting of Risk Management**

In most firms, the risk management function is subordinate to and thus reports to the finance (treasury) department. This is because of the close relationship between protecting assets from loss, financing losses, and the finance function. However, some firms with substantial liability exposures have the risk management department report to the legal department. A smaller proportion of firms have the risk management unit report to the human resources department (2).

(1) (2) Harrington, S. E. and G. R. Niehaus (1999). Risk Management and Insurance. United States, the McGraw-Hill Companies, Inc, pp 14-15.

The role of Internal Audit in Risk Management

Internal audit, in both its assurance and its consulting roles, contributes to the management of risk in a variety of ways. Internal Auditing's core role with regard to risk management is to provide objective assurance to the board on the effectiveness of an organization's risk management activities to help ensure key business risks are being managed appropriately and that the system of internal control is operating effectively.

▪ Core internal auditing roles in regard to risk management

- ✓ Giving assurance on risk management processes.
- ✓ Giving assurance that risks are correctly evaluated.
- ✓ Evaluating risk management processes.
- ✓ Evaluating the reporting of key risks.
- ✓ Reviewing the management of key risks.

▪ Legitimate internal auditing roles with safeguards

- ✓ Facilitating identification and evaluating of risks.
- ✓ Coaching management in responding to risks.
- ✓ Coordinating risk management activities.
- ✓ Consolidating the reporting on risks.
- ✓ Maintaining and developing the risk management framework.
- ✓ Championing establishment of risk management.
- ✓ Developing risk management strategy for board approval.

▪ **Roles internal auditing should not undertake**

- ✓ Imposing risk management processes.
- ✓ Management assurance on risks.
- ✓ Taking decisions on risk response.
- ✓ Implementing risk responses on management's behalf.
- ✓ Accountability for risk management
- ✓ Setting the risk appetite.

Organizations should fully understand that management remains responsible for risk management. Internal auditors should provide advice, and challenge or support management's decisions on risks, as opposed to making risk management decisions. The nature of internal Auditing's responsibilities should be documented in the audit charter and approved by the audit committee (1).

(1) The role of internal auditing in Enterprise- wide Risk Management, IIA, September 29, 2004, pp1-2.

Challenges for the profession of Internal Auditing (1)

▪ The New Dimensions of Internal Auditing

The internal auditor should develop significant insight into operations and opportunities for improvement that can be in the form of consultation, advice, written communications or through other products all of which should be properly communicated to the appropriate management or operating personnel.

Against this measure is the changing context of internal auditing which is summed up in the IIA's work on the context for internal auditing competency frameworks, in Chapter 5 of the IIA Handbook Series on "implementing the professional practices framework":

Past Focus

Hard control

Control evaluation

Control

Risk

Risk threats

Past

Review

Additional Focus

soft control

self-assessment

risk

context

risk opportunities

future

preview

(1) K.H.Spencer Pickett, the Essential Handbook of Internal Auditing, John Wiley & Sons Ltd, England, 2005, pp 271-273

Detective	preventive
Operational audit	strategy audit
Auditor	consultant
Imposition	invitation
Persuasion	negotiation
Independence	value
Audit knowledge	business knowledge
Catalyst	change facilitator
Transaction	processes
Control activities	management controls
Control	risk
Consciousness	consciousness

▪ **Globalization**

One real development in internal auditing coincides with the way business (and public services) are becoming increasingly internationalized. Physical location is no longer an issue as buying activity is moving away from the local high street as it launches into hyperspace through the internet. The IIA has grasped this new thinking and is developing the profession into a global internal auditing organization whose broad business objectives included:

Establishing global standards for the practice of internal auditing

- Promoting the professional certificate of internal auditors worldwide
- Fostering the development of the profession around the globe
- Representing and promoting internal auditing across national borders.
- Facilitating the timely sharing of information among Members associations.
- Searching for globally applicable products and services.

▪ **The Changing Auditor.**

Philip Sainty has described a survey conducted by the institute in the wake of the WorldCom debacle, concerning the way the internal auditing profession has moved away from traditional financial auditing towards risk-based auditing. Four groups were described in terms of attitudes towards this change in focus:

➤ **The Evangelist**

Some 48% of respondents fell into this group. They believed that the move towards risk-based auditing has not had a negative impact on the traditional work of internal audit and should continue unfettered.

➤ **The Doomsayer**

Some 24% of respondents fell into this group. They believe that the move towards risk-based auditing has damaged the traditional work of internal audit and should not continue.

➤ **The Pragmatists**

Some 18% of respondents fell into this group. They felt that the move to risk-based auditing had changed the traditional work of the internal audit, but said that the trend should continue nonetheless.

➤ **The Doubters**

Some 5% of the respondents fell into this group. They felt that the move to risk-based auditing had not damaged the traditional work of internal audit but said that the trend should not continue. It is important not to throw the baby out with the bathwater. Professor Andrew Chambers has warned about the dangers of getting swept away on the tide of consulting styles and not retaining a semblance of our original role.

▪ **Meeting the Challenge**

All countries to a greater or lesser extent are coming to recognize the great value from an internal audit service. It is hard to think of any particular corporate service that is enshrined in laws and regulations and which carries the burden of the social expectations that it was mentioned. In August 2002, LeRoy E. Bookal, chairman of IIA, Inc, wrote that: With our unique viewpoint as independent but inside observers , internal auditors play a vital role within governance processes by keeping the board, senior management , and external auditors aware of risk and control issues and by assessing the effectiveness of risk management ... Audit committees and boards are facing skyrocketing liability costs and ever-increasing workloads. It's no wonder that liability costs rising –boards have to meet more governance challenges each year, but their resources for information about their increasingly complex organizations are

limited. In the post-Enron era, it is surprising that boards of directors for any publicly held companies would choose to do without internal auditing. It is also surprising that investors, liability insurers, and other stakeholders have not questioned the decision to do without internal auditing more often....There is no simple checklist showing everything internal auditors can do to add value, because, at times, techniques for adding value are as unique and personalized as the organizations for which we work. The challenges of today's changing world introduce great opportunities for management and the board and point to the necessity for competent internal auditing. Especially in these times of constant change, internal auditing is critical to efficient operations, effective internal controls and risk management, strong corporate governance, and in some cases, the very survival of the Organization.

CHAPTER FOUR

The data and information with the analysis of the questionnaire, findings of the questionnaire, the recommendation and suggestions for improvement

- 1) To whom dose the internal Audit Department Report?
- 2) What is the Scope of the Internal Audit function?
- 3) What is the level of the organizational Status of the Department?
- 4) What is the qualification and experience of the Audit staff?
- 5) What is the view of other Depts. regarding the internal Audit performance?
- 6) What is the level of implementing internal Audit recommendation?
- 7) What are polices and procedures governing the internal Audit?
- 8) What are your suggestions and recommendations for the enhancement and development of the internal Audit function?

Table # 1

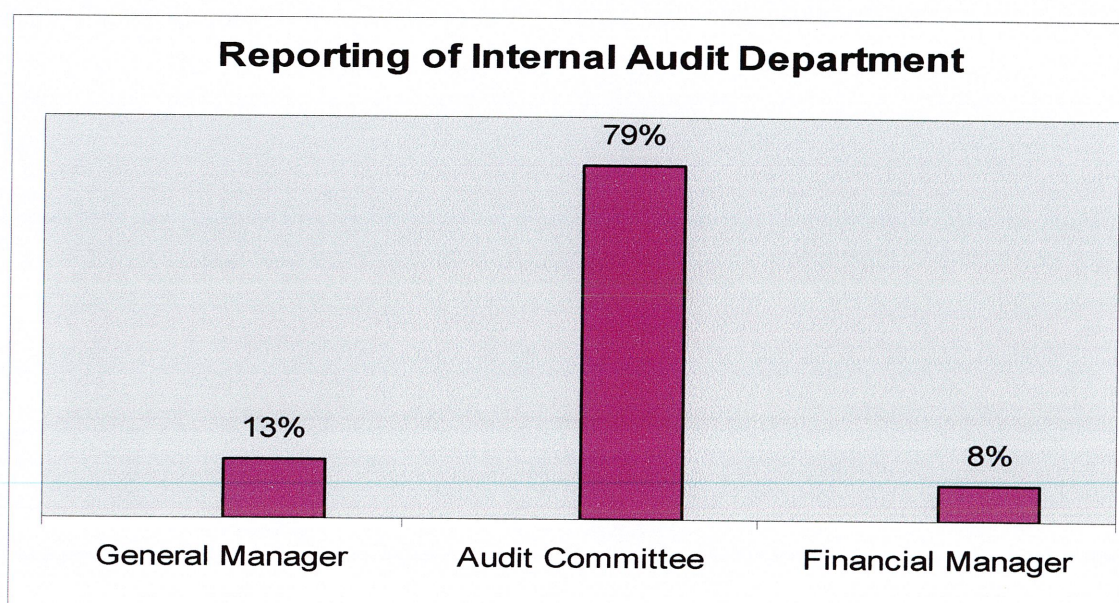
Reporting of Internal Audit Department

The level of report	No	%
General Manager	6	13
Audit Committee	37	79
Financial Manager	4	8
Total	47	100

Results:

The above schedule results show that the majority of the internal audit department of trading companies in Kingdom of Bahrain, which represent 79 % report to the audit committee. This indicates a very good indication of a healthy situation and a good level of independent. In addition to that the remaining of 21 % the internal audit department is reporting to general manager and financial manager.

Figure # 1



Since the financial manager is an executive level in the company, then this indicate that the level of report is insufficient which is due to lack of independence, this however, shows a weakness in the role of internal audit in trading companies in Kingdom of Bahrain.

An ideal chief internal audit should report to a higher and independent level of nearest to a 100 % so that weakness can be rectifiable and actions be taken.

Recommendations:

The level of report should be 100% to an independent and high-level body such as Audit Committee or Shareholders or General Manager in which the key role is to ensure reasonable corporate governance in organizations' management and decision-making structure.

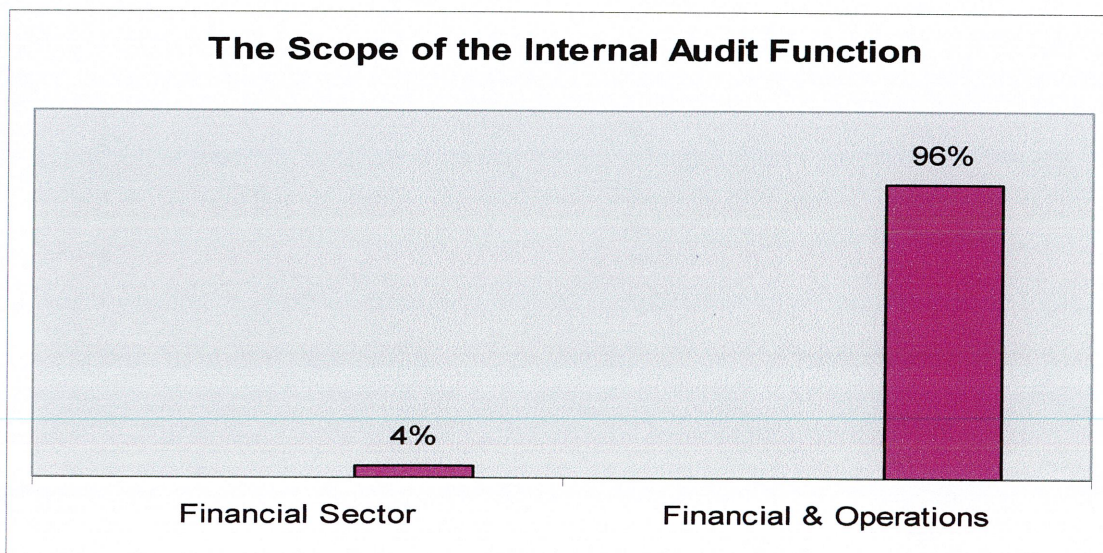
It is important that the stakeholders have confidence in the audit committee's integrity and commitment, and that in turn; the audit committee has confidence in the stakeholders. An audit committee has to be independence and fearless, and it has to report accurately back to the stakeholders on the true state of affairs of the organization. An audit committee has to be independence of the board as well as the management. Thus an effective audit committees and risk management plans are the indicators of best corporate governance practice that can markedly improve organizational performance, including decision-making. Another side of independence is that the fundamental position for an audit committee is to be in a position to discuss matters with the auditors (internal and external) freely, without the constraint of having senior management on the committee. Audit committees can ensure that acceptance audit recommendations are followed up and properly addressed. This can greatly improve both the external and, of course, the internal audit effectiveness.

Table # 2**The scope of the internal audit function**

The scope of internal audit	No	%
Financial sector	2	4
Financial & operation	45	96
Total	47	100

Results:

The above schedule results that about 4% of the General Managers and Owners of the trading companies in Kingdom of Bahrain think that the internal auditors are only concerned with safe guarding of assets, books, the financial statements, stock records, invoices, cash. And in contrast to that 96% of the General Managers and Owners of the trading companies believe that the internal auditors should concerned with the whole organization ant not merely with finance and accounting and consequently it involves the audit operations in general such as those relating to the production, personnel, advertising, research and development.

Figure # 2

The scope of internal audit varies widely and depends on the size and structure of the entity and the requirement of its management.

Recommendations:

The Internal audit should not confine him-self to the routine checks of financial statements, records, invoices, but has to conduct an appraisal of various functions.

Providing advice and recommendation to the activities as well as operations reviewed.

Internal Auditors are business generalists who specialize in efficiency and effectiveness for the ongoing of the organization and its shareholders, they should help the management to accomplish its objectives, and provide a new dimension to the audit function based in the operational auditing whereby the management auditors looks at the efficiency of the organization's operations and report upon ways in which costs could be reduced or profitability improved as an appraisal of management performance and alternatively, the audit could be intended to satisfy the shareholders that the company was being run properly in line with the financial matters auditing . Its has been suggested that management auditing or operational auditing should become mandatory in the private sector. They should help the management to accomplish its objectives, also serve as in house consultant on many areas.

Table # 3

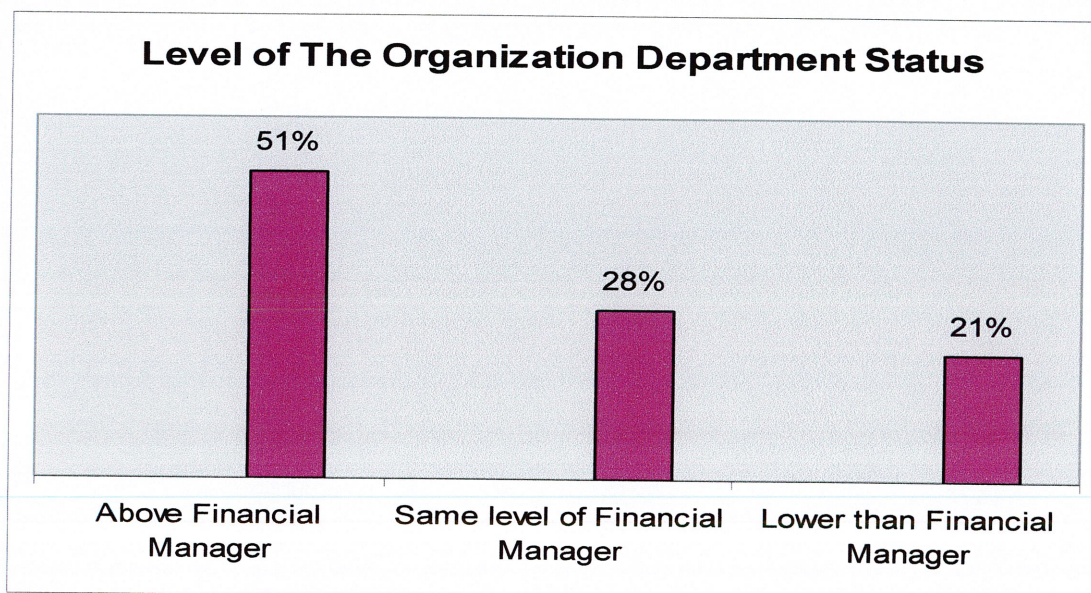
Level of the organizational status of the department

Level of the organization status	No	%
Above the financial manager	24	51
Same level of financial manager	13	28
Lower than financial manager	10	21
Total	47	100

Results:

The results of the above schedule shows that 49% of the trading companies in Kingdom of Bahrain consider that the internal auditors are in the same or lower level in status than the financial manager which is inappropriate and indicate that the reports and recommendations when have to be for the upper level have to be to the financial manager, which is inappropriate procedures and will weakness the company's system.

Figure # 3

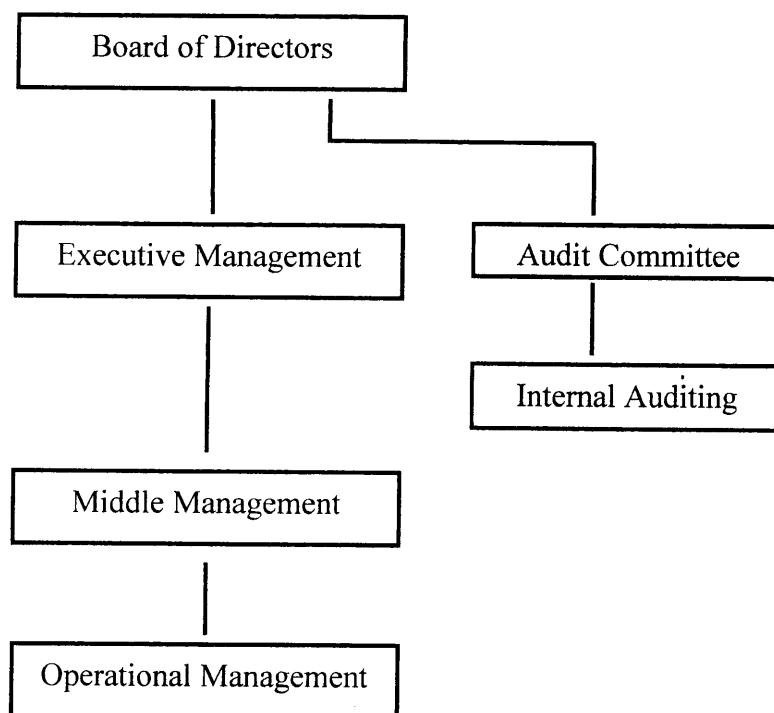


And on the other side it shows that the remaining of 51% of trading companies considers that the internal auditors should be above the financial manager level which indicates a favorite situation.

Recommendations:

Ideal level of the organizational status of internal audit is to be the solid line to a top executive to assure consideration of audit recommendations and access to all operations in the organization and a dotted line to the board to protect the internal auditing from the potentially disastrous effect of unwarranted displeasure on the part of the chief executive officer as shown below.

Practical Positioning of Internal Auditing



I recommend the status of internal auditing must be sufficient to permit accomplishment of its objectives; proper organizational status enhances the independence and objectivity of internal auditing.

The director of internal auditing should have an access to the board of directors and report directly to higher levels of management executives with sufficient to promote and ensure:

- Internal auditing independence.
- Board audit coverage.
- Adequate audit coverage.
- Appropriate action on audit recommendations.

Table # 4

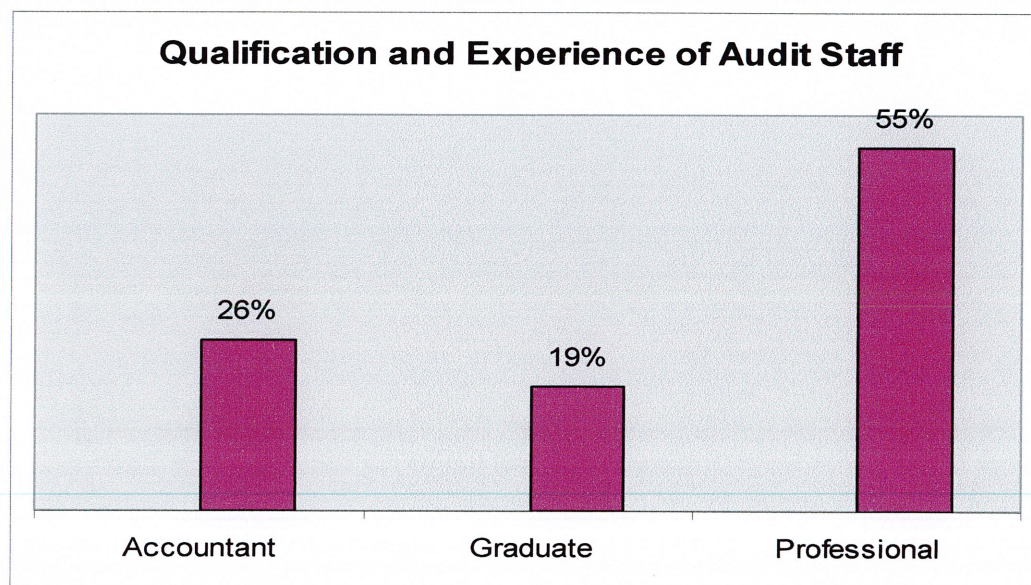
Qualification and experience of audit staff

Qualification & Experience	No	%
Accountant	12	26
Graduate	9	19
Professional	26	55
Total	47	100

Results:

The above schedule results that 55 % of the companies' owners or directors do realize the important of the internal auditing in their organizations. Internal auditors should receive proper education and training as this will not only enhance the general efficiency and effectiveness of the internal audit function, but also may be seen as important for the enhancement of independence, as it raises the status of the auditor.

Figure # 4



In addition, a well-informed and competent auditor will be better able to recognize the dangers of mental dependence. And in contrast to that 45 % of the companies' owners and directors do not realize the important of the internal auditing in their organization because they think that the internal auditor is only for detection of fraud in the organization so he has to be a Clark or junior accountant or some times there is no need for him.

Recommendation:

Qualification and Experience of the internal auditor is very important nowadays.

It is recommended that all trading companies' public or private should have a fully resourced, independent internal audit. It is vital that the staff assigned to an investigation has the necessary skills and experience to cope and they may go far beyond the traditional knowledge of accounting and bookkeeping skills. It is also recommended that the internal audit department will have to recruit staff with qualifications in a range of technical and managerial skills and social skills to enable them to communicate effectively with the subjects of their investigation and obtain their active cooperation. Its necessary for those who do not belong to a professional body could be encouraged to take relevant training, perhaps sitting the CIA's examinations. In addition internal audit staff should be required to approach their work with a degree of professionalism similar to that displayed by the external auditor to carry out their audit responsibilities.

Table # 5

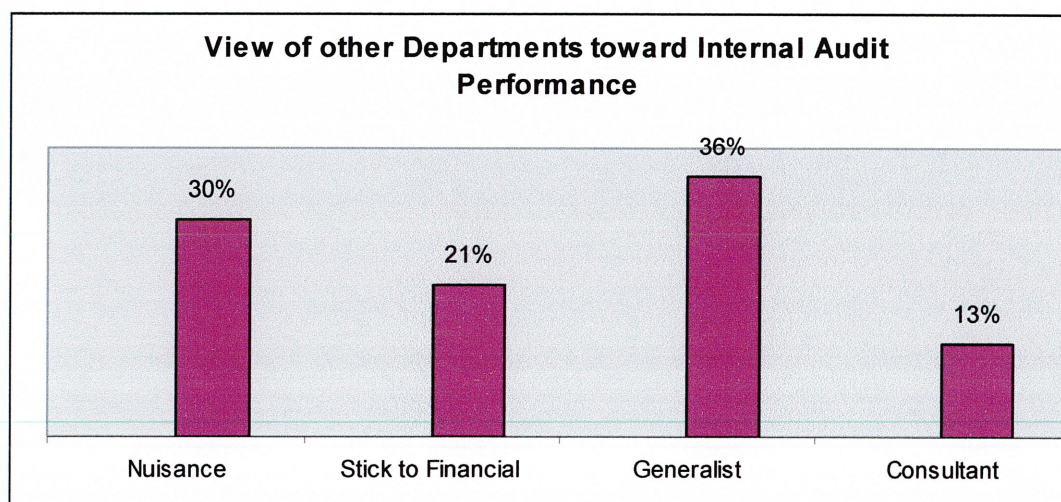
View of other departments regarding the internal audit performance e

View of other department	No	%
Nuisance	14	30
Stick to financial matters	10	21
Generalist	17	36
Consultant	6	13
Total	47	100

Results:

The above schedule results that 36 % i.e. the majority of the auditee consider that the internal audit is practically concerned with the general matters whereas 30 % of the auditee consider that the internal audit seems to be as nuisance for them and mainly intruder in others work.

Figure # 5



It also shows that 21 % of the audittee believe that internal audit is basically concerned with the financial matters. And in contrast to that only 13% of the audittee believe that the internal audit should concentrate on consultancy matters.

Internal Auditor today in any organization is perhaps the most misunderstood person. This because he has to work and communicate in an atmosphere where he may come across conflicts, frictions, resentment, mistrust and fear response of audittee and management.

Recommendation:

It is recommended that the owners or directors of the organization have to encourage internal auditors to act as a business generalist or consultant who specialized in efficiency and effectiveness for good of the organization and its shareholders as a valuable resource to executive management and board of directors in accomplishing overall goals and objectives. It is recommended that the role of internal auditors should be changed from a traditional audit approach to a more proactive value-added approach where internal auditors are taking up partnership with management whereby suggesting improvements that add value to or strengthen the organization and to concentrate on a consultative approach within which the organization operates, dealing with efficiency and effectiveness rather than accounting of recording. Additionally internal auditors should tend to make use of the phrase "assurance services" instead of auditing and provide advice up front to management to assist in the business objectives. Also the internal auditors need to be seen to undertake continual professional development to keep up to date with changing business practice and remain capable of providing a value-added service in their audit approach. Collaborative attitude is needed in internal audit profession. It is recommended that the internal audit have to adopt a new approach, which achieve common organization objective. Under this approach internal audit reports will be more realistic and they will become joint and collaborative efforts

Table # 6

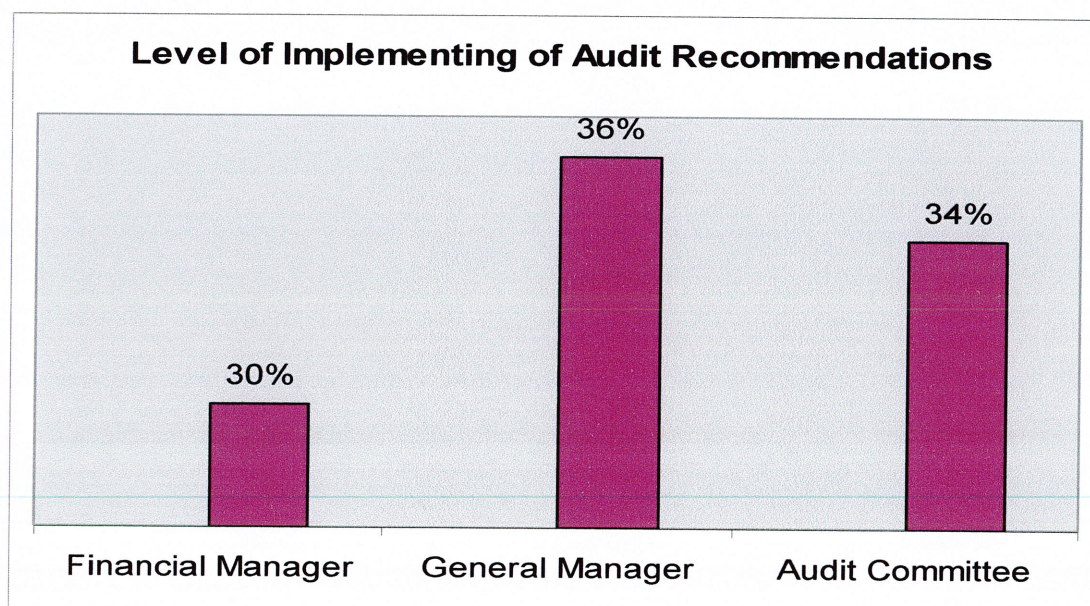
Level of implementing of internal audit recommendation

Level of implementing I.A. Recommendation	No	%
Financial Manager	14	30
General Manager	17	36
Audit Committee	16	34
Total	47	100

Results:

The schedule above shows that 30% of the internal auditors in Kingdom of Bahrain believe that the financial manager implements recommendations whereas 36% of the internal auditors of the trading companies believe that the General Manager implements recommendations.

Figure # 6



This indicates that the result will be inadequate and insufficient because financial manager and the general manager may take action or may not consider the recommendation is not important and ignore it due to the lack of independency. Alternavetely the above result shows that 34% of the internal auditors believe that the audit committee should ensure that the the recommendations are implemented. This indicates a healthy situation and accordingly the owners and the directors of the organization should increase their perception in respect of implementing the recommendation through the audit committee.

Recommendation:

Internal Audit recommendations should be reported to director or owner because they are who have the authority to take action and it is implemented or performed as intended. It is recommended that the internal audit recommendation should be reported to an independent and high level body such as director or owner or an audit committee who have the authority to action and ensure that the implementation of the recommendations are performed as intended.

It is important to consider the following criteria to ensure the best practice of implementing the recommendations:

- The degree of independence of the audit members.
- The competence of audit committee members.
- The quality of audit committee.
- The level of the resources available to audit committee.
- The extent to which audit committee members display due professional care.
- Diligent and knowledgeable audit committee members.

Table # 7

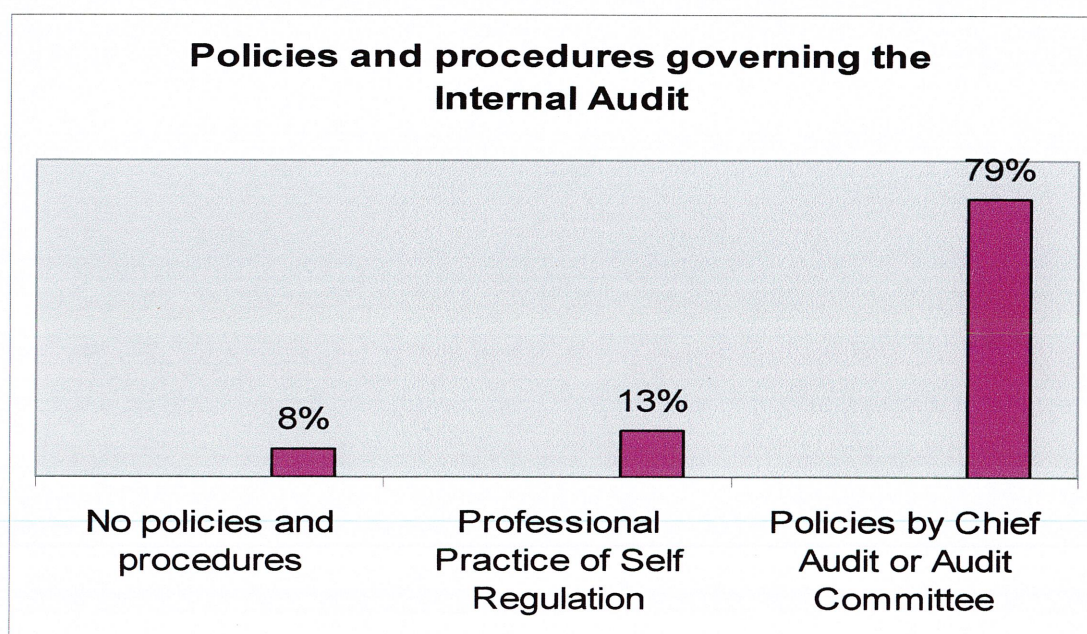
Policies and procedures governing the internal audit

Policies and procedures governing the I.A	No	%
No policies and procedures	4	8
Professional practice of self regulation	6	13
Policies by chief audit or audit committee	37	79
Total	47	100

Results:

The above schedule results that 79% of trading companies' directors determines that policies and procedures are governed by chief audit or audit committee. This indicates good picture. Whereas 8% of the directors determines that the policies and the procedures is governed through professional practice of self regulation.

Figure # 7



This also represents a healthy condition and leads to improve the area of internal audit in future. Whereas the remaining 13 % of the directors determine that there are no policies and procedures governing the internal audit. The professional practice of internal auditing is governed through a system of self-regulation based on widely accepted standards, ethical, principles and other guidance indicative of best practice.

Recommendations:

Chief audit executive should establish policies and procedures to guide the internal audit activity. Audit-committees should charge case with the responsibility of ensuring that internal audit work is performed in accordance with the standards. The audit committee should help in the smooth running of both the company and the audit function. Its activity can be extended to cover important matters such as planning audit work and recommendations internal control and control procedures. It must be noted that the audit committees exists to aid communication between the auditor and the company, but should never be regarded as a substitute for generally accepted audit procedures, but to enforce and approve the auditing policies, standards, and procedures.

Table # 8

Suggestions for enhancement and development of internal audit

No	Suggestions in order for development of internal audit.
1.	Importance of knowledge among the internal audit staff
2.	Encourage an atmosphere of mutual trust in the organization
3.	Emphasize on control issues rather than audit finding
4.	Emphasize on business improvement and training
5.	Focus on consulting and value-added services
6.	Encourage periodical meeting with audit committee
7.	To ensure implementation of recommendations.
8.	To ensure that risks are managed properly
9.	To justify services to top management on continuous basis
10.	To improve the effectiveness of audit committee
11.	To assess the value of internal audit department

Recommendations:

An active and knowledgeable audit staff is fundamental to achieving and maintaining an effective control environment, and an atmosphere of mutual trust and respect between the internal audit function and the organization staff.

Tips below for building strong relationship between internal audit and other for enhanced corporate governance

- A corporate governance program should provide a mechanism for businesses process improvement, integrity standards, training, a "hot-line" and their reporting processes, and appropriate compliance review.
- Presentation should drive towards discussion of control issues rather than audit findings, and additional material should accompany presentation to provide contextual insight about the control issues under discussion.
- Internal Audit should focus on delivering results and implementing preventive action rather than simply uncovering problems after the fact.
- In addition to regular audit meetings the chief auditing executive should have periodic meetings with audit committee to discuss broader issues facing the organization.

Finally, research brought to light the general recommendations for the benefit of all concerned parties in internal auditing field:

- **Customer Service**

The internal auditing organization should be active in trying to determine what it can do to help these various classes of customers through surveying their customers which used to be a useful technique in assessing the amount of value that their department is providing.. It should be proactive in anticipating their needs and in making plans to accommodate them.

- **Quality control**

It is recommended that the standards of quality must be observed to produce information that is dependable and appropriate for use by the internal audit department's customers. Therefore, the audit organization should "establish and maintain a quality assurance program that will ensure that quality work conforms to the Audit Standards and to good auditing practice.

- **Information system auditing**

As the information processing becomes an important element of the organization's operations, it is recommended the internal auditor should give a priority audit effort when there is extensive computer support for operations.

Control self- assessment

It is recommended that company's management should encourage to adopt and practice control self-assessment (CSA) as a new technique to internal auditors which concentrates on learning and adopting a shared vision within an organization (the new definition of audit) rather than command-and control (the traditional audit approach). As this new vision of internal auditing develops CSA

is likely to develop alongside, introducing internal auditors and management to a shared vision of achieving business objectives and in which internal auditors will act as facilitators of change, guiding individuals of the organization through process analysis, enhancing each participant's understanding of the total process under review. Thus CSA is fundamentally a partnership process whereby the internal auditors will become involved in contributing to the development of the organization's shared vision.

Composition of the audit committee

It is recommended that companies seeking listing on the Bahrain Exchange Stock must appoint an audit committee from amongst its directors which fulfils the following requirements:

- The audit committee must be composed of no fewer than 3 members;
- A majority of audit committee must be independent; and
- At least one member of the audit committee must be a member of Institute of Chartered Accountants or Institute of Internal Auditors and if not a member, he must have at least 3 years working experience,
- Listed issuer must ensure that no alternate director is appointed as a member of the audit committee.

Chairman of the audit committee

The member of an audit committee shall elect a chairman from among their number who shall be an independent director.

Attendance of directors and other employees

A listed issuer must ensure that other directors and employees attend any particular audit committee meeting only at the audit committee's invitation, specific to the relevant meeting.

Audit committee report

A listed issuer must ensure that its board of directors prepares an audit committee report at the end of each financial year.

Review of the audit committee

The board of directors of a listed issuer must review the term of office and performance of an audit committee and each of its members at least one every 3 years to determine whether such audit committee and members have carried out their duties in accordance with their terms of reference.

As internal auditing is attracting more people and becoming a major profession, it is recommended that the practice of internal auditing to be monitored and controlled by law as is external auditing.

CHAPTER FIVE

Conclusions

The research concludes with important recommendations and suggestions for improving the internal audit function in general and the Trading business in Kingdom of Bahrain in particular .

It is significant to sum up the main points concluded on this research as follows:

The research pointed out that 51 % of the trading companies as indicated in table 3 consider that the internal auditors should be above the financial manager level whereas the remaining 49 % of the trading companies consider to be in lower or the same status level than the financial manager which inappropriate , rather proper organizational status should be encouraged by the shareholders of these companies to enhance the independence and the objectivity of internal auditing function in order to act as an executive staff of the organization as it was shown by the recent study that the demand for the internal auditors is expected to increase by 35 – 40 percent in the next ten years (American college Testing , Hunt Valley. MD, 1993), and therefore, the internal auditors should become more accruable to audit committees of Board of Directors rather than exclusively to management.

The interviews brought to light the high professional and stated that they have to have a strong support from the top management of their organizations to support the level of the organizational status to be in line if not more than other managers in the organization. It also came to light that in addition to their roles of monitoring , assessing , analyzing organization risks, control, reviewing, compliance with policies, procedures and laws, interviews stated working in partnership with management in providing executive management assurance that the organization's governance is strong and effective, and the Board should believe that the internal audit deliver more

value through ideas which generate cost saving revenue enhancements and process improvements while at the same time internal audit is being challenged to cover all the expanding exposures more efficiently (Ernst & Young , Business Risk and Internal Audit Services , 2/5 /2005).

The research also pointed out as indicated in table 4, that 55 % of internal audit staff is typically professional and most of them are certified and most auditing departments operate under approved charters. Whereas on the other hand the remaining 45 % of internal auditors are graduated and with accounting background and with inadequate practical experience in auditing. This might reflect that the directors do not realize the importance of internal auditing in their organizations, because they think that the internal auditor is mainly exist for deduction of fraud in the organization, therefore, it is necessary to encourage those who do not belong to a professional body could be encouraged to take relevant training , perhaps CIA's examination.

Further more, 87 % of the interviews as indicated in table 5, stated that the organization's staff looked at the internal auditor as nuisance, stick to financial matters and generalist, whereas 13 % stated that internal auditors act as consultants. Rather this perhaps reflects the organization's culture toward the role of internal audit and therefore, the Board of the organization have to change the concept of the internal audit from a traditional audit approach to a more proactive value added approach where internal auditors act as a part of the executive staff of the organization whereby the internal auditors will become involved in contributing toward the development of the organization's shared vision.

The research stated that the majority i.e. 66 % as indicated in table 6 , of the recommendations are implemented by the general managers and financial managers whereas, the remaining 34 % indicated that the implantation of recommendations implemented through the audit committee. Rather, this indicated that the results and

actions will be inadequate and insufficient because financial managers as well as the general manager may take action or may not consider the recommendation is important and perhaps ignore it due to lack of independency. Therefore, the Board advised to have a high level body such as a director or an audit committee whereby these recommendations are executed.

The research also brought to light that 8 % as stated in table 7 of the companies have no written policies, procedures and ethical standards governing the business organization. Furthermore, it also came to light that 4 companies representing 11 % out of 10 companies were not responded stated the reason of not having such internal audit department in their organizations and therefore, Board of these companies are advised to look further to the important role of the internal audit department for improving of business organization as a whole and it was noted that one company did not responded due to the its company policy which not allowed to answer such questionnaire.

Furthermore, the interviews brought to light that the Charter concept is not enough, it is believed to establish a vision statement; a description of what the internal auditing organization will do and its contribution to the well being of the organization and to those other organizations and individuals associated on its periphery.

APPENDIX A

THE HAND –DELIVERED QUESTIONNAIR

PART 1: RESPONDENT INFORMATION

1. Name:

2. Age:

☐ Under 25 ☐ 25 -30

☐ 30-35 ☐ 35-44

☐ 40-45 ☐ 45-50

☐ 50-55 ☐ Over 55

3. Gender:

☐ Male ☐ Female

4. Nationality:

- ☐ Bahraini
- ☐ Middle Eastern
- ☐ Western (European & American)
- ☐ Asian
- ☐ Others, please specify:

.....

5. Level of Education:

- ☐ High School
- ☐ Bachelor's Degree
- ☐ Professional
- ☐ Master's Degree
- ☐ Ph.D.
- ☐ Others please specify:

.....

6. Current Position:

- ☐ Director
- ☐ Manager
- ☐ Senior (chief, head, supervisor)
- ☐ Associate (consultant)
- ☐ Others please specify:

.....

PART 11: COMPANY INFORMATION

1. **Company's Name:**

2. **Nature of Business:**

- ☐ Investment Bank
- ☐ Commercial Bank
- ☐ Insurance Company
- ☐ Trading Company
- ☐ Others, please specify:

.....

3. **Total Number of Employees:**

- ☐ 1 - 99
- ☐ 100 – 299
- ☐ 300 or more

4. **Year of Establishment:**

5. The current legal form of the company:

- ☐ Public joint stock company (BSC)
- ☐ Closed joint stock company
- ☐ Private company with limited liabilities (WLL)
- ☐ Exempt (offshore) company
- ☐ Partnership
- ☐ Branch of a Foreign Company
- ☐ Fully owned Foreign Company
- ☐ Other, please specify:

.....

PART III: INTERNAL AUDIT DEPARTMENT QUESTIONNAIR

Please for questions 1 to 7; tick your answer according to your company's current position

1. To whom does the Internal Audit Department Report?

- ☐ General Manager
- ☐ Audit Committee
- ☐ Financial Manager
- ☐ Other, please specify:

.....

2. What is the Scope of the Internal Audit function?

- ☐ Financial sector
- ☐ Financial & Operation
- ☐ Other, please specify:

.....

3. What is the level of the Organizational Status of the Department?

- ☐ Above the Financial Manager
- ☐ The same level with the Financial Manager
- ☐ Lower level than Financial Manager
- ☐ Other, please specify:

.....

4. What is the qualification and experience of the Audit staff?

- ☐ High School & Diploma
- ☐ Bachelor's Degree in Accounting
- ☐ Professional
- ☐ Experience in Accounting
- ☐ Other, please specify

.....

5. What is the view of other departments regarding the Internal Audit?

Performance?

- ☐ Nuisance
- ☐ Stick to Financial matter
- ☐ Generalist
- ☐ Other, please specify

.....

6. What is the level of implementing Internal Audit Recommendation?

- ☐ Financial Manager
- ☐ General Manager
- ☐ Audit Committee
- ☐ Other, please specify

.....

7. What are policies and procedures governing the Internal Audit?

- ☐ There are no Policies and procedures governing the internal Audit
- ☐ The professional practice of internal auditing is governed Through a system of self-regulation
- ☐ Policies and procedures are governed by Chief audit or Audit Committees
- ☐ Other, please specify.

.....

8. What are your suggestions and recommendations for the enhancement and development of the Internal Audit Function?

Please arrange your answer in order i.e. 1 – 11 according to your opinion.

- ☐ Importance of active and knowledgeable audit staff in order to maintain an effective control environment.
- ☐ To encourage an atmosphere of mutual trust and respect Between the internal audit function and the organization staff.
- ☐ To emphasize on control issues rather than audit findings.
- ☐ To provide a mechanism for business process improvement Integrity standards, training, reporting processes and compliance review.
- ☐ Periodic meeting with audit committee to discuss broader Issues facing the organization.

- ☐ To focus on consulting and value-added services
In addition to its traditional assurance services.
- ☐ To provide assurance that risks to the organization
Are understood and managed appropriately.
- ☐ To justify the Services of internal auditing to top
management on a continuous basis.
- ☐ To ensure timely implementation of recommendation by
The upper management.
- ☐ To provide rules to improve the effectiveness of audit
Committee.
- ☐ To assess the value of the internal auditing department by
sending a survey to their customers. .

APPENDIX B

Names of companies included in the sample	
1.	Bahrain Maritime & Mercantile International
2.	Bahrain Commercial Facilities Company
3.	General Trading & Food Processing Company (trafco)
4.	Aradio Technical Services
5.	Abdulla Ahmed Nass Group
6.	Abdulla Essa Al Nooh & Sons
7.	Ahmed Mansoor Al A'Ali Company
8.	Yousif Khalil Al Moayyed & Sons
9.	Al Zayani Investments Company
10.	Berger Paints Bahrain Company
11.	National Import & Export Company
12.	Bahrain Flour Mills Company
13.	A.A. Bin Hindi Company
14.	Midal Cable Company
15.	Gulf Aluminum Rolling Mill Company
16.	Bahrain Airport Services
17.	Bahrain Telecommunication Company
18.	Takaful International Company
19.	Ahli United Bank
20.	Bank of Bahrain and Kuwait
21.	Bahrain Islamic Bank

22.	National Bank of Bahrain
23.	Bahrain Saudi Bank
24.	Arab Banking Corporation
25.	Gulf International Bank
26.	Investcorp Bank
27.	Taib Bank
28.	First Islamic Bank
29.	Shamil Bank
30.	Al Baraka Bank
31.	Kuwaiti Finance House
32.	Standard Chartered Bank
33.	H S B C Bank
34.	Bahrain National Insurance
35.	Arab Insurance Group
36.	Al Ahlia Insurance Company
37.	Bahrain and Kuwait Insurance Company

Appendix C

Analysis of selected companies' samples

Number of selected samples of companies	37	100 %
Number of not responding	10	27 %
Actual number of selected samples received	27	73 %
Total selected companies	37	100 %

Details of not responding companies

Companies not having internal audit department	4	11 %
Companies not respond /not received	5	14 %
Company policy not allowed	1	2 %
Total of not responding	27	27 %

Total number of questionnaires received 47

Appendix D

International Standards for the Professional Practice of Internal Auditing

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 accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, compliance with the International Standards for the Professional Practice of Internal Auditing is essential if the responsibilities of internal auditors are to be met. If internal auditors are prohibited by laws or regulations from complying with certain parts of the Standards, they should comply with all other parts of the Standards and make appropriate disclosures.

Assurance services involve the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved in assurance services: (1) the person or group directly involved with the process, system or other subject matter – the process owner, (2) the person or group making the assessment – the internal auditor, and (3) the person or group using the assessment - the user.

Consulting services are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice – the internal auditor, and (2) the person or group seeking and receiving the advice – the engagement client. When performing consulting services the internal auditor should maintain objectivity and not assume management responsibility.

The purpose of the *Standards* is to:

1. Delineate basic principles that represent the practice of internal auditing as it should be.
2. Provide a framework for performing and promoting a broad range of value-added internal audit activities.
3. Establish the basis for the *evaluation* of internal audit performance.
4. Foster improved organizational processes and operations.

The Standards consist of Attribute Standards, Performance Standards, and Implementation Standards. The Attribute Standards address the characteristics of organizations and *parties* performing internal audit activities. The Performance

Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated. While the Attribute and Performance Standards apply to all internal audit services, the Implementation Standards apply to specific types of engagements.

There is one set of Attribute and Performance Standards; however, there are multiple sets of Implementation Standards: a set for each of the major types of internal audit activity. *The Implementation Standards have been established for assurance (A) and consulting (C) activities.*

The Standards are part of the Professional Practices Framework. The Professional Practices Framework includes the Definition of Internal Auditing, the Code of Ethics, the Standards, and other guidance. Guidance regarding how the Standards might be applied is included in Practice Advisories that are issued by the Professional Issues Committee.

The *Standards* employ terms that have been given specific meanings that are included in the Glossary.

The development and issuance of the Standards is an ongoing process. The Internal Auditing Standards Board engages in extensive consultation and discussion prior to the issuance of the Standards. This includes worldwide solicitation for public comment through the exposure draft process.

All exposure drafts are posted on The IIA's Web site as well as being distributed to all IIA Affiliates. Suggestions and comments regarding the Standards can be sent to:

*The Institute of Internal Auditors Global Practices Center, Professional Practices
Group 247 Maitland Avenue Altamonte Springs, FL 32701-4201, USA
E-mail:*

standards@theiia.org

Web: <http://www.theiia.org>

*The latest additions and amendments to the Standards were issued in December
2003, and became effective January 1, 2004.*

ATTRIBUTE STANDARDS

1000 – Purpose, Authority, and Responsibility

The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board.

1000. A1 - The nature of assurance services provided to the organization should be defined in the audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances should also be defined in the charter.

1000. C1 - The nature of consulting services should be defined in the audit charter.

1100 – Independence and Objectivity

The internal audit activity should be independent, and internal auditors should be objective in performing their work.

1110 – Organizational Independence

The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.

1110. A1 - The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

1120 – Individual Objectivity

Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.

1130 – Impairments to Independence or Objectivity

If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

1130. A1 – Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an *internal* auditor provides assurance services for an activity for which the *internal* auditor had responsibility within the previous year.

1130. A2 – Assurance engagements for functions over which the chief audit executive has responsibility should be overseen by a party outside the internal audit activity.

1130. C1 - Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130. C2 - If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement.

1200 – Proficiency and Due Professional Care

Engagements should be performed with proficiency and due professional care.

1210 – Proficiency

Internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

1210. A1 - The chief audit executive should obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210. A2 – The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210. A3 – *Internal auditors should have knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.*

1210. C1 - The chief audit executive should decline the consulting engagement or obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220 - Due Professional Care

Internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1220. A1 - The internal auditor should exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives.
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied.
- Adequacy and effectiveness of risk management, control, and governance processes.
- Probability of significant errors, irregularities, or noncompliance.
- Cost of assurance in relation to potential benefits.

1220. A2 - *In exercising due professional care the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques.*

1220. A3 – The internal auditor should be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220. C1 - The internal auditor should exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results.
- Relative complexity and extent of work needed to achieve the engagement's objectives.

- Cost of the consulting engagement in relation to potential benefits.

1230 – Continuing Professional Development

Internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development.

1300 – Quality Assurance and Improvement Program

The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program should be designed to help the internal auditing activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the Standards and the Code of Ethics.

1310 – Quality Program Assessments

The internal audit activity should adopt a process to monitor and assess the overall effectiveness of the quality program. The process should include both internal and external assessments.

1311 – Internal Assessments

Internal assessments should include:

- Ongoing reviews of the performance of the internal audit activity; and
- Periodic reviews performed through self-assessment or by other persons within the organization, with knowledge of internal audit practices and the *Standards*.

1312 – External Assessments

External assessments, such as quality assurance reviews, should be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organization.

1320 – Reporting on the Quality Program

The chief audit executive should communicate the results of external assessments to the board.

1330 – Use of "Conducted in Accordance with the Standards"

Internal auditors are encouraged to report that their activities are "conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*." However, internal auditors may use the statement only if assessments of the quality improvement program demonstrate that the internal audit activity is in compliance with the *Standards*.

1340 – Disclosure of Noncompliance

Although the internal audit activity should achieve full compliance with the *Standards* and internal auditors with the *Code of Ethics*, there may be instances in which full compliance is not achieved. When noncompliance impacts the overall scope or operation of the internal audit activity, disclosure should be made to senior management and the board.

PERFORMANCE STANDARDS

2000 – Managing the Internal Audit Activity

The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.

2010 – Planning

The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.

2010. A1 - The internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. The input of senior management and the board should be considered in this process.

2010. C1 - The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Those engagements that have been accepted should be included in the plan.

2020 – Communication and Approval

The chief audit executive should communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and to the board for review and approval. The chief audit executive should also communicate the impact of resource limitations.

2030 – Resource Management

The chief audit executive should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

2040 – Policies and Procedures

The chief audit executive should establish policies and procedures to guide the internal audit activity.

2050 – Coordination

The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to the Board and Senior Management

The chief audit executive should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management.

2100 – Nature of Work

The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance *processes using a systematic and disciplined approach.*

2110 – Risk Management

The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

2110. A1 - The internal audit activity should monitor and evaluate the effectiveness of the organization's risk management system.

2110. A2 - The internal audit activity should evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the

- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations.
- Safeguarding of assets.
- Compliance with laws, regulations, and contracts.

2110. C1 - During consulting engagements, internal auditors should address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2110. C2 – Internal auditors should incorporate knowledge of risks gained from consulting engagements into the process of identifying and evaluating significant risk exposures of the organization.

2120 – Control

The internal audit activity should assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2120. A1 - Based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. This should include:

- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations.
- Safeguarding of assets.
- Compliance with laws, regulations, and contracts.

2120. A2 - Internal auditors should ascertain the extent to which operating and program goals and objectives have been established and conform to those of the organization.

2120. A3 - Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

2120. A4 - Adequate criteria are needed to evaluate controls. Internal auditors should ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors should use such criteria in their evaluation. If inadequate, internal auditors should work with management to develop appropriate evaluation criteria.

2120. C1 - During consulting engagements, internal auditors should address controls consistent with the engagement's objectives and be alert to the existence of any significant control weaknesses.

2120. C2 – Internal auditors should incorporate knowledge of controls gained from consulting engagements into the process of identifying and evaluating significant risk exposures of the organization.

2130 – Governance

The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- *Promoting appropriate ethics and values within the organization.*
- *Ensuring effective organizational performance management and accountability.*
- *Effectively communicating risk and control information to appropriate areas of the organization.*
- *Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.*

2130. A1 – *The internal audit activity should evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs and activities.*

2130. C1 – Consulting engagement objectives should be consistent with the overall values and goals of the organization.

2200 – Engagement Planning

Internal auditors should develop and record a plan for each engagement, including the scope, objectives, timing and resource allocations.

2201 - Planning Considerations

In planning the engagement, internal auditors should consider:

- The objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity's risk management and control systems compared to a relevant control framework or model.
- The opportunities for making significant improvements to the activity's risk management and control systems.

2201. A1 – When planning an engagement for parties outside the organization, internal auditors should establish a written understanding with them about objectives, scope, respective responsibilities and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201. C1 - Internal auditors should establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding should be documented.

2210 – Engagement Objectives

Objectives should be established for each engagement.

2210. A1 – *Internal auditors should conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives should reflect the results of this assessment.*

2210. A2 - The internal auditor should consider the probability of significant errors, irregularities, noncompliance, and other exposures when developing the engagement objectives.

2210. C1 – Consulting engagement objectives should address risks, controls, and governance processes to the extent agreed upon with the client.

2220 – Engagement Scope

The established scope should be sufficient to satisfy the objectives of the engagement.

2220. A1 - The scope of the engagement should include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

2220. A2 - *If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.*

2220. C1 – In performing consulting engagements, internal auditors should ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations should be discussed with the client to determine whether to continue with the engagement.

2230 – Engagement Resource Allocation

Internal auditors should determine appropriate resources to achieve engagement objectives. Staffing should be based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.

2240 – Engagement Work Program

Internal auditors should develop work programs that achieve the engagement objectives. These work programs should be recorded.

2240. A1 - Work programs should establish the procedures for identifying, analyzing, evaluating, and recording information during the engagement. The work program should be approved prior to *its implementation*, and any adjustments approved promptly.

2240. C1 - Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement

Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

2310 – Identifying Information

Internal auditors should identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

2320 – Analysis and Evaluation

Internal auditors should base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Recording Information

Internal auditors should record relevant information to support the conclusions and engagement results.

2330. A1 - The chief audit executive should control access to engagement records. The chief audit executive should obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330. A2 - The chief audit executive should develop retention requirements for engagement records. These retention requirements should be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2330. C1 - The chief audit executive should develop policies governing the custody and retention of engagement records, as well as their release to internal and external parties. These policies should be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2340 – Engagement Supervision

Engagements should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

2400 – Communicating Results

Internal auditors should communicate the engagement results.

2410 – Criteria for Communicating

Communications should include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410. A1 – *Final communication of engagement results should, where appropriate, contain the internal auditor's overall opinion and or conclusions.*

2410. A2 – *Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.*

2410. A3 – *When releasing engagement results to parties outside the organization, the communication should include limitations on distribution and use of the results.*

2410. C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420 – Quality of Communications

Communications should be accurate, objective, clear, concise, constructive, complete, and timely.

2421 – Errors and Omissions

If a final communication contains a significant error or omission, the chief audit executive should communicate corrected information to all *parties* who received the original communication.

2430 – Engagement Disclosure of Noncompliance with the *Standards*

When noncompliance with the *Standards* impacts a specific engagement, communication of the results should disclose the:

- *Standard(s)* with which full compliance was not achieved,
- Reason(s) for noncompliance, and
- Impact of noncompliance on the engagement.

2440 – Disseminating Results

The chief audit executive should communicate results to the appropriate *parties*.

2440. A1 - The chief audit executive is responsible for communicating the final results to *parties* who can ensure that the results are given due consideration.

2440. A2 - *If not otherwise mandated by legal, statutory or regulatory requirements, prior to releasing results to parties outside the organization, the chief audit executive should:*

- *Assess the potential risk to the organization.*

- *Consult with senior management and/or legal counsel as appropriate*
- *Control dissemination by restricting the use of the results.*

2440. C1 - The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440. C2 – During consulting engagements, risk management, control, and governance issues may be identified. Whenever these issues are significant to the organization, they should be communicated to senior management and the board.

2500 – Monitoring Progress

The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.

2500. A1 - The chief audit executive should establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

2500. C1 – The internal audit activity should monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Resolution of Management’s Acceptance of Risks

When the chief audit executive believes that senior management has accepted a level of residual risk that *may be* unacceptable to the organization, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

Appendix E

The Non-Executive Director

Introduction

The Non-Executive Director

The Board of Directors

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Obligations / Responsibilities

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Disclaimer

The Ministry of Commerce Mission

The Ministry of Commerce Vision

To make Bahrain as a global and competitive marketplace clustered around knowledge driven economy, and to become a model for innovation and timely customer services.

In addition, there are other laws that regulate the formation and operation of banks and insurance companies in Bahrain.

All companies operating in Bahrain must take one of the legal forms provided for in the Companies Law. Companies other than partnerships enjoy the benefit of having their liability limited to their share of the company capital, whereas partnerships generally are unlimited, with the exception of certain partnership types, which provide for both limited and unlimited partners.

Article 363 of the Companies Law provides, that any company established prior to the coming into force of the Companies Law, has a maximum period of 3 years from the effective date of the Companies Law to amend its articles of association to conform to the Companies Law, or else the company must be placed into liquidation.

2. The Non-Executive Director

In order to ensure that directors, both of private and public shareholding companies, are aware of their legal responsibilities, the MOC has set out, in other booklets in this series, the specific legal responsibilities and obligations of directors, in particular under the Companies Law, with regard to each of the company types provided for in the law.

This booklet, specifically considers the Non-Executive Director (“NED”) in the context of his/her functions, duties and responsibilities. In addition, it seeks to identify the contribution, which NEDs can make to the management of the company, while also identifying the moral and professional responsibilities, which they owe to their position. However, the duties and responsibilities of NEDs set out in this booklet are over and above the responsibilities, which NEDs generally have as a member of the Board. As such, it is prudent and

indeed necessary, in order for you to understand the duties, roles and responsibilities of NEDs completely, to also understand the role, responsibilities and duties of directors generally. In this context, we direct you to the booklet on director's specific legal obligations, which has been published by the MOC in this series of booklets.

3. The Board of Directors

Almost all corporate failures are linked in some way or the other to the poor performance of the directors, either in terms of the lack of awareness of their responsibilities (which in some instances extends to gross negligence), or to the abuse of their authority.

Directors need to be fully aware, not only of their legal responsibilities, but also of the wider role and obligations that they owe to shareholders in particular, and to other stakeholders in general.

*It is the responsibility of the board of directors (the “**Board**”) to provide strategic direction to the company independent, in particular, from management; this forms the basis on which the company's strategies and policies are built, and underpins the activity of the executive management in running the company. It is then, the Board's responsibility to ensure that an effective internal control mechanism is present to provide reasonable assurance that the company's objectives are being followed, in terms of identifying and managing business opportunities and risks, managing the company's assets, complying with all laws and regulations, and reporting all significant issues to the shareholders and other interested parties.*

It is the responsibility of directors to understand the business of the company, to be involved in its management through attendance at the Board meetings, and to ensure that the company abides by the law and its memorandum and articles of association. It is the director's responsibility to be familiar with such obligations and limitations as are prescribed in the law and the company's memorandum and articles of association.

It is not sufficient that directors ensure that appropriate control mechanisms have been installed; they also need to be certain that these mechanisms are being implemented, and are reviewed periodically to ensure their effectiveness and relevance.

Importantly, the chairman and members of the Board are jointly and severally liable to the company, shareholders and third parties for all acts of fraud, misappropriation and for every violation of the Companies Law and/or the company's articles of association, and for mismanagement of the company, generally.

The director's specific legal obligations and responsibilities are set out in other booklets in this series. In this particular booklet we will look at those other responsibilities and obligations which a conscientious and responsible NED owes to the company.

3.1 What is a NED?

By NED, we mean a director of a company who is not involved in the day to day management of the company i.e. a person who is not an “executive director”, but who is a member of the Board.

3.2 Obligations / Responsibilities

As members of the Board, NEDs must comply with the duties and obligations placed on directors under the Companies Law and other laws in Bahrain (as described in this and other booklets). However, the specific role of the NED over and above his or her role as a member of the Board includes assisting in the development of the company’s strategy by bringing his or her own expertise to the Board, bringing an independent view to the Board (being one step removed from the executive management of the company), reviewing the performance of the Board and executive, assisting in areas of potential conflict and ensuring that executive directors are accountable to the company’s shareholders.

In addition, the NED must ensure that appropriate control mechanisms are implemented and are followed on an ongoing basis to ensure:

- (a) That the company’s objectives are being followed;*
- (b) To identify and manage business opportunities and risks;*
- (c) To manage the company’s assets,*
- (d) That the company is complying with all laws and regulations; and*
- (e) That all significant issues are reported to the shareholders and other interested parties of the company.*

Accordingly, the NED will: (a) attend meetings of directors and the general assembly of shareholders, (b) receive a fee: (i) for

undertaking the role and responsibility of an NED (ii) in recognition of his inputs in bringing independent judgement, (iii) for bringing his expertise on such issues as strategy, risk and performance and (iv) for performing a supervisory function over the executive directors.

The Organisation for European Co-operation and Development (the "OECD") has published Principles of Corporate Governance intended to assist OECD Member and non-Member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. Part V of these Principles relates to the responsibilities of the board. In relation to the position of NEDs, the OECD states that "the board should be able to exercise objective judgement on corporate affairs independent, in particular, from management". In the OECD's notes to this principles it is acknowledged that the variety of board structures in different countries will require different approaches to implementing this principle, however states that board independence usually requires that a sufficient number of board members not be employed by the company and not be closely related to the company or its management through significant economic, family or other ties. Independent board members (i.e. NEDs) can "contribute significantly to the decision making of the board... can bring an objective view to the evaluation of the performance of the board and management... can play an important role in areas where the interests of management, the

company and shareholders may diverge". The Principles further state that, in unitary board systems, the separation of the roles of the chief executive and chairman is often proposed as a method of ensuring an appropriate balance of power, increasing accountability and increasing the capacity of the board for independent decision making.

A further OECD Principle states that "Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration".

The Principles also note that, as one of the responsibilities of the Board as a whole is to have access to accurate, relevant and timely information concerning the company, it is imperative that NEDs are given the same access to information as the executives (which is often not the case) to enhance their contribution to the management of the company.

4. Contribution, Commitment, Care

Directors of Bahrain public companies normally receive remuneration for their attendance at Board and general assembly meetings. The Companies Law limits such remuneration to a maximum of 10% of net profits after having issued at least a 5% dividend, and after having made all required provisions. In recognition of the importance of the Board, it is charged with the responsibility of steering the company to

achieve its "vision" and "mission" for the benefit of all stakeholders. It is the role of individual directors to effectively participate in this management process, to contribute to achieving the good performance of the company, managing its affairs so as to enhance shareholder value over the long term, and taking into account the interests of other stakeholders. At the same time the board and its directors must ensure that the company operates in accordance with the applicable laws and regulations. We might call this management at the 'macro' level, since whilst it may be necessary for directors to look at certain individual transactions, procedures, systems, management by NEDs is normally carried out at a higher level, and concerns itself in considering overall strategies and policies – that is, the bigger picture. It is the 'executives' of the company that manage the day-to-day operations and to an extent, especially in light of recent events, the NEDs oversee that this is done in the best interest of all stakeholders and they act to limit the control which the executives have to perform acts in the name of the Company.

*Nevertheless, in order for a director to make a positive and responsible **Contribution** to the performance and management of the company, simply attending and contributing at Board meetings is not sufficient. The directors need to make a greater contribution in terms of time and involvement, if they are to add value to the management of the company and ensure that their legal governance responsibilities are being fulfilled.*

The Companies Law does not restrict individuals from being directors of more than one company; however responsible directors will limit their directorships to a manageable number, which will permit a

sufficient **Commitment** to be made to each company. Sufficient commitment in this context depends on the nature and complexity of the company and the current circumstances, and economic climate relevant to the company's operations. In broad terms, a NED would normally be expected to spend 24 days + per annum on each directorship, which really interprets to mean that one executive and one non-executive position is just about the limit that could be handled by any one individual. In the past companies would often engage a NED on the Board simply for his name, and for the credibility, which this would provide to the company.

In many cases quite obviously the NED could not possibly perform the duty properly due to other commitments. How, for example, could a NED effectively participate in the management of a number of public companies, if he was also the Chief Executive of another company? The NED might be induced to act in this capacity simply for the prestige which this offered, but the responsibility and accountability now demanded of directors in accordance with good corporate governance standards, and the growing demands of shareholders in terms of accountability and transparency, means that this is no longer acceptable, and would-be NEDs should critically assess their ability to contribute before taking on such a position.

Article 185 of the Companies Law, provides for liability for, among other things, 'mismanagement' against the Chairman and Board. Accordingly, when carrying out his role a NED should exercise adequate care and attention so as to ensure that all issues are understood, and wherever uncertain on a particular issue, that he makes

sufficient effort to gain a good understanding and forms and independent opinion based on all material facts.

NEDs need to be aware of their role and responsibilities to shareholders, and the right of shareholders to hold the directors accountable for their actions, and to force through change. Companies are entities under collective ownership, and the director's role is to look to the interests of this collective ownership, failure to do this, may well result in shareholder action.

5. Who should be a director?

The new economy and the impact of information technology, is having a major effect on the dynamics of business; companies are increasingly turning to eCommerce as a part of their strategy, whether on a "business to business", or "business to customer" basis, and the complexity of the technology and of the businesses models, is placing a greater burden on NEDs to be conversant with current technology, whilst at the same time fully appreciating the traditional, 'bricks-and-mortar' model and values. In this section, we are not intending to discuss the legal qualifications or other prerequisites to become a director, but rather the desirable qualities and characteristics a person should possess in order to be appointed as a NED.

Typically directors are elected/appointed for the value and expertise which they can bring to the boardroom by virtue of their experience in the industry/areas which the company operates, or for proven experience in an executive capacity within the same or other relevant industry, or for their particular skills or qualifications. Accordingly, it is

in the interests of the company and its shareholders to elect/appoint directors who will:

- (a) Contribute effectively;*
- (b) Be committed to the aims of the company, and*
- (C) Exercise due care when considering boardroom and other management issue;*
- (d) Exercise independent judgement from the management of the company; and*
- (d) Have the knowledge, skills, experience and characteristics to effectively participate.*

Finally, in some countries an upper age limit is imposed for directors, typically of 70 years. Whilst there is currently no such limitation in Bahrain, shareholders should nevertheless give careful consideration to the age of the prospective NED

6. Institutional investment as an additional corporate governance check

While not specifically relating to the roles and responsibilities of the NED, we note that institutional investors are now playing an increasingly important role in contributing to good corporate governance, by seeking a more active role and participation in corporate governance and its implementation. In many countries institutional investors make up a significant percentage of the total investment population. In the USA, for example, institutional investors, including pension funds, hold around 50% of all listed stock. The focus of these institutional investors has been changing in recent years from that of 'trading' to longer-term ownership of shares, which has an

implication on participation in the management of the companies in which they invest. This paradigm shift is having an influence on corporate governance in the sense that institutional investors require a greater level of accountability and transparency, and have the back-office resources to ensure that they can play an effective role as concerned and active shareholders. The OECD has also considered this increasing trend in the following extract.

Extract from :OECD Principles of Corporate Governance

'.... Controlling shareholders, who may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behavior. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance...'

Institutional investment in Bahrain is usually held as a longer-term investment, but historically this has not been a significant sector. However, changes in the regulations permitting foreign ownership, the growing number of investment funds actively investing in local stocks, and the lack-lustre performance of overseas markets, is focusing investors' attention more on the local market, and will likely result in more active shareholder participation in future years, which will itself place a focus on the performance of directors.

The Companies Law provides that a number of shareholders who collectively own 10% or more of the company's shares, may request the chairman to include an issue on the agenda for a general assembly meeting, and in any event may discuss such issue at the request of interested parties. The effect of this provision is that active institutional

or other shareholders have the ability to call the Board to task over particular issues, and also to require change.

7. Transparency

While the next section considers the need for good corporate governance, here we focus on the issue of transparency.

The Oxford English Dictionary defines ‘transparency’ as being ‘...easily seen through; evident; obvious; easily understood; free from affectation or disguise....’

In its paper ‘Enhancing bank transparency, the Basel Committee on Banking Supervision stated that ‘it is difficult to hold the board of directors and senior management properly accountable for their actions and performance when there is a lack of transparency.’

It is important that all corporate governance issues be communicated to shareholders, and not only through the annual report, and that such communications should be clear, easily understood, and based on an open approach. One of the landmark corporate governance initiatives was the UK’s Cadbury Report 1992 (the principles of which are now set out in the Combined Code together with the principles of the UK’s Greenbury Report (1995) and the Hampel Report (1998)), which sets out a best code of practice, an extract of the relevant issues is given below:

Code of Principles

3.2 *The principles on which the Code is based are those of openness, integrity and accountability. They go together. Openness on the part of companies, within the*

limits set by their competitive position, is the basis for the confidence, which exists between the business and all those who have a stake in its success. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts Boards to take effective action and allows shareholders and others to scrutinize companies more thoroughly.

3.3 Integrity means both straightforward dealing and completeness. What is required of financial reporting is that it should be honest and that it should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.

3.4 Boards are accountable to their shareholders and both have to play their part in making that accountability effective. Boards need to do so through the quality of the information, which they provide, to shareholders, and shareholders through their willingness to exercise their responsibilities as owners.

Shareholders are increasingly demanding more accurate, timely and comprehensive information, regulators are looking into the respective roles of all stakeholders to ensure that they are held properly accountable, Boards are concentrating efforts on ensuring good internal control and risk management mechanism, and standard setters continue to review the efficacy of accounting standards in presenting a true and fair view of companies' financial situation.

In their book 'Building Public Trust' the authors present one possible model of corporate transparency:

The Three-Tier Model of Corporate Transparency

and state that 'Investors and other stakeholders will benefit fully only if companies communicate the information in each tier in an integrated fashion that provides a holistic view of the enterprise – its marketplace opportunities, its

strategies and their implementation, its value drivers, and its financial outcome..'

It becomes obvious that one the main responsibilities of the NED is to ensure that all stakeholders are kept well informed of all corporate governance issues...transparency, transparency, transparency.

8. Good Corporate Governance – it's in your hands

The recent corporate accounting scandals in the US have focused the public attention on the responsibility of the board of directors on managing the affairs of the company in the best interests of all stakeholders; these include not only shareholders, but also employees, creditors, and the community at large.

There are many issues which have been recommended as being critical to the establishment of good corporate governance, particularly in respect to public companies, and a number of landmark reports have been issued, including The Cadbury and Turnbull Reports, and the OECD 'Principles of Corporate Governance', all of which focus on the need for director's close involvement (particularly in strategic planning, risk management and performance assessment), the need for transparency and full disclosure, and the need for internal mechanisms that ensure that the governance objectives are met.

The board is responsible for identifying and managing risk, and this risk can come from numerous sources, including competition, failure of new products, risk of losing critical employees to name but a few. In addition to the need of identifying and managing risk, is the need to be equally able to identify new business opportunities, and where

necessary to take calculated business risks. Often the risk of taking no risk is riskier than the risk itself.

Good internal control mechanisms are critical to ensuring the objectives of all stakeholders are being met, and should, inter alia, include financial, operational compliance controls, as well as risk management policies which will significantly reduce the possibility of poor judgment in decision making, human errors, and deliberate breach of procedures.

It is also not sufficient that such controls and mechanism are built into operations; they must also be monitored for effectiveness, reliability and relevance.

Internal audits of the company and the establishment of an audit committee are also key components of a good corporate governance structure.

As a Partner or Manager responsible for the management of a WLL company, it is your responsibility to ensure that a good corporate governance structure is in place, and where it is not to raise your concerns, and advise your colleagues on the Board of the risk of not managing the affairs of the company in a manner which protects the interests of all the stakeholders.

9. Where to get help/advice

If you are in any doubt as to your responsibilities or obligations under the Companies Law and other laws in Bahrain, in relation to your position as a partner or manager of a WLL company, staff at MOC, will be only too pleased to assist.

You may also visit the OECD web site at www.oecd.org for information on Corporate Governance issues.

You should also make yourself familiar with the Companies Law, and with your company's memorandum of association and articles of Association.

If you have a question on any particular issue concerning your company, ask for an explanation from the key management staff responsible.

What every you do, do not keep silent if you are unsure about an issue, silence means acceptance, and could make you liable.

10. Role of MOC

MOC is primarily the Registrar of companies, but does also have a regulatory role in ensuring that companies comply with their obligations under the Companies Law. However the strategic focus of MOC is on ensuring that the commercial legal and administrative infrastructure is conducive to the development of globally competitive businesses, and it perceives good corporate governance, and the role-played by directors, as being the cornerstones of success.

11. Useful contacts:

Dr. Abdulla A. Mansoor : Undersecretary [Tel / Fax]

Mr. Ali Radhi, Assistant Undersecretary, Internal Trade

Mr. Abdulraheem Saeedi, Director of Company Affairs

www.commerce.gov.bh

12. Disclaimer

Every care has been taken to ensure the accuracy of the information in this brochure; however, MOC makes no warranty, and accepts no responsibility, for the completeness or accuracy of the information contained herein.

Directors should read the full text of the Companies Law and the memorandum and articles of association of the company or companies of which they are directors, and where uncertain on any particular point, seek legal advice to ensure a complete understanding of their obligations and responsibilities.

The Ministry of Commerce Mission

- *To provide a relevant, market-driven commercial infrastructure based on a suite of laws and regulations, which support Bahrain's legitimacy as a home for business, and which provides balanced protection for both investors and consumers.*
- *To promote and foster the take-up of eCommerce as a business driver in Bahrain to support business competitiveness, and as a growth sector in its own right.*
- *To provide an efficient, fast and cost effective incorporation service.*
- *To promote and foster the take up of ISO registration amongst Bahraini companies with a view to enhancing their international competitiveness.*
- *To promote the interests of Bahrain's companies by negotiating bilateral trade agreements with trading partners; and establishing trade representatives in strategic locations around the world.*
- *Represent the interest of the business community and the citizens of the Kingdom of Bahrain on the international arena through the active participation in WTO, UNCTAD, WIPO and other international organizations.*

- *Boosting the reputation of the kingdom of Bahrain in the sector of pearl, jewelry and gemstones through the provision of high quality testing and assay services.*
- *Creating a legal infrastructure that is inductive to fair competition and in accordance with the market economy principles.*
- *To enforce anti-trust laws as to combat monopolistic practices and suspicious trading.*
- *Promoting regional integration under the GCC umbrella.*
- *Promoting the Kingdom of Bahrain's as internal and regional center for exhibition and conventions.*
- *To adhere and promote recognized international standards and best practices.*
- *To ensure that the Kingdom of Bahrain has a voice in international trade issues, and that the Kingdom's interest and those of its citizens and corporations are represented in the global arena, through such organizations as the WTO, UNCTAD, WIPO etc.*
- *To provide an efficient gem and precious stones testing laboratory in order to ensure that the reputation of Bahrain as a home for natural pearls and quality jewelry is protected, and to promote the interests of local jewelers.*

<http://www.commerce.gov.bh/>

Monday , Sep 20, 2004

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