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AuditAble

Very few NGOs in India have an internal audit system. You can't blame them either-apart from the statutory audit, tax-audit and FCRA audit, they have to frequently face donor-instituted audits as well.

However, it is also true that a good internal audit could gradually reduce the need for donor audits.

In this inaugural issue of AuditAble, we discuss some of the technical issues associated with internal audit of NGOs.

Meaning of Audit

What does the word 'auditor' mean? Simply one who listens. In early days, an auditor would *listen* to the accounts narrated by the manager. Partly this was because reading and writing was not commonly known, except among the clergy.

The history of audit in India is somewhat different. Reading and writing skills were well-advanced from an early date.

Therefore, auditors did not have to be called auditors. They were instead called *ganak* (गणक)¹. *Arthashastra*² provides detailed guidance on manner of accounting³ and its verification⁴. It even lays down the fine to be levied when an accountant delays in producing the books for audit⁵. Similarly, *Mahabharat* contains references to auditing⁶. *Shukra Neeti* also provides guidance on types of income and accounting processes⁷.

However, all these books refer to Government accounting or auditing. Very little is known about commercial accounting. Similarly, little is known about temple or ashram accounting.

¹ *Udyog Parv-Sanjay Yaan Parv* (5.2.30.26, vol. 3, p. 2117), *Mahabharat*

² Possibly composed around 2400 years ago (321-300 BCE)

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अध्यक्षप्रचारः

[2.7.15

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[पञ्चविंशं प्रकरणम् - अक्षपटले गाणनिक्याधिकारः]

अक्षपटलमध्यक्षः प्राङ्मुखमुदङ्मुखं वा विभक्तोपस्थानं निबन्धपुस्तकस्थानं कारयेत् । १ ।

तत्राधिकरणानां संख्याप्रचारसंजाताग्रं, कर्मान्तानां द्रव्यप्रयोगवृद्धिक्षयव्ययप्रयामव्याजीयोगस्थानवेतनविष्टिप्रमाणं, रत्नसारफलगुक्प्यानार्घ्वप्रतिवर्णकमानप्रतिमानोन्मानावमानभाण्डं, देशग्रामजातिकुलसंघानां धर्मव्यवहारचरित्रसंस्थानं, राजोपजीविनां प्रग्रहप्रदेशभोगपरिहारभक्तवेतनलाभं, राज्ञश्च पत्नीपुत्राणां रत्नभूमिलाभं निर्देशौत्पातिकप्रतीकारलाभं, मित्रामित्राणां च संघिविग्रहप्रदानादानं निबन्धपुस्तकस्थं कारयेत् । २ ।

ततः सर्वाधिकरणानां करणीयं सिद्धं शेषमायव्ययौ नीवीमुपस्थानं प्रचारं चरित्रं संस्थानं च निबन्धेन प्रयच्छेत् । ३ ।

उत्तममध्यमावरेषु च कर्मसु तज्जातिकमध्यक्षं कुर्यात्, सामुदयिकेष्ववकृतिकं यमुपहत्य राजा नानुत्प्येत । ४ । सहग्राहिणः प्रतिभुवः कर्मोपजीविनः पुत्रा भ्रातरो भार्या दुहितरो भृत्याश्चास्य कर्मच्छेदं वहेयुः । ५ ।

त्रिशतं चतुःपञ्चाशच्चाहोरात्राणां कर्मसंवत्सरः । ६ । तमाषाढीपर्यवसानमूनं पूर्णं वा दद्यात् । ७ । करणाधिष्ठितमधिमासकं कुर्यात् । ८ ।

³ 2.6.12-28, Sh. R.P. Kangle's *Kautiliya Arthashastra*, Vol. 2, pp. 78-80

⁴ 2.7.1-41, pp.80-85, *Ibid*

⁵ 2.7.21, 2.7.34, pp. 83, 84, *Ibid*

⁶ *Sabha Parv-Lokpal Sabha Aakhyan Parv* (2.2.5.73, vol.1, p.681) *Mahabharat*

⁷ Ch. 2, *shlok* 321-352

Internal Audit by Statutory Auditors?

It is commonly believed that statutory auditors should not do internal audit. What is the basis for this view?

If we trace the history of this function, we find that in earlier times, it was common for the same firm to provide both the services.

This made sense as the organization did not have to deal with multiple audit firms. The understanding gained by the firm during internal audit would help reduce the time and effort for the statutory audit. The overall costs of the audit would also come down as the total time would reduce. Further, effectiveness of both the audits would increase.

However, this changed with the introduction of MAO-



CARO in 1975 for companies. MAOCARO was an initiative undertaken to improve the governance and accountability of companies. This required the statutory auditors to comment on several aspects of governance and legal compliance.

One of the aspects they needed to comment on was the quality and effectiveness of internal audit at the company. This created an ethical problem.

Let us say that firm ABC is doing the statutory audit, where it certifies the financial statements, and gives MAOCARO comments. It is also doing the internal audit, for

which it gives separate reports. In the MAOCARO comments, the firm would also have to say that it is doing a good internal audit.

This kind of self-review was seen as a threat to independence. How can you yourself say that you are doing a good job? Apart from being immodest, it would also be unethical. Therefore, The Institute of Chartered Accountants of India issued a ruling. It said that the same firm should not undertake both the audits.

“A statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report issued under sub-section 4A of section 227 of the Companies Act, 1956 read with the Companies (Auditors’ Report) Order 2003.”⁸

This resulted in a separation of the two, so far as the company audits were concerned. While initially it was a matter of compliance, gradually this became a generally accepted practice.

However, should this practice be applied to the NGO sector also? We don’t think so. Remember, the basic logic of the ICAI ruling was that an auditor can not comment on their own work. This comment was required as part of MAOCARO. MAOCARO⁹ does not apply to the NGO sector.

Therefore, in our view, so long as the statutory auditors do not comment on the quality of internal audit in an NPO, it would be perfectly fine for them to undertake both.

However, some auditors think that the same principle should be extended to NGO audits as well, and statutory auditors should not take up internal audit as well for the same client.

In such a situation, it would be best for you to take an informed decision¹⁰ or approach the Council for a definite ruling.

⁸ Para 3.4.15, ICAI Guidance Note on Independence of Auditors (Revised), Jan-2005

⁹ Now renamed as CARO, 2003 [Companies (Auditor’s Report) Order]. Section 25 companies exempted vide clause 2 (iii) of Para 1 of CARO.

¹⁰ Refer to para 1.3 of the above mentioned Guidance Note for a definition of independence; para 1.9 for a test of reasonableness; para 2.1-2 for a discussion of self-review threats; and para 3.4.9 for rules related to public sector audits. Para 4.2 provides the overarching philosophy behind the note.

Terms of Reference

The design and direction of the Internal Audit depends very much on the Terms of Reference. These are usually finalized jointly by the client and the auditor. At this stage, you need to take into account what kinds of issues are important to the management.

It is also important to remember that your client may not have a deep understanding of the role and advantages of internal audit. Therefore, you also need to assess what additional issues should be covered—just as a good doctor may go beyond the symptoms described by the patient.

Key Issues

The orientation of an internal audit may be more towards transaction verification, or towards system testing. A third possible approach could be donor assurance: this would focus on whether justifiable expenses have been charged to correct budget heads.

1. Transaction Verification

This involves extensive vouching and review of transactions. The objective is to reassure oneself that account books have been maintained properly. Other routine tests such as asset verification (cash, equipment, etc.) are also carried out.

This orientation is useful for smaller organizations, where the accounts department is not fully developed and stable.

2. System Assurance

This would involve looking at different areas of the control system to assess whether these are functioning properly. Common areas include cash-bank, sales-income, purchases, distribution¹¹, stock control, payroll, program expenses, statutory compliance, cost-reduction, fixed assets usage, etc.

During such an audit, some auditors also make systems suggestions. This is partly in response to management expectations. However, this is frowned upon by the purists, who see system-design and system-audit as two different functions, which should be undertaken by independent teams.

3. Donor Assurance

This approach is designed to reassure the donors that their funds are being spent properly. This focuses on looking at budgeting, budget monitoring, cost-effectiveness, distribution of assistance, internal transparency, governance, quality and timeliness of donor reporting, etc. Some test-verification of program expenses is also included in most cases.

Reports

What kind of reports should be written for NPOs? In NPOs, the users of internal audit reports are likely to be people who are not familiar with audit jargon. Therefore, the reports should be written in a non-technical way.

Specific details should be provided for each observation—just giving voucher references does not help. Details could include particulars about the nature of expense, and the persons involved in the transaction.

You also need to guide the reader on the implications of an observation. For instance, a cautiously worded statement such as ‘support not found’ may not mean anything at all to an NPO user. You need to take the next step and tell the reader what exactly does this mean.

If you are making any system recommendations, then the background and rationale must be explained in clear, simple language. If this is not done, then the recommendation may not get implemented.

Most NGOs are anti-system to some extent, and tend to avoid records and procedures, which reduce flexibility or increase operating overheads. Therefore, you should be economical in your system recommendations.



¹¹ This refers to distribution of assistance among beneficiaries

What is AuditAble: Each issue of ‘AuditAble’ covers a different topic related to NGO auditing and is mailed to about 500 NGO auditors in India. AccountAid encourages reproduction or re-distribution of ‘AuditAble’ in professional circles for non-commercial use, provided the source is acknowledged.

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