

Internal and External Audit: The Dual Pillars Fortifying Corporate Governance in a Dynamic Era

In this intricate and rapidly evolving business environment, internal and external audits transcend their traditional roles as mere regulatory obligations. They have evolved into indispensable strategic mechanisms for fortifying corporate governance. These two distinct yet complementary functions act as dual pillars, providing critical layers of assurance, strategic insights and a disciplined approach to risk management and control. Their combined force creates a comprehensive governance framework that promotes transparency, accountability and ethical conduct, ultimately safeguarding organizational value and ensuring sustainable growth. This articles elucidates the scope & role of Internal & External Audit in organizations.



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INTRODUCTION

THE IMPERATIVE OF ROBUST CORPORATE GOVERNANCE

Setting the Stage: Why Corporate Governance matters more than ever?

Corporate governance serves as the fundamental framework guiding how a company is directed and how it manages its relationships with shareholders and a broader spectrum of stakeholders. It is the essential architecture upon which trust, transparency, and accountability are meticulously built, fostering long-term capital formation and contributing significantly to economic stability. This critical role is underscored by global standards such as the G20/OECD Principles of Corporate Governance, which were last revised in 2023 and have received endorsement from G20 Leaders. These principles offer comprehensive recommendations spanning shareholder rights, corporate disclosure, board responsibilities, and the crucial aspect of sustainability. India's corporate governance framework, for instance, draws heavily from these international principles, alongside its domestic Companies Act, 2013, and SEBI regulations, which collectively aim to enhance fairness, responsibility, and openness in corporate conduct.

Effective governance directly influences a company's access to capital markets, which in turn fuels innovation, productivity and entrepreneurship. It ensures that those who provide capital can participate and share in the company's value creation on fair and equitable terms, thereby impacting the cost at which corporations can secure financing for growth. The increasing emphasis on these aspects reflects a significant evolution in the understanding of corporate governance. Initially, the focus might have been primarily on adherence to regulations and avoiding penalties. However, the consistent articulation of "transparency," "accountability," "trust," and "sustainability" as core tenets by various regulatory bodies and industry experts indicates a deeper shift. This progression suggests that governance is now perceived not merely as a compliance exercise but as a proactive strategic imperative for building a resilient, trustworthy, and sustainable enterprise. This broader perspective naturally extends to the audit functions, demanding their evolution beyond traditional compliance roles.

How Internal and External Audits serve as indispensable pillars for Governance Fortification?

In this intricate and rapidly evolving business environment, internal and external audits transcend their traditional roles as mere regulatory obligations. They have evolved into indispensable strategic mechanisms for fortifying corporate governance. These two distinct yet complementary functions act as dual pillars, providing critical layers of assurance, strategic insights and a disciplined approach to risk management and control. Their combined force creates a comprehensive governance framework that promotes transparency, accountability, and ethical conduct, ultimately safeguarding organizational value and ensuring sustainable growth.

Corporations today navigate a complex array of challenges, including rapid technological advancements, escalating geopolitical risks, and the emergence of new regulatory demands, particularly in areas like Environmental, Social and Governance (ESG) disclosures. These factors collectively intensify regulatory scrutiny and heighten stakeholder expectations for greater transparency and accountability.

The pervasive emphasis on “trust” by leading audit firms and regulatory bodies alike underscores a fundamental shift in the audit profession’s mandate.

Yet, in practicality significant trust deficit is observed not only with stakeholders but also with other institutions encompassing government, business and markets. This observation implies that the role of audit has to be expanded beyond simply ensuring financial compliance; it has to be a critical strategic function for building and maintaining the foundational trust essential for corporate growth and capital market stability.

This perspective highlights that audit is a strategic imperative for building and maintaining stakeholder trust, rather than merely a technical or regulatory obligation.

INTERNAL AUDIT: THE SENTINEL WITHIN

The scope of internal audit is notably broad, extending beyond mere financial scrutiny to encompass financial operations, compliance, operational efficiency, and information technology across the entire enterprise. Internal auditors are tasked with objectively evaluating risks, analyzing systems for efficiencies, conducting spot-checks for as-yet-unknown issues, and ensuring departments remain aligned with business objectives. They identify concerns such as compliance issues, perform comprehensive risk assessments, investigate internal or external fraud, and detect data inaccuracies in financial reporting. Their role also involves reviewing processes and procedures, examining financial records, and developing recommendations to enhance risk management.

INTERNAL AUDIT’S INTEGRAL ROLE IN CORPORATE GOVERNANCE: RISK MANAGEMENT, INTERNAL CONTROLS, OPERATIONAL EFFICIENCY AND CULTIVATING AN ETHICAL CULTURE

Internal audit plays a vital and multifaceted role in corporate governance by assessing and reporting on the effectiveness of governance, risk management and control processes. These processes are specifically designed to help the organization to achieve its strategic, operational, financial and compliance objectives.

In the realm of **risk management**, internal audit systematically assesses the organization’s framework for identifying and mitigating potential threats. This includes evaluating the adequacy of controls against various risks such as operational disruptions, environmental compliance issues, cybersecurity vulnerabilities, geopolitical shifts and macroeconomic fluctuations. This proactive approach ensures that risks are identified and addressed before they escalate. For example, an internal audit might uncover discrepancies in inventory valuation within a manufacturing company, thereby preventing potential financial misreporting and regulatory penalties.

Regarding **internal controls**, internal audit evaluates both the design and operational effectiveness of controls

across a wide array of processes, from financial reporting to day-to-day operational activities. This scrutiny is crucial for ensuring the accuracy and reliability of financial information and for safeguarding against fraud and errors. Internal auditors are recognized as experts in control design evaluation and testing.

Internal audit significantly contributes to **operational efficiency**. Through their systematic evaluation of processes, auditors can identify areas where procedures can be streamlined or strengthened. For instance, an internal audit in a retail chain could reveal inefficiencies in procurement procedures that cause delays, prompting management to revise these processes for improved operational efficiency. The Institute of Internal Auditors (IIA) emphasizes that internal audit provides “insight” and acts as a “catalyst” for management and the board to gain a deeper understanding of governance processes and structures. This function moves beyond merely identifying problems; it actively stimulates positive change and innovation within the organization, fostering organizational confidence and enabling more informed decision-making. This evolution signifies that internal audit is not merely a reactive compliance function but a proactive, strategic partner that helps in shaping the organization’s future by anticipating and addressing risks and opportunities, thereby enhancing overall corporate resilience and innovation.

Prompt reporting of such findings enables the organization to take corrective action and address systemic issues.

Beyond detection, internal audit actively promotes ethical awareness throughout the organization. This is achieved by conducting training programs, effectively communicating company policies and procedures, and championing ethical decision-making through workshops and various communication channels. They also assess the adequacy and effectiveness of the organization’s ethics and compliance programs, identifying areas for improvement.

THE CRITICAL PARTNERSHIP WITH THE AUDIT COMMITTEE: ENSURING INDEPENDENCE AND EFFECTIVE OVERSIGHT

The relationship between the internal audit function and the audit committee is absolutely paramount for establishing and maintaining robust corporate governance. A strong and supportive relationship between these two groups is essential for creating and enhancing the independence and objectivity that an effective internal audit function requires. This independence is crucial because it allows internal auditors to provide unbiased, factual feedback to the board and senior management, thereby building trust in the auditing process.

The audit committee is expected to be attentive to the needs of the internal audit function, provide guidance throughout the year, and conduct regular briefing sessions. This reciprocal relationship fosters an environment where internal audit can operate with the necessary autonomy. The effectiveness of internal audit is directly proportional to the audit committee’s engagement and its commitment to safeguarding internal audit’s independence. This strong,

supportive relationship is not merely a formality; it actively fosters the objectivity and trust that are indispensable for internal audit's impact on corporate governance.

EXTERNAL AUDIT: THE INDEPENDENT ASSURANCE

1. External Audit's Crucial Role in Corporate Governance: Enhancing Financial Transparency and Stakeholder Confidence

An external audit is an independent financial review conducted by qualified accountants who operate independently of the entity being evaluated. These auditors meticulously examine and analyze a business's financial records and statements. The primary objective of an external audit is to provide assurance to external stakeholders, such as shareholders, creditors, and regulatory bodies, regarding the accuracy, reliability, and fairness of the financial statements and the company's compliance with applicable laws and regulations.

External audits are critical mechanisms for building and sustaining trust within the corporate landscape. They ensure clear financial reporting by providing an accurate and fair representation of a company's financial health, which is absolutely vital for stakeholders to make informed decisions regarding investments and credit. This transparency and independent verification significantly boost a company's market reputation, making it a more appealing prospect for investors, partners and customers.

This impact extends beyond mere compliance; external audit serves as a systemic enabler of capital market functionality and trust. The explicit purpose of external audits is to provide "assurance to external stakeholders... regarding the accuracy and reliability of financial statements" and to "increase stakeholders' confidence in financial records". This directly impacts market perception and valuation. Furthermore, financial institutions rely on audited financials when determining creditworthiness, indicating that companies undergoing routine audits are often perceived as lower risk, which can lead to more favorable credit terms and financing options. This demonstrates that external audit is not merely a company-level check but a fundamental mechanism that underpins the trust and efficiency of global capital markets. Any compromise to external audit quality or independence therefore poses systemic risks, potentially impacting investor confidence, creditworthiness, and broader economic stability.

The scope of internal audit encompasses financial operations, compliance, operational efficiency and information technology across the entire enterprise. Internal audit significantly contributes to operational efficiency. Through their systematic evaluation of processes, auditors can identify areas where procedures can be streamlined or strengthened.

During the audit process, external auditors meticulously assess the effectiveness of a company's internal controls. This evaluation helps to identify any weaknesses or deficiencies in critical processes such as cash handling, inventory management, and the recording of financial transactions. By pinpointing these vulnerabilities, external audits significantly contribute to reducing the risks of errors or fraudulent activities. This systematic review not only validates the integrity of financial data but also strengthens the overall control environment, thereby safeguarding the company's assets and reputation against external financial risks.

2. The Unwavering Imperative of Auditor Independence

Auditor independence stands as the cornerstone of external audit credibility. An external auditor is fundamentally defined as an accountant who conducts independent evaluations, meaning they must be entirely free from any influence or bias from the entity being evaluated. This independent nature is not merely a professional guideline; it is crucial for ensuring an impartial and objective presentation of financial information, which directly impacts a company's reputation and credibility in the eyes of investors, lenders, and other stakeholders.

Any compromise to this independence, such as conflicts of interest (e.g., deep connections between senior directors and the audit firm, or auditors having a vested interest in the audit results), can severely undermine the audit report's effectiveness and objectivity. Leading audit firms, including the Big Four, consistently emphasize their unwavering commitment to independence and ethical behavior in their annual transparency reports. These reports detail their legal structures, governance frameworks, and robust systems of quality control designed to safeguard auditor objectivity. This commitment is vital for maintaining public trust in financial reporting and the integrity of the capital markets.

MODERN DYNAMICS: AI, ESG, AND THE EVOLVING AUDIT LANDSCAPE

1. The Digital Transformation of Audit: Leveraging Artificial Intelligence and Advanced Analytics

The rapid pace of **digital transformation**, driven by advancements in Artificial Intelligence (AI) and advanced analytics, is profoundly reshaping the audit profession, fundamentally altering how organizations ensure accountability, regulatory compliance, and risk management. AI tools are enhancing auditors'



capabilities to process vast amounts of data with unprecedented speed and accuracy, enabling the identification of patterns and anomalies that may indicate fraud, error, or non-compliance.

3. Benefits of AI in Audit:

- **Enhanced Data Processing:** AI algorithms can rapidly sift through enormous volumes of financial records, procurement data, and transaction logs. This capability streamlines the audit process, allowing for quicker and more accurate determinations of compliance and accuracy.
 - **Bias Elimination:** AI helps to mitigate human bias in auditing, ensuring that decisions are based on objective data rather than subjective opinions. It can perform automated risk assessments impartially, allowing auditors to focus on investigating irregular patterns flagged by the algorithms.
 - **Predictive Capabilities:** AI's predictive analytics are invaluable for proactive risk management. They can forecast potential risks and vulnerabilities in operations by analyzing historical data, enabling auditors to concentrate resources on high-risk areas and preemptively detect fraudulent activities. For instance, AI can predict which departments are likely to experience budget overruns or compliance issues based on past performance, allowing auditors to enhance their procedures accordingly.
 - **Efficiency and Value Creation:** By automating routine and data-intensive tasks like data entry and initial analysis, AI frees up human auditors to focus on higher-level planning, critical thinking, and value-added advisory work.
- ### 4. Challenges of AI in Audit:
- **Algorithmic Integrity and Bias:** Errors can inadvertently be introduced into AI systems through biased training data or design choices, leading to skewed outcomes that compromise audit accuracy and reliability. If historical data used to train AI models contains inherent biases, the AI may replicate and reinforce these patterns, leading to misleading conclusions. Ensuring equity and fairness in AI algorithms requires stringent control and continuous development.
 - **Overreliance on AI:** While AI is a powerful tool, it must be guided by human judgment and cannot yet perform many functions requiring real-world insight and experience. Overreliance on AI can lead to missed discrepancies; for example, an AI tool might analyze expense reports based on historical patterns but fail to detect a novel type of fraudulent claim that does not match past data.
 - **Lack of AI Governance:** The absence of clear AI governance frameworks and legal constraints can impede AI implementation and limit its potential benefits. AI-based systems, especially deep learning models, are inherently more complex and less transparent than traditional IT systems, posing unique challenges for IT auditors.
 - **AI Skepticism:** Resistance or skepticism from employees or stakeholders towards new technology can hinder AI adoption, potentially leading to underutilized investments if tools are not embraced.

government auditing, where classified information and personal citizen data are involved. Integrating AI tools, particularly from third parties, escalates the risks of data breaches and vulnerabilities in algorithms or data pipelines.

- **Data Security and Privacy:** A significant concern is ensuring the security of sensitive data, especially in

The integration of AI into audit presents a complex dynamic. While AI offers immense potential for

enhancing audit quality, efficiency, and risk management, the same technology introduces new, complex risks related to data security, algorithmic bias, and the critical need for robust AI governance. This implies that while AI is a powerful enabler, its irresponsible application or a lack of adequate oversight can undermine the very governance it aims to fortify. Therefore, organizations must develop comprehensive AI governance frameworks that meticulously address ethical considerations, data privacy, and algorithmic transparency to harness AI's benefits while effectively mitigating its inherent risks. This ensures that AI truly strengthens, rather than erodes, trust in corporate operations.

ESG: A NEW FRONTIER FOR CORPORATE RESPONSIBILITY AND VALUE CREATION

Environmental, Social and Governance (ESG) factors have rapidly ascended to the forefront of corporate agendas, becoming crucial metrics for assessing a company's commitment to sustainability and ethical behavior. This shift is driven by increasing awareness among consumers and investors, who now demand greater corporate responsibility for social and environmental impacts. Strong ESG performance is increasingly viewed as an indicator of long-term success and an effective means of mitigating various risks. Legal risks related to "greenwashing" are anticipated to rise, driven by new disclosure requirements introduced by the Central Consumer Protection Authority (CCPA) through guidelines aimed at preventing greenwashing and curbing false claims of environmental benefits.

The evolution of ESG from a "nice-to-have" to a "must-have" reflects its transformation into a fundamental governance imperative. ESG has transitioned from a voluntary, reputational concern to a critical element of corporate strategy and regulatory compliance. This progression implies that companies can no longer treat ESG as a peripheral activity; it must be integrated into core business strategy, risk management, and governance frameworks, supported by robust audit and assurance mechanisms, to ensure long-term value creation and avoid significant legal and reputational repercussions.

In this evolving landscape, the role of external auditors, particularly the Big Four firms has become increasingly significant. As companies strive to strengthen their ESG credentials, the assurance of sustainability reports has emerged as a key driver of improved performance. Experienced and high-quality auditors play an essential moderating role, reinforcing the connection between board diversity and better sustainability results.

THE AUDIT COMMITTEE'S EVOLVING AGENDA: NAVIGATING EMERGING RISKS (CYBERSECURITY, AI, ESG)

Audit committees today face an increasingly complex and dynamic risk landscape, expanding their responsibilities far beyond traditional financial reporting and internal

controls. Cybersecurity, enterprise risk management (ERM), and the effective management of finance and internal audit talent consistently rank as top priorities on their agendas.

- **Cybersecurity Oversight:** Audit committees are increasingly responsible for overseeing cybersecurity risk, which includes assessing the resilience of the company's cybersecurity program and understanding recovery plans in the event of an attack. This necessitates regular engagement with the Chief Information Security Officer (CISO) or equivalent leader.
- **Enterprise Risk Management (ERM):** Effective ERM is crucial for achieving organizational objectives and safeguarding the company's reputation. Audit committees must remain acutely aware of emerging risks and ensure that management's risk assessment processes are dynamic and responsive to changing conditions.
- **AI Oversight:** The oversight of generative AI is rapidly emerging as a significant priority. This involves ensuring compliance with evolving laws and regulations governing AI, overseeing the development and maintenance of related internal controls, and establishing robust risk management frameworks for AI systems. Audit committees may find themselves responsible for navigating a complex "patchwork of differing laws and regulations" related to generative AI.
- **ESG Disclosures:** Audit committees are tasked with clarifying oversight responsibilities for new climate, sustainability, and other ESG disclosures. A critical aspect of this role is ensuring the quality and reliability of the underlying data supporting these disclosures.

The audit committee has become the nexus of modern risk oversight. Its agenda has expanded significantly beyond traditional financial reporting and internal controls to encompass complex, interconnected risks like cybersecurity, AI, and ESG. This indicates that the audit committee is now the central hub for overseeing the most critical and dynamic threats to corporate value and reputation. Its ability to effectively navigate these risks is paramount for overall corporate governance. Boards must therefore ensure that audit committees possess the necessary expertise (e.g., cybersecurity expertise), adequate resources, and direct access to relevant C-suite executives to effectively fulfill their expanded oversight responsibilities. Continuous professional development for committee members in these emerging and rapidly evolving areas is no longer optional but a non-negotiable imperative.

FORTIFYING CORPORATE GOVERNANCE: STRATEGIC RECOMMENDATIONS FOR THE FUTURE

To navigate the complexities of the modern business landscape and ensure long-term sustainability, organizations must proactively fortify their corporate

governance frameworks. This requires a multi-pronged approach that integrates robust audit functions, cultivates a strong ethical culture, embraces technology responsibly, and adapts to evolving regulatory environments.

- **Strengthening Board Oversight and Enhancing Audit Committee Effectiveness**

A cornerstone of strong corporate governance lies in the effectiveness of the board and its audit committee. Boards must prioritize recruiting diverse and competent directors, ensuring a balanced mix of executive and non-executive members, including Independent Directors. In India, for instance, this includes the mandate for at least one woman director. Diversity on the board has been shown to enhance performance and bring unique perspectives to decision-making. It is imperative to establish clear roles and responsibilities for the board and its committees, ensuring they are not unduly influenced or “managed” by the executive team. Audit committees should strive to improve the quality of presentations and discussions during meetings, focusing on concise executive summaries backed by detailed appendices to maximize efficiency and depth of engagement. Furthermore, cultivating strong relationships with finance and internal audit leaders, serving as mentors, and ensuring appropriate resource allocation to these critical functions are vital for effective oversight.

- **NFRA's Expanding Role in Strengthening Audit Effectiveness**

The evolving role of the National Financial Reporting Authority (NFRA) has added significant depth to India's corporate governance landscape, particularly in strengthening the responsibilities of internal and external auditors. NFRA has consistently emphasized the importance of professional skepticism, urging auditors to avoid over-reliance on management representations and to critically assess the effectiveness of internal controls. It has also called for greater engagement between statutory auditors and audit committees, especially those led by Independent Directors, to facilitate informed discussions on key financial judgments such as the recoverability of deferred tax assets, provisioning policies, and forward-looking profitability assumptions. This shift encourages a more proactive and risk aware audit environment, aiming not merely at regulatory compliance but at enhancing early fraud detection and institutional accountability. NFRA's recent guidance reflects a broader move towards positioning the audit function as a cornerstone of ethical oversight and enterprise.

CONCLUSION: THE ENDURING VALUE OF AUDIT IN CORPORATE GOVERNANCE

In an era defined by rapid change, increasing complexity, and heightened stakeholder expectations, internal and external audit functions stand as truly indispensable pillars, providing the twin

assurances necessary to fortify corporate governance. Internal audit acts as the vigilant sentinel within, offering proactive insights into operational efficiency, risk management, and internal controls, while fostering an ethical culture that permeates the organization. External audit, conversely, serves as the independent arbiter, lending crucial credibility to financial reporting and instilling confidence among external stakeholders in the integrity of capital markets.

The symbiotic relationship between these two audit functions, strengthened by seamless collaboration and the strategic integration of advanced technologies like AI, transcends mere compliance. This unified approach transforms audit into a strategic asset, safeguarding organizational value, enhancing market reputation, and ensuring long-term sustainability. The lessons from past corporate failures serve as stark reminders of the catastrophic consequences that arise when these audit pillars falter, underscoring the critical need for diligence, independence, and robust oversight. Conversely, the success stories of organizations that proactively embrace strong audit practices highlight the tangible competitive advantage derived from such commitment.

For Company Secretaries and governance professionals, the mandate is unequivocally clear: championing audit excellence is paramount for future-proofing their organizations. This requires actively advocating for robust and empowered internal audit functions, fostering seamless and transparent collaboration with external auditors, and proactively engaging with the evolving landscape of AI and ESG. By embracing technology responsibly, cultivating a pervasive culture of integrity and accountability, and committing to continuous professional development, organizations can not only meet stringent regulatory expectations but also build a resilient, trustworthy, and truly future-ready enterprise. The enduring strength and integrity of corporate governance in the years to come will undoubtedly hinge on the unwavering commitment to these dual pillars of assurance.

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