

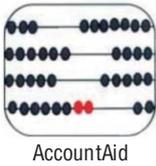
# AccountAble™

133. Internal Audit

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## IN THIS ISSUE

- The Audit Function • What is Internal Audit? • Financial Audit • Tax Audit • Grant Audit • Internal Audit pg1
- Does Size Matter? • Benefits • Frequency and Coverage pg2
- Fees and Costs • Who Should Do it? • Internal Staff • Independent Firm pg3
- The Hearing pg4



Do NGOs need internal audit? How will it help them? Who will bear the cost of internal audit? Who can do this audit?

This issue of AccountAble looks at some of the above.

### The Audit Function

In good old days, when the owner and the manager were the same, there was no need for an audit. As things became more complex, owners felt the need to ensure that the managers did not cheat them. This led to the emergence of auditors.

### What is internal audit?

Till quite recently, there was only one type of audit. As organisations and processes became more complex, specialisation emerged. Presently, the following types of audits are common:

#### Financial Audit

This is also known as statutory audit, as it required by statute (law). This involves review of General Purpose Financial Statements.

#### Tax Audit

This audit is done on behalf of the Income Tax Department. A special purpose report is issued. This helps the Tax Department figure out whether any extra tax should be assessed.

For commercial concerns, this is done under section 44AB of the Income Tax Act. A report is issued in form 3CD<sup>1</sup>.

For NPOs, this is required under section 12A. A report is issued in form 10B.

#### Grant Audit

This audit is done on behalf of the donor agency.

A special purpose report is issued. This involves determining whether grant funds have been spent properly.

#### Internal Audit

Internal audit is part of the internal control system. It helps the management to identify errors and problems in accounting and control systems. A



special purpose report is issued for the management.

In large companies, internal audit is like a compulsory requirement. Statutory auditors are required<sup>2</sup> to comment on the quality of the internal audit system.

It is not compulsory for NPOs to have internal audit. However, larger NPOs often introduce internal audit to reassure themselves.

<sup>1</sup> Accompanied by form 3CA or 3CB

<sup>2</sup> Companies (Auditor's Report) Order, 2003

## Does Size Matter?

When does internal audit become useful? This mainly depends on the size and complexity of the NGO. Therefore, it is not easy to lay down hard and fast rules for this. Broadly speaking, it is useful when the organization is big, is working through multiple offices and has complex operations.

A simple thumb rule would be that an NGO with an annual income of Rs. 1 crore or above would find it a useful investment of time and money.

As the NGO grows in size, the utility of internal audit also grows. By the time an NGO crosses Rs. 5 crores, internal audit should be considered as an essential requirement of good governance.

## Benefits

Internal auditors perform several useful functions. They help in ensuring that your control systems are functioning, and are also relevant to your needs.

This may involve looking at accounting to ensure that only genuine expenses are accounted, under the correct accounting head and budget codes. They can also review propriety aspects to ensure that undue favors are not shown in recruitment or purchases etc.

They can also examine legal compliance and make sure that you don't get into trouble with the law. And of course, they are supposed to keep a sharp eye out<sup>3</sup> for any fraud or diversion.

The audit may also involve their looking at the systems to make sure that all checks and controls are actually being carried out properly. In many cases, the auditors also help you evaluate and fine-tune your systems in an ongoing manner.

What internal auditors do depends entirely on their terms of reference. Therefore, careful thought must be given to framing these

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before the audit is taken up. It is usual to frame the terms of reference in consultation with the auditors.

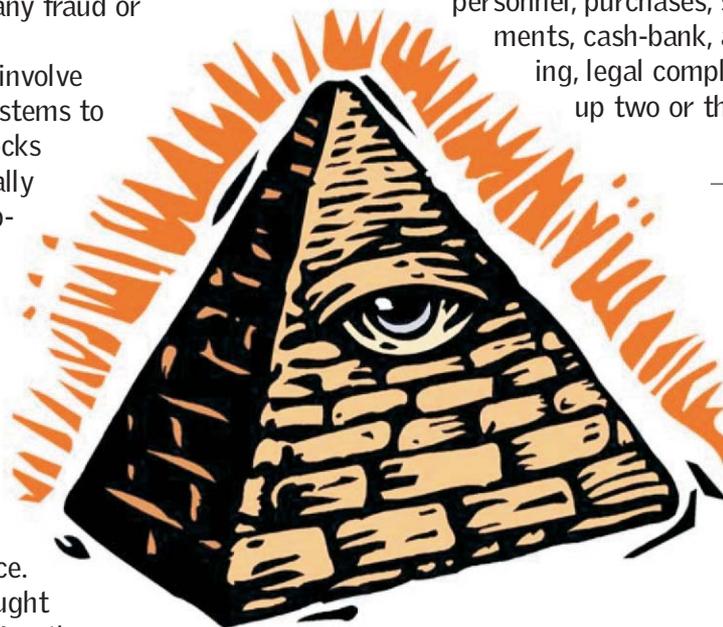
## Frequency and coverage

The frequency of audit depends on the terms of reference and your needs.

If you have set up your own department, then audit will continue throughout the year. The team will cover different areas or regions from time to time.

If an independent firm is doing the audit, it may be done monthly, quarterly or half-yearly. In order to be useful, internal audit must look at fairly recent transactions.

The audit coverage may be designed on the basis of regions or departments. Some auditors also divide their work into different audit areas, such as personnel, purchases, stock, grant disbursements, cash-bank, advances, donor reporting, legal compliance, etc. They then take up two or three areas in each audit.



<sup>3</sup> The Institute of Chartered Accountants of India has also adapted a verse from the *Kathopanishad* (2.2.8) as its motto: य @; स ढतु ङगित ढThat person who is awake when everything is asleep). The ever-watchful eye seems to be a favorite symbolism with auditors across the world.

## Fees and Costs

This normally depends on the size and seniority of the audit team. The complexity of your work, regional dispersion, frequency of reporting also have a bearing on the costs. To give you an indication, a firm may budget any thing between a lakh to three lakh rupees for an organization with about 2 crores of annual expenditure and 2-3 branch offices. Travelling and out of pocket expenses are budgeted separately.



## Who should do it?

If you want to introduce internal audit, an important question is regarding staffing. Should your own staff do this? Can you outsource it to an independent firm? Can your statutory auditors do this also?

### Internal Staff

Some organizations set up an internal audit department. There are several advantages in this. Firstly, this can be cheaper if your organisation is large, and there is enough work to keep the auditors occupied throughout the year. Secondly, you can have more control over the team, in terms of coverage and consistency of focus. Thirdly, follow-up tends to be better in such cases. Fourthly, an internal department tends to develop a deeper understanding of your work and organisation. This helps improve quality of work.

On the other hand, an internal audit department may develop a closed perspective, as they do not get exposed to diverse audits. Secondly, it could lose independence due to administrative interference or pressure from colleagues. This may result in loss of effectiveness. Thirdly, internal audit department is sometimes used as a spare wheel— people are borrowed whenever another department is short staffed.

If the disadvantages outweigh the advantages, an organization may appoint an independent firm as internal auditors.

### Independent Firm

In India, CA<sup>4</sup> firms usually provide internal audit services. Some firms specialize in this area, while others may be doing a wider spectrum of work.

However, NPO internal audit is quite different from corporate internal audit. Therefore, NGOs usually prefer a firm familiar with their environment and operating conditions.

CA firms have the advantage of independence, experience, professional expertise and exposure to a wide variety of audit situations. They are also able to guide you on current best practices in other organizations. For smaller NPOs, appointing a CA firm also makes good sense from the point of view of cost.

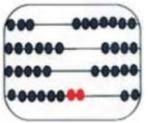
However, their work may also suffer due to frequent change of staff, and lack of personal attention from senior partners.

In the case of NPOs<sup>5</sup>, the same CA firm<sup>6</sup> can do internal and statutory audit.

<sup>4</sup> Chartered Accountant

<sup>5</sup> Even where the NPO is a section 25 company, the normal rules of separation of internal audit and statutory audit do not apply, as such companies are exempt from CARO [clause 2 (iii) of Para 1 of CARO].

<sup>6</sup> Some CA firms have a policy of not accepting both internal and statutory audit of an organisation at the same time.



## The Hearing



The word audit comes from the Latin *auditus*, which means a hearing. In old times, the owner of an estate would send a person to check whether the estate was being run properly. The manager would then meet him and verbally *narrate* all the details of crops, livestock etc. This came to be called *auditus* or a hearing. The person, who heard the accounts, was called an auditor.

This was a time when only the clergy knew how to read or write. Gradually, as common people also learned how to write, accounts came to be written on paper.

Auditors have also evolved over the years. They no longer hear accounts verbally. However, the term 'auditor' has remained in popular (or unpopular) use.

## What is AccountAble?

Each issue of 'AccountAble' covers a different topic related to NGO regulation or accounting and is mailed to about 3,500 persons in NGOs, Agencies and audit firms. AccountAid encourages reproduction or re-distribution of 'AccountAble' in workshops or NGO newsletters for non-commercial use, provided the source is acknowledged.

## Interpretation of law

Interpretation of law given here is of a general nature. Please consult your advisors before taking any important decision.

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अकाउण्टेबल हिन्दी में 'लेखा-योग' के नाम से उपलब्ध है।

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## Questions and doubts?

AccountAid provides complimentary advice to implementing NGOs and NGO auditors on matters related to accounting or financial regulation. You can send your questions by e-mail or letter. You can also discuss these over the phone.

## Comments

Your comments and suggestions can be sent to AccountAid India, 55-B, Pocket C, Siddharth Extension, New Delhi - 110 014; Phone: 011-2634 3128; Phone/Fax: 011-2634 6041; e-mail: [accountaid@vsnl.com](mailto:accountaid@vsnl.com); [accountaid@gmail.com](mailto:accountaid@gmail.com)  
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