



Internal Audits

Early Warning Signals in Internal Audits

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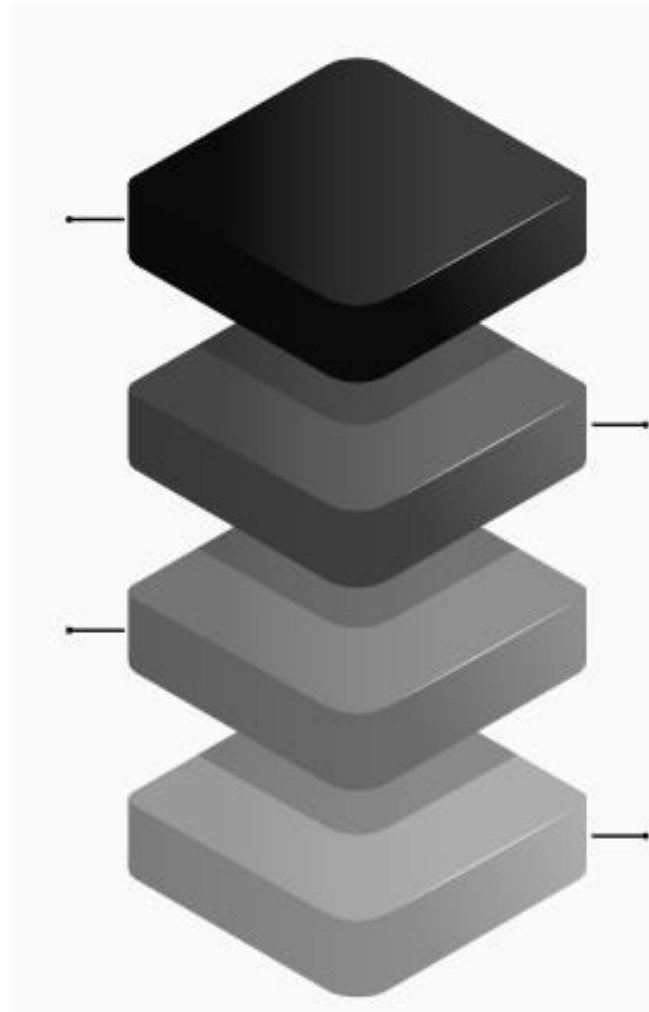
Internal Audit: Definition

Independent Management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including entity's strategic risk management and internal control system.

Independent Management Function

Suggest improvement to:

- a. Governance Mechanism
- b. Strategic Risk Management
- c. Internal Control System



Suggest Improvement and Value Addition

Continuous & Critical Appraisal of Processes

Key Objectives of Internal Audits

Defining the primary goals of internal audits in manufacturing units

Ensuring Adherence to Quality Standards

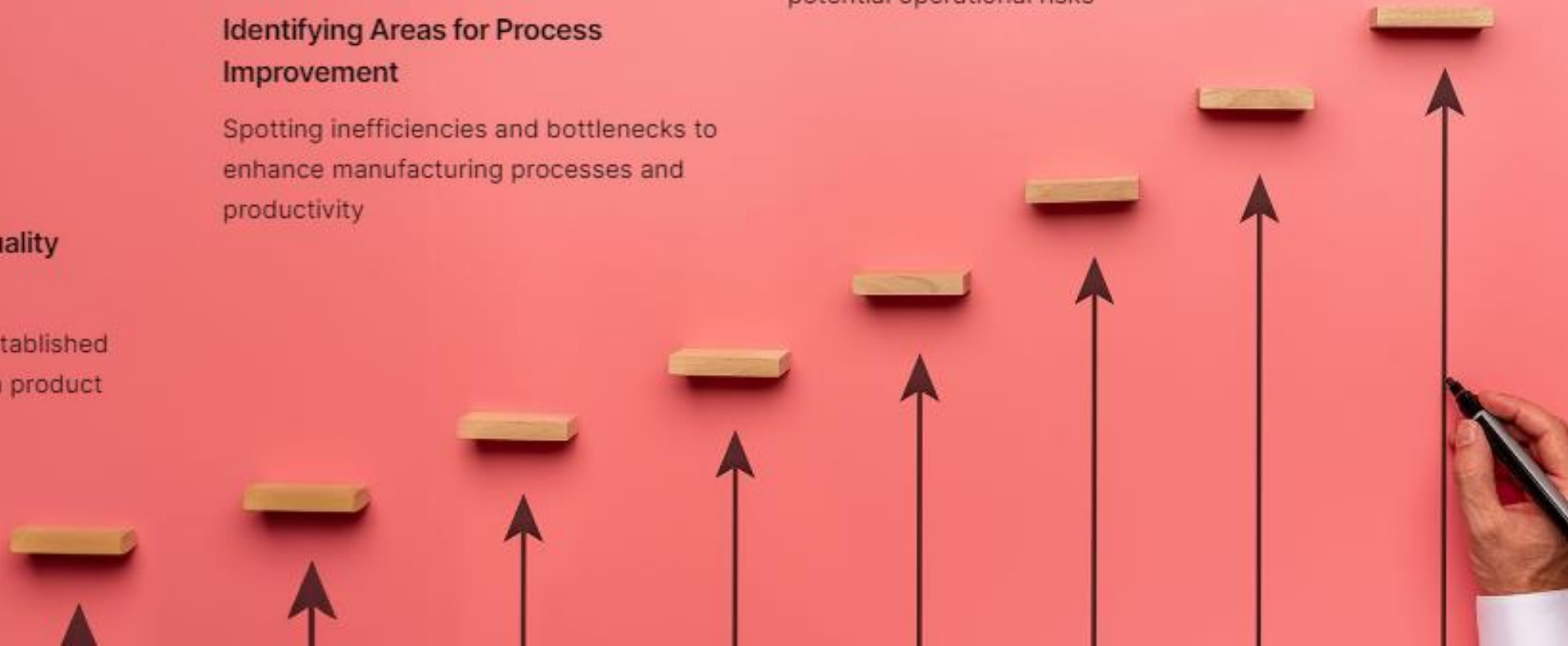
Verifying compliance with established quality standards to maintain product integrity

Identifying Areas for Process Improvement

Spotting inefficiencies and bottlenecks to enhance manufacturing processes and productivity

Evaluating the Effectiveness of Risk Management Processes

Assessing the efficiency of risk management strategies to mitigate potential operational risks



External Threats

IT Security

Risks resulted from breach of IT Security, Virus, Ransomware, Data Theft, Backup Procedures etc.

People

Risks resulted from staff inefficiency, breach of trust, roles' conflict & over dependency on people instead of Processes.

Compliance

Risks resulted from non-compliance of statutory requirements leading to interests & penalties.

Business Risks

Process & Operations

Risks resulted from Process Inefficiency & Ineffectiveness, inappropriate process compliance, duplication of work & documentation.

Finance

Risks resulted from inappropriate Financial Accounting Systems, financial arrangements with FI's, inappropriate financial reporting.

Internal Threats



**Tip of an
Iceberg**



- **Main Observation**
- **Root Cause**
- **Business Impact**

Understanding Early Warning Signals

EWS

Classification of Internal Controls

- **Preventive Controls:** Internal Controls that are put in place to avert an adverse event from occurring.
- **Detective Controls:** Internal Controls that raise an alert after the event has occurred. These controls are effective if detection happens before material harm occurs.
- **Corrective Controls:** Internal Controls that are designed to correct the negative impact of the unwarranted event and bring the earlier existing situation back to the extent possible.

Examples of Internal Controls

Preventive Controls

- Segregation of Duties
- Pre-Audit
- Prior Approval
- Delegation of Authorities
- Dual Signature
- Back-Up
- Input Edit Controls

Detective Controls

- Physical Verification
- Reconciliation
- Internal Audit
- Audit Trail
- Confirmation of Balances

Corrective Controls

- Insurance
- Root Cause Analysis for Defects
- IT Controls such as Patching, Quarantining a Virus etc.

Main Processes in Manufacturing Units



Core Processes

- 1 Production Management
- 2 Inventory Management
- 3 Quality Assurance
- 4 Procurement to Pay
- 5 Supply Chain

Support Processes

- 1 Machine Maintenance
- 2 Environment Health & Safety [EHS]
- 3 Finance & Accounts
- 4 Product Costing
- 5 Human Resource Management
- 6 Scrap Management
- 7 Statutory Compliances
- 8 Logistics
- 9 Receivable Management
- 10 Information Technology

● Examples of Early Warning Signals

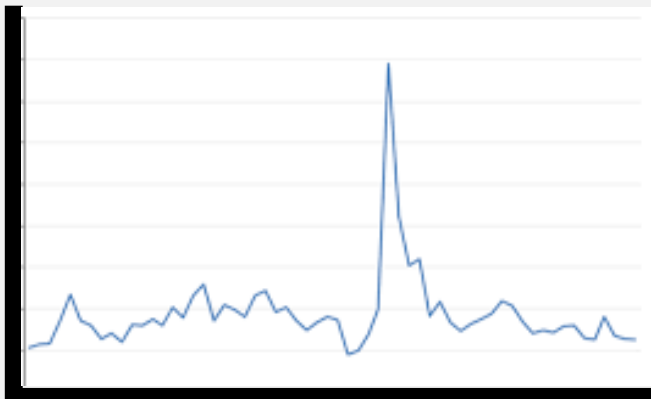
- Embrace the power of Internal Auditing in identifying Early Warning Signals in Internal Audits

EWS – 1: Production Management

Sudden Spike in Production Costs

Excess RM Consumption, Unrecorded Production & Sales

Key Data to be Checked: BOM, Direct Costs, Indirect Costs, Sales Trends, Production Log Book, Stores' material issue data, FG dispatch register etc



Internal Controls:

1. Preventive: Automatic Bar Code Pasting & Production Recording through Scanning
2. Detective: Regular Input – Output Reconciliation, MIS Reports
3. Surprise Production Audits on floor
4. Strict Dispatch Controls by Security at Gate

EWS – 2: Production Management

High Machine Running Hours in comparison to Low Output
Machines Preventive Maintenance not conducted, Inefficiency in Machine Operations, Inadequate Machine Operation Training to Operators

Key Data to be Checked: Machine log book, production data, PPC Data, Preventive Maintenance Schedule, Maintenance Log book, Training Records.



Low
Output

Internal Controls:

1. Preventive: Compliance with Preventive Maintenance Schedule
2. Preventive: Regular Machine Operations Training to Operators
3. Detective: Daily & Weekly Review of Standard vs Plan vs Actual Output and do RC-CAPA

EWS – 3: Production Management

High Rework, Rejections & Overtime

Frequent change in the Conveyor Belt Speed by Workers during Night Shifts

Key Data to be Checked: Interviews, Surprise Visits to shop floor, Rejection & Rework Data, Plan operation roaster.



Internal Controls:

1. Preventive: Access Control over changes in the conveyor belt speed
2. Detective: Weekly Review of conveyor belt speed change log

EWS – 4: Production Management

Incorrect Material Consumption of RM captured leading to Mismatch in Standard Consumption vs Actual Consumption of RM

Incorrect Profitability Reporting

Key Data to be Checked: BOM, Production Data, Material Consumption Data, Stores' material issue records, material requisition slips, rejection & rework data.

Internal Controls:

1. Control over Production Log Books
2. Material issue by stores only on authorized requisitions slips
3. Proper Recording of Data in Production MIS Reports
4. Periodic Review of RM Consumption – Standard vs Actual and take corrective actions on timely basis



EWS – 5: Production Management | Job Work

High Job Work Payments in comparison to FG declared by the unit

Excess Payment, Mismatches in Quantity Reconciliation

Key Data to be Checked: Job work issue and receipts data, BOM, Job work invoices, job work input – output reconciliation



Internal Controls:

1. Job Work Challans Preparation
2. Job Work Log Book
3. Regular Reconciliation and Monitoring of Job Work Issue vs Received
4. Approved Job Work Rate from Management
5. Job Work Orders to be prepared in Tally / ERP
6. Periodic stock physical verification at job work sites

EWS – 6: Quality Assurance

Spike in Customer Complaints, Warranty Costs

Inadequate Quality Checking of Products – RM / WIP / FG

Key Data to be Checked: Warranty costs ledger, customer complaints data, QC records, RC-CAPA process, surprise checking at QC (intentional addition of defective item in WIP to check whether QC will hold such item or not)



Internal Controls:

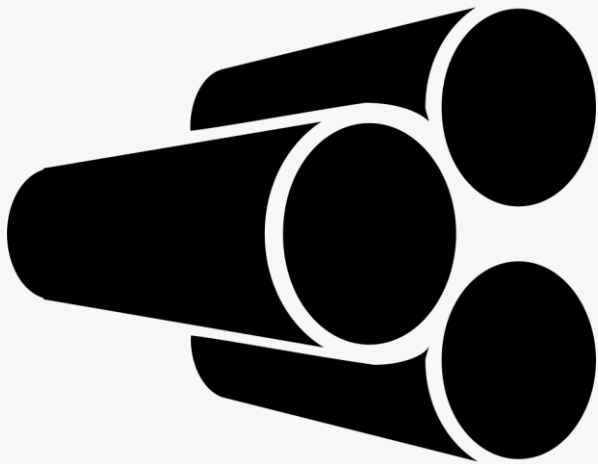
1. Stringent Quality Checking Procedures
2. Regular Quality Audits
3. Surprise Quality Audits

EWS – 7: Quality Assurance | Procurement

Sub-standard Raw Material Quality Accepted and used for production

Excess Wastage or Rejection leading to Excess Working Capital Usage

Key Data to be Checked: Rejection & Rework records, Inward QC process & records, purchase orders issued to the suppliers specifying the desired quality norms, QC certificates submitted by the supplier



Internal Controls:

1. Quality Check Control over Raw Material Received for Production
2. Levying Penalty on Vendors for Quality Defects or Rejections
3. Keeping Proper Records of Quality Tests for Future Course of Actions and Vendor's Performance Evaluation

EWS – 8: Procurement | Inventory

Excess Purchase of Material leading to Inventory Accumulation

Lower Inventory Turnover Ratio

Key Data to be Checked: Purchase requisitions, ROL, Inventory Ageing Records, Inventory Turnover Ratio



Internal Controls:

1. Safety Level and Re-order Levels for running stock items.
2. Regular review of Purchase, Consumption & Closing Stock
3. Monthly Review of Inventory Turnover Ratio

EWS – 9: Inventory | Finance

Non-moving / Aged Inventory leading to Working Capital Blockage

High Inventory Ageing

Key Data to be Checked: Inventory Ageing Records, Inventory Turnover Ratio, ROL, Subsequent purchases of items already lying in stock, process of publishing inventory ageing, Auto blocking of PO in case of breaching max stock level



Internal Controls:

1. Safety Level and Re-order Levels for running stock items.
2. Regular Review of Inventory Position
3. Inventory Liquidation Plan

EWS – 10: Scrap Management

Errors in the Scrap Sale: High Scrap Sales vs Sales & Production

Incorrect Scrap Sale Price, Incorrect Scrap Quantity billed, Delay in Scrap Sale Proceeds Collection

Key Data to be Checked: BOM, Surprise visits at scrap yard, surprise checking of scrap loaded vehicle, scrap weighment records.



Internal Controls:

1. Approved Scrap Sales Price from Management
2. Recording of Scrap Generation & Scrap Sales
3. Reconciliation of Scrap Generation vs Scrap Sales Qty

EWS – 11: Inventory Management

Differences in Inventory Physical Verification

RM, WIP, Consumables, Spares, FG: Excess material consumption, unrecorded production, unrecorded sales, unidentified thefts etc

Key Data to be Checked: Inventory PV Records, production records, BOM, input-output records, sales records



Internal Controls:

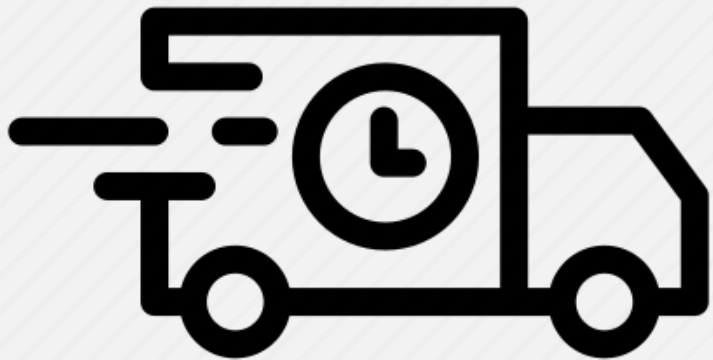
1. Periodic & Surprise Inventory Physical Verification
2. Maintaining proper Inventory Records for Receiving, Issue, Consumption, Return, Dispatch Processes
3. Recording of WIP Reels Stock – Issue and Balance Reels
4. Weighment of WIP Reels' Balance Stock to be used for next orders

EWS – 12: Dispatch | Logistics | Revenue Recognition

Delay in Dispatch – FG Produced but not invoiced, or Invoiced but delay in Dispatch

Delay in Revenue Recognition. Working Capital Blockage

Key Data to be Checked: Revenue recognition policy, dispatch schedule vs actual dispatch records, delivery confirmations by customers



Internal Controls:

1. Production to be done based on Approved Sales Orders only
2. Electronic Records to be prepared for entire Process end-to-end: Sales Orders → Production Orders → FG Conversion → Invoicing → Dispatch
3. Timely identification of non-invoiced stock and to follow up with customers for timely pick up
4. Identifying such customers who take delayed delivery and negotiation with them during next orders

EWS – 13: Receivable Management

Incorrect Sale Price used for Billing

Loss of Revenue

Key Data to be Checked: Sales invoice data, price master, price master change log, list of approved prices with change effect data.



Internal Controls:

1. Approved Sales Price from Management
2. Sales Orders in Tally/ ERP approved from Management & Invoicing done through ERP only
3. Regular Review of Approved Price vs Actual Sales Price
4. Control over Early Payment Discount to Customers

EWS – 14: Receivable Management

High Debtors Turnover Ratio

Delay in Collection from Customers

Key Data to be Checked: Credit Policy, Payment terms, debtors ageing report, sales reports, change in payment terms, sales order report.



Internal Controls:

1. Access controls for change in payment terms
2. Regular Review & Reminders to Debtors
3. Credit Check in Tally / ERP
4. Control over Sales Price or discounts to non-performing customers
5. Annual Debtors Performance Review Process

EWS – 15: Logistics

Inconsistent Transportation Costs for Same Route

Manual changes in Delivery Terms by person while creating Sales Orders in ERP leading to transportation borne by Company for Ex-Works Deliveries

Key Data to be Checked: Delivery terms agreed with customers, sales order dump from ERP, customer ledger, transportation invoices.



Internal Controls:

1. Preventive: Person creating sales orders in ERP cannot change delivery terms
2. Detective: Weekly Review of transportations done vis-à-vis delivery terms agreed with the customers

EWS – 16: Human Resource Management

Ghost Employees

- *No deductions from Salary / Wages – Gross Pays*
- *No leaves taken during the year*
- *Same punch-in and punch-out times every day*
- *No punching in canteen*
- *No attendance in get together and office parties*

Key Data to be Checked:

- Attendance & Leaves Data
- Canteen card punching data
- Payroll data
- Attendance of get togethers & parties
- Employee master log report

Internal Controls:

1. Preventive: Authorization Controls, Maker-Checker, SOD in Employee Master Updation
2. Detective: Weekly Reconciliations of different data as mentioned above with attendance records
3. Auto alerts from system based on pre-defined rules to highlight such cases



EWS – 17: Procurement to Pay

Bribery Payments / Kickbacks by Suppliers

- *Several Concessions to the supplier by Procurement Staff*
- *Early Payments*
- *Buy more than the required quantity*
- *Independent Quotations from other Suppliers not taken or inadequate measures while conducting technical or commercial comparatives*



Internal Controls:

1. Preventive: Authorization Controls, Maker-Checker, SOD
2. Preventive: SOP w.r.t. RFQ, Quotes Receiving, Opening & Analysis
3. Detective: Periodic Audits of high value purchases and new vendors on-boarded

How to Find Early Warning Signals

- Risk Register – Identify What Can Go Wrong in each Sub-Process
- Understand the Process in depth
- Understand Data Prepared at various stages
- Prepare Process Flow chart with Data Points

Various Methods of Identifying EWS:

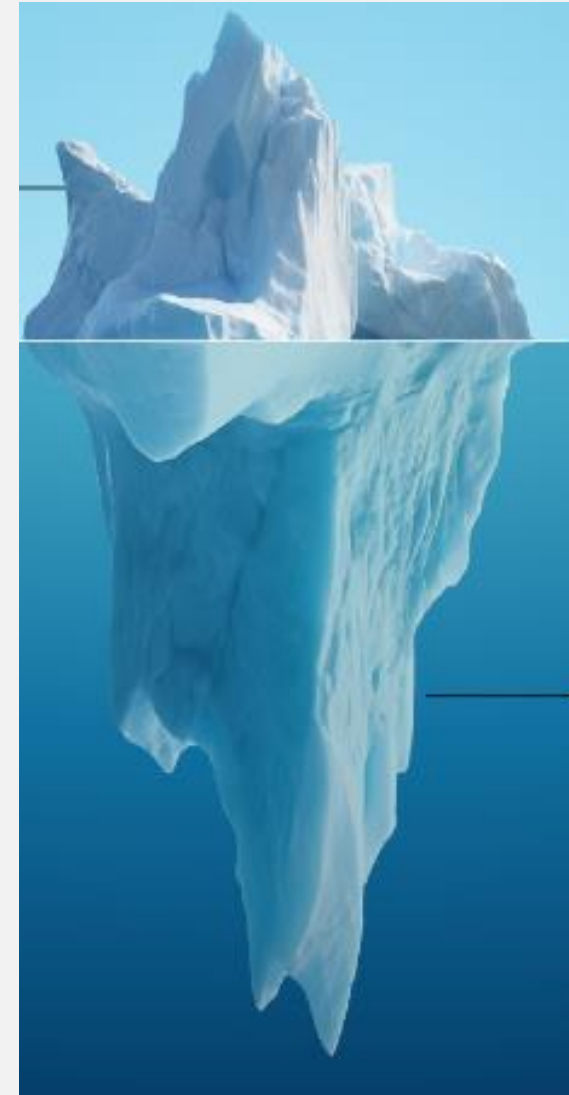
- Data Analytics
- Surprise Checks
- Physical Verification
- Reconciliation
- Review of Audit Trail

Have you Found this ?



Lets' now go a little deeper to see what's there below this TIP

- Detailed Data Analytics
- Base Records Verification
- Cross Checking of Various Records
- Interviews with Auditees
- Historical Data Analysis
- Detailed Internal Audit Checks



Any
QuestiOns

Thank You

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