CHAPTER I

INTERNAL AUDIT SERVICES – FRAMEWORK AND STRUCTURE

1. Background

1.1 The Royal Government of Bhutan (RGoB) established an Internal Audit Service (IAS), as part of its efforts to further enhance good governance, transparency, accountability and efficiency and effectiveness of government operations, including risk management and the internal control framework of Ministries and all government entities that directly receive and manage budget allocations.

1.2 The RGoB has already established Internal Audit Divisions (IADs) in all Ministries and Dzongkhags. Subject to the availability of adequate and appropriate resources, it is the policy of the RGoB to establish IADs in other budgetary bodies as well.

1.3 Under Section 23 (O) of the Public Finance Act, 2007, the Ministry of Finance (MOF) has the responsibility for administering the IAS, and issuing guidelines.

1.4 In fulfilling its responsibility under the Public Finance Act, 2007, the Ministry of Finance has established an Internal Audit Charter. The Charter provides the organizational framework for the provision of internal audit services and prescribes policies, standards and responsibilities for the efficient and effective functioning of the IAS in the RGoB.

1.5 In order to ensure that the internal audit services are provided in a professional manner and in accordance with best international practices, the Ministry of Finance has adopted the International Professional Practices Framework (IPPF), issued by the Institute of Internal Auditors to regulate the work of the IAS. The IPPF comprises the:

   (i) Definition of Internal Audit – Schedule I.

   (ii) Code of Ethics for Internal Auditors – Schedule II.

   (iii) Internal Auditing Standards – Schedule III

2. Management Responsibilities and Accountability Framework

2.1 The Public Finance Act, 2007 declares that the Kingdom of Bhutan shall have a sound system of public finance based on the principles of: (a) Efficiency; (b) Economy; (c) Effectiveness; (d) Equity; (e) Sustainability; (f) Transparency; and (g) Accountability.

2.2 Following these principles, the Public Finance Act, 2007 assigns various responsibilities to the MOF, the Ministries, Dzongkhags and other budgetary bodies with respect to the proper management of public finances. The Ministry of Finance has issued Financial Regulations to further elaborate the provisions of the Act and prescribe more detailed policies and procedures to ensure that the aforementioned principles are implemented. The Act, and the Financial Regulations, together, establish the environment for the proper management of public finances in the RGoB.

2.3 Chief Executives and officials of Ministries, Departments, Dzongkhags and other budgetary bodies, as responsible managers, have to establish appropriate risk management and internal control systems to ensure compliance with the Public Finance Act, 2007 and the Financial Regulations so that the goals and objectives of their respective Organizations are achieved efficiently and effectively.

2.4 The IADs play a critical role in providing the Chief Executives of their respective organizations independent and objective assurances that the governance, risk management and internal control systems of their entities are in fact meeting their objectives. In addition, the division also assist the Chief Executive identify opportunities for achieving the organizational goals and objectives in an efficient and effective manner.

3. Organizational Structure of Internal Audit Services

3.1 Based on current RGoB policy, the IAS consists of:

(i) **The Central Coordinating Agency/Internal Audit Bureau, Ministry of Finance (CCA/IAB)** - This body enables the Ministry of Finance to fulfill its statutory responsibilities under Section 23 (o) of the Public Finance Act, 2007 for administering the IAS, issuing appropriate guidelines on internal auditing in the RGoB and coordinating the activities of the IAS in enhancing the quality and reliability of the internal audit work.

(ii) **Internal Audit Division (IAD)** - These are established in all Ministries, and in designated Dzongkhags and other entities that receive and manage budget allocations through the government budget. An IAD is an entity headed by a Chief Internal Auditor (CIA) and consists of a team of Internal Auditors and support staff. The division is responsible for providing internal audit services in accordance with the Internal Audit Charter and in compliance with the Code of Ethics for Internal Auditors, Standards for Internal Auditing and other guidelines issued by the Ministry of Finance. The CIA reports directly to and is functionally responsible to the Chief Executive of the entity where the IAD is established.

4. The Internal Audit Charter

> *IIA Standard 1000 - Purpose, Authority, and Responsibility:*
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> *The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The Chief Internal Audit must periodically review the internal audit charter and present it to senior management and the board for approval.*

4.1 The IAS in RGoB is established by the Internal Audit Charter issued by the Ministry of Finance. The Charter mandates the IAD to conduct internal audit within an entity in the RGoB. The Charter specifies the responsibilities and authorities of the CIA and the IAD with respect to the audit function and requires the internal audit activities to be managed in accordance with the Code of Ethics for Internal Auditors, the Standards for Internal Auditing and other guidelines issued by the Ministry of Finance.

4.2 The CIA is functionally responsible to the Chief Executive of the entity for the efficient and effective management of the audit function in accordance with the Internal Audit Charter.

4.3 The Charter also prescribes the responsibilities of the Chief Executive and management of the entity with respect to the internal audit function. In particular, the Chief Executive has responsibility to ensure that the IAD is properly resourced and is operationally independent so as to enable it to provide independent and objective assurance, opinions and reports. The Chief Executive also has responsibility to ensure that all audit findings and recommendations are properly acted upon.

5. Definition and Purpose of Internal Audit

5.1 The Institute of Internal Audit has defined Internal Audit as:

"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."

5.2 Based on the above IIA definition, the RGoB has accordingly defined the purpose of the Internal Audit in the Internal Audit Charter as:

"The Internal Audit Units conduct audits and reviews, using a systematic and disciplined approach, to provide the respective Chief Executives of Ministries, Dzongkhags and other budgetary bodies with:

(i) Independent and objective assurance on the efficiency and effectiveness of their respective Entity's governance, risk management, control and accountability processes.

(ii) Proposals and recommendations for improving the efficiency and effectiveness of the Entity's operations, achieving organizational objectives and proper stewardship of resources."

6. The Code of Ethics for Internal Auditors

6.1 As the profession of internal auditing is based on the trust placed in its independent and objective assurance, opinions and reports about governance, risk management, and control, it is necessary that it be governed by a Code of Ethics.

6.2 The Code of Ethics for Internal Auditors, adopted by the Ministry of Finance, consists of a set of Principles relating to Integrity, Objectivity, Confidentiality and Competency. In addition the code include Rules that describe the behaviour norms expected of professional internal auditors, assist in the interpretation and practical applications of the Principles and guide the ethical conduct of internal auditors.

6.3 Conducting audit work in accordance with ethical principles is the responsibility of both the CIA and the staff of an IAD. The credibility of the internal auditors and the internal audit reports, among others, is gauged on compliance with the Code. The Code also enables Internal Auditors to foster a culture of ethics, an important cornerstone of good governance, within their organization.

6.4 The users of this Manual should study and familiarize themselves with the Principles and the Rules contained in the Code of Ethics adopted and issued by the Ministry of Finance. Civil service regulations and rules also contain various elements that relate to the ethical conduct of civil service staff. Adherence to the Code of Ethics does not absolve the Internal Auditors from compliance with the rules and regulations of the civil service. In the event of any conflict between the two, appropriate guidance should be obtained from the CCA/IAB.

7. Internal Auditing Standards

7.1 The purpose of the Auditing Standards, issued by the IIA, and adopted by the Ministry of Finance, is to:

    (i)   Outline basic principles that represent the professional practice of internal auditing.

    (ii) Provide a framework for performing and promoting a broad range of value-added internal auditing services.

    (iii) Ensure its relevance in Bhutanese context

    (iv) Establish the basis for the evaluation of internal audit performance.

    (v)   Foster improved organizational processes and operations

7.2 The Standards are divided into Attribute and Performance Standards. Attribute Standards (1000) address the attributes of organizations and individuals performing internal auditing. The Performance Standards (2000) describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured.

7.3 The IIA also from time to time issues Practice Advisories related to specific standards to provide clarification on particular issues. These Advisories deal with most aspects of planning, conducting and reporting the internal auditing engagement, as well as with the management aspects of the internal audit activity. These are listed and referred to in the relevant Chapters, where appropriate and necessary.

7.4 All Internal Auditors must comply with the Auditing Standards. Internal Auditors therefore need to thoroughly familiarize themselves with and obtain a good understanding of the Auditing Standards, including the interrelationships between different Standards. Practice Advisories should also be reviewed together with the Standards.

7.5 The Auditing Standards directly relevant to the specific subjects under discussion in the various Chapters of the Manual have been reproduced in text boxes for easy reference and for better understanding of the audit processes.

8.   Professional Attributes of the Internal Audit Unit and the Internal Auditors.

The importance of adhering to the Code of Ethics and the Auditing Standards has already been emphasized. This Section discusses some of the more critical attributes, encompassed in the Code of Ethics and the Attribute Standards that provide the foundation for the professional practice of Internal Auditing. These relate to the quality, integrity and credibility of the work undertaken by the IADs and the Internal Auditors in every step of the audit process and activity.

8.1   Independence and Objectivity

IIA Standard 1100 - Independence and Objectivity:

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

IIA Standard 1110 - Organizational Independence:

The Chief Internal Audit must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The Chief Internal Audit must confirm to the board, at least annually, the organizational independence of the internal audit activity.

8.1.1   Independence is an essential condition for ensuring that the work of the CIA and the IAD is free from any form of bias or influence and is in fact impartial. The Charter has various provisions to ensure the organizational, functional, operational and reporting independence of the CIA and the staff of the IAD. These include:

(i)   The CIA reports to and has direct access to the Chief Executive.

(ii)   The Chief Executive approves the Annual Workplan of the IAD and monitors its execution through communications received from the CIA.

(ii)   The CIA has unhindered access to all forms of information, employees, contractors and facilities of the entity for the purpose of performing the internal audit function.

(iii)   The CIA or the IAD have no direct authority or responsibility for the activities it reviews. In particular, the staff of the IAD have no direct responsibility for developing or implementing procedures or systems and do not prepare records or engage in original line processing functions or activities.

(iv)   The IAD is provided an independent budget allocation to fund the internal audit activity.

(v)   The CIA and IAD is able to conduct audits and report findings, opinions, and conclusions objectively without fear of reprisal.

8.1.2   IIA Practice Advisories 1110-1: Organizational Independence provides further guidance concerning Independence.

IIA Standard 1120 - Individual Objectivity:

Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

8.1.3   Objectivity in carrying out professional responsibilities is another attribute that is essential to ensure the credibility of auditing. Objectivity includes:

(i)   Being independent in fact and appearance when carrying out audit engagements.

(ii)   Maintaining an attitude of impartiality,

(iii)   Having intellectual honesty.

(iv)   Being aware of conflicts of interest and acting accordingly.

8.1.4   IIA Practice Advisory 1120-1: Individual Objectivity should be referred to for further guidance on the subject.

8.1.5   Conflict of interest is a condition that affects not only the auditors themselves but also the Auditees. Conflict of interest may be defined differently across different organizations. IIA defines conflict of interest as "a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfil his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively."

8.1.6   Individual Auditors have to ensure that they understand and adhere to the Code of Ethics and report any impairment of independence or objectivity to the CIA, particularly when there is a conflict of interest situation. The CIA has to ensure that due consideration is given to presence of any actual conflicts of interest or potential bias while giving assignments. Individual Auditors should report any impairment to their independence and objectivity to the CIA.

IIA Standard 1130 - Impairment to Independence or Objectivity:

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

8.1.7   Impairment to organizational independence and individual objectivity may occur as a result of many situations and factors. Some such instances include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding. IIA Practice Advisory 1130-1: Impairment to Independence or Objectivity provides further guidance on the subject.

8.1.8   When impairment occurs or is perceived to have occurred, the CIA should take appropriate action to remove the impairment. If the impairment persists, the CIA should disclose the nature of the impairment to the Chief Executive of the organization, together with an assessment of its impact upon the internal audit activity and the organization and recommendations to address impairment.

8.1.9 So long as an independent, objective and factual perspective has been maintained in their work, Internal Auditors should be prepared to fully defend their findings and recommendations against challenges. They must be prepared to demonstrate that rigorous relevant and reliable methodologies have been applied and that adequate and sufficient relevant evidence, appropriate in quality and quantity, has been obtained to support findings and conclusions.

8.2 Proficiency and Due Professional Care

IIA Standard 1200 - Proficiency and Due Professional Care:

Engagements must be performed with proficiency and due professional care.

IIA Standard 1210 - Proficiency:

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

IIA Standard 1220 - Due Professional Care:

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

8.2.1 The quality of internal audit work relate to Proficiency and due professional care. The credibility, reliability of audit findings and recommendations rest on these two important attributes. Consequently the need to exercise due professional care is emphasized throughout the Manual. All Internal Auditors should carefully review the following three IIA Practice Advisories on the exercise of due professional care:

  (i) Practice Advisory 1200-1: Proficiency and Due Professional Care.

  (ii) Practice Advisory 1210-1: Proficiency.

  (iii) Practice Advisory 1220-1: Due Professional Care.

8.2.2 The standards require auditors to apply knowledge, skills, and experience needed in performing internal audit services. As a matter of general policy and practice, Internal Auditors should:

  (i) Engage only in those services for which they have the necessary knowledge, skills, and experience.

  (ii) Perform internal auditing services in accordance with the Internal Auditing Standards and other authoritative guidance.

  (iii) Improve their proficiency, skills and effectiveness on a continuous basis to enhance the quality of their services.

8.2.3   The staff assigned to perform an audit engagement must collectively possess adequate professional competence for the tasks required. These competencies are identified in the position descriptions, job announcements, and the selection process for auditor positions. Competence is a qualitative attribute that is derived from a combination of both education and experience. Using these criteria, the CIAs should generally ensure that the staff assigned to conduct an audit engagement has:

(i)   The technical knowledge and skills collectively to competently perform the work on the assignment.

(ii)   General knowledge of the subject matter under review and the environment in which the audited entity operates.

(iii)   The experience to apply knowledge to the work being performed.

(iv)   Skills to communicate clearly and effectively, both orally and in writing.

(v)   Specific skills appropriate for the work being performed (i.e. statistical sampling, information technology, specialized audit methodologies and analytical techniques, etc.).

8.2.4   IIA standards also require Internal Auditors to have:

(i)   Sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

(ii)   Internal auditors must have sufficient 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.

8.2.5   As the range of audit work is broad and diverse, Internal Auditors should stay abreast of developments in the profession, Internal Auditors are encouraged to maintain competence by a commitment to learning and development throughout their professional career. Competence enables an auditor to make sound professional judgments.

8.2.6   The IAS will continuously assess staff competencies against identified needs and endeavour to upgrade the collective competencies of staff within the IAS through a programme of staff development so as to ensure the professionalism of the IAS.

8.2.7   Due professional care impacts the quality of the audit work and therefore has to be conscientiously exercised throughout the audit planning, execution and reporting phase. The CIA should establish procedures and workflow to ensure that due professional care is indeed exercised at every phase of the audit activity.

8.2.8   Internal auditors must exercise due professional care, as per IIA Standard 1220.A1, in considering the:

(i)   Extent of work needed to achieve the engagement's objectives.

(ii)   Relative complexity, materiality, or significance of matters to which assurance procedures are applied.

(iii) Adequacy and effectiveness of governance, risk management, and control processes.

(iv)   Probability of significant errors, fraud, or noncompliance.

(v)   Cost of assurance in relation to potential benefits.

8.2.9   The exercise of due professional care is greatly facilitated and enhanced when Internal Auditors use technology-based audit and other data analysis techniques in their work.

8.3.   Confidentiality

8.3.1   The term confidential means and applies to all sensitive or restricted information. It relates to both information obtained from an entity during the course of audit and the results of the audit itself. These are privileged information. Internal Auditors, unless authorized by the Internal Audit Charter or required by law, should take care not to disclose any information obtained during the audit process.

8.3.2   When information is requested by third parties, including other government agencies, they should be advised to approach the management of the entity.

8.3.3   Information obtained during the audit process should only be used for the purpose of the audit. Such information should not be used inappropriately for personal gain or in a manner contrary to the legitimate interests of the entity.

9.   Audit Process - Overview

9.1   Introduction

9.1.1   Different internal audit organizations may identify a number of steps using a variety of terminology to identify and delineate the audit phases. For the purpose of IAS in the RGoB, the internal auditing process essentially comprises four main phases, as outlined in the following sections and summarized in Annex I -1.

9.2   Planning - Audit Strategy and Annual Audit Plan

9.2.1   At the most fundamental level, the CIA and IAD must establish what is going to be audited through a risk based planning process. This will generally determine the audit activities to be undertaken during the next year and the following two years.

9.2.2   The Annual Plan would include a number of Audit Engagements that have been prioritized on the basis of risks and other important factors. The Audit Engagement represents the audit work that will be undertaken by the CIA and the IAD in selected areas of the entity. At the time when an engagement is included in the Annual Plan, the preliminary Audit Objective and the Scope of Audit to be undertaken and the audit resources allocated for the Engagement would be included in the Audit Plan.

9.2.3   Details relating to this phase are included in Chapter III of the Manual.

9.3   Engagement Planning and Execution

9.3.1   In the first step of this phase, the work to be done in the Engagement is properly planned. Since it is neither practical nor cost-effective to audit everything, the CIA must identify the significant risks associated with the audit subject area. Information on the governance, risk management and internal controls processes as well as other pertinent information relating to the subject area are obtained through documents, interviews of key Auditee staff and other relevant stakeholders, preliminary surveys and preliminary or 'walk through' testing. The information thus collected is then analyzed and used to refine and if necessary reformulate meaningful Audit Objectives and establish an appropriate Audit Scope to achieve the audit Objective. This process helps the CIA ensure that audit resources and effort are devoted to a relatively few key areas that can have a significant impact on the performance and results of the programme, organization or activity being audited. At the end of this planning process, the CIA would have prepared an Engagement Plan that would clearly articulate what will be audited, why it will be audited, and how it will be audited based on an audit programme that clearly outlines the audit approach and audit steps.

9.3.2   The next step in this phase, also commonly termed as Field Work, concentrates on executing or implementing the Engagement Plan. The main objective at this stage of the process is to obtain appropriate and sufficient evidence to support findings and conclusions with respect to the Audit Objectives and identify the causes underlying any deficiencies that may be found.

9.3.3   The information or the audit evidence collected is systematically documented to facilitate the formulation of audit recommendations and the engagement Audit Report. Where feasible, during this phase, potential findings and recommendations are already discussed with the Auditee.

9.3.4   Details relating to this phase are included in Chapter IV of this Manual.

9.4   Reporting

9.4.1   In this phase, after the evidence obtained is carefully evaluated, the findings and conclusions are refined and recommendations that will help Management mitigate risks and root causes of deficiencies are formulated. The Audit Report on the engagement is then prepared on the basis of this information.

9.4.2   The draft Audit Report is discussed with the Auditee to obtain agreement on the facts, findings and the appropriateness of the recommendations. The Draft Report may be further refined on the basis of inputs received from the Auditee.

9.4.3   When the draft Report is finalized, the Auditee is requested to provide the action plan for the implementation of the recommendations. This action plan is then incorporated into the Report.

9.4.4   The final Report is issued to the Chief Executive, and the Auditee. Where necessary the report is presented orally to the Chief Executive.

9.4.5   Details on reporting process are in Chapter V of the Manual.

9.5   Follow-up and Monitoring

9.5.1   Internal Auditors should take reasonable measures to ensure that Management takes action on all the internal audit recommendations so as to ensure that the organization benefits from the audit engagement.

9.5.2   Chapter VI of the Manual provides guidance on the follow-up and monitoring processes to be implemented by the IAD.

ANNEX I -1

THE INTERNAL AUDIT PROCESS

Phase	Process	Steps / Tasks
1. Strategic and Annual Planning (CHAPTER III)	1. Establishing Internal Audit Strategy	1. Identify Audit Universe & Auditable Areas 2. Establish Audit Strategy
	2. Establishing Annual Audit Plans	1. Determine and allocate resources. 2. Understand Organizations. 3. Conduct macro risk assessment. 4. Rank risks by Auditable Areas 4. Consult with key stakeholders 5. Prioritize Audit Engagements by risk and other priorities. 6. Establish Audit Plan
2 Engagement - Planning and Conducting (Field Work) (CHAPTER IV)	1. Engagement Planning	1. Notify Auditee. 2. Gather information and understand Auditable area. 3. Conduct risk assessment of Auditable area. 4. Review and assess internal controls in Auditable area. 5. Evaluate and identify significant issues in terms of governance, risks and controls. 6. Refine audit objectives, scope. 7. Establish audit criteria 8. Consider audit approach and methodology and prepare Audit Programme. 9. Allocate resources and schedule field work.
	2. Conducting the Audit Engagement (Fieldwork)	1. Entry meeting with Auditee. 2. Conduct fieldwork according to Audit Programme and document evidence – noting its relevance and adequacy. 3. Evaluate evidence and establish findings. 4. Conclude based on criteria. 5. For deficiencies – identify causes and effects. 6. Develop preliminary recommendations. 7. Exit meeting with Auditee

3. Communicating Results (Reporting) **(Chapter V)**	1. Preparing Audit Report	1. Evaluate / review audit evidence 2. Refine audit findings, conclusions and recommendations. 3. Prepare draft report 4. Confer and agree with Auditee the accuracy of facts and reasonableness of findings, conclusions and recommendations. 5. Obtain Action Plan for implementing recommendations from Auditee.
	2. Issuing Final Report to Chief Executive Officer and other relevant stakeholders.	1. Finalize Issue Report ensuring quality standards. 2. Issue report of CEO and other relevant stakeholders. 3. Brief CEO and other senior managers. 4. Obtain feedback from Auditees and other stakeholders and analyze and note results for quality improvement.
4. <u>Monitoring and Follow-up of implementation of audit recommendations</u> <u>**(Chapter VI)**</u>	1. Monitor implementation of recommendations	1. Establish database of recommendations. 2. Obtain regular feedback from Managers on implementation. 3. Determine where follow-up audits are required.
	2. Follow-up audit to verify implementation of more complex recommendations	1. Conduct follow-up audits as are necessary. 2. Report to CEO on follow-up audits.
	3. Report to CEO and senior managers on status of implementation of recommendations	1. Issue periodic reports to CEO and other relevant stakeholders on status of implementation of recommendations.