

Knowledge Booklet II

A New Era In Internal Audit – Companies Act, 2013



Internal Audit Standards Board
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

The Institute of Chartered Accountants of India

Our Mission

The Indian Accountancy Profession will be the Valued Trustees of World Class Financial Competencies, Good Governance and Competitiveness .

The Institute of Chartered Accountants of India (ICAI) is a statutory body established under the Chartered Accountants Act, 1949 (Act No. XXXVIII of 1949) for the regulation of the profession of Chartered Accountants in India. During its 65 years of existence, ICAI has achieved recognition as a premier accounting body not only in the country but also globally, for its contribution in the fields of education, professional development, maintenance of high accounting, auditing and ethical standards. ICAI now is the second largest accounting body in the whole world.

The Institute has 5 Regional Councils, 146 Branches covering the length and breadth of the country and 23 Chapters abroad. Founded about sixty five years ago with just seventeen hundred members, the Institute has grown to cross the mark of 2,25,000 members and 8,00,000 students as of now. It has come to occupy a stellar role in national economy and has forayed to initiate steps to benchmark the CA qualification from India on a global altar. Being amongst the largest accounting bodies in the world; and represented at major international forums on accountancy, the ICAI is endeavouring to position brand Indian Chartered Accountancy globally. Within the country, the Chartered Accountants have stamped their authority in their respective domain of work and have been partnering in every sphere of economic activity.

Internal Audit Standards Board Mission

The Internal Audit Standards Board is a Non-Standing Committee of the ICAI. It has been established with a mission to reinforce the primacy of the Institute of Chartered Accountants of India as a promoter, source and purveyor of knowledge relating to internal audit and other aspects related to it in the society so as to enable its members to provide more effective and efficient value added services related to this field to the Industry and others and help the latter to systematize and strengthen their governance process by systematizing and strengthening their control and risk management process.

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Internal Audit

Internal audit, as we understand it today, began around the time of the Second World War. It was, and is, a way of ensuring businesses and public sector organizations use resources efficiently and apply process consistently. The business landscape has changed dramatically and the need to create greater transparency, establish sound corporate governance and understand risk exposure has never been greater. Internal audit is one element in the whole ecosystem of the financial and non-financial reporting supply chain within the broader corporate governance environment. “*Preface to the Standards on Internal Audit*” issued by The Institute of Chartered Accountants of India defines “Internal Audit” as follows:

“Internal audit is an 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 the entity’s strategic risk management and internal control system. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance.”

Internal audit’s value to both operations and governance of organizations is being recognized by all sectors throughout the world. There is a major progress in the scope of internal audit’s coverage and level of service to all areas of the enterprise.



The Companies Act, 2013

The Companies Act, 2013, was enacted on August 30, 2013 which provides for a major overhaul in the corporate governance norms for all the companies in the country. The Act consolidates and amends the law relating to companies. The requirements under the Companies Act, 2013, and the rules notified there under would be applicable for every company or a class of companies (both listed and unlisted) as may be provided therein. In the light of the above, the year 2014 holds changes for the way internal audit is positioned in corporate India. Apart from mandatory requirement for internal audit function for certain classes of companies, the Companies Act, 2013, also specifically requires Audit Committee or Board to formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

Section 138 of the Companies Act, 2013 states as follows:

“Internal Audit”

- 138 (1) Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.
- (2) The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.”

Companies (Accounts) Rules, 2014

With respect to internal audit, Companies (Accounts) Rules, 2014, which comes into effect from April 1, 2014, lays down as follows:

“13. Companies required to appoint internal auditor:-

- (1) The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:-
 - (a) every listed company,
 - (b) every unlisted public company having –
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
 - (c) every private company having –
 - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Provided that an existing company covered under any of the above criteria shall comply with the requirements of Section 138 and this rule within six months of commencement of such section.

Explanation – For the purposes of this rule –

- (i) The internal auditor may or may not be an employee of the company;
- (ii) The term “Chartered Accountant” shall mean a Chartered Accountant whether engaged in practice or not.

- (2) The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit."

While listed companies, as per requirement in Clause 41 of Listing Agreement, already maintained internal audit departments, the Companies Act, 2013 has extended the coverage to unlisted public companies and private companies meeting specified criteria. This requirement is intended to ensure that the specified companies have a mechanism in place to regularly review and assess their internal control system and, thereby, to identify any weaknesses and develop and implement appropriate measures. The internal audit function plays an important role in the corporate governance framework, and would thereby protect investors and public interest.

Further, the above mentioned Rule is applicable from April 1, 2014, which means that by September 30, 2014, companies which are required to appoint internal auditor should comply with the provisions of Section 138 and the corresponding Rules, thereby allowing sufficient time for companies that have not yet done so. The Rules also provide leverage to the companies to keep an employee of the company as internal auditor.



Reporting to Audit Committee

Effective discharge of internal audit responsibilities pertaining to financial reporting, corporate governance and corporate control requires a reporting relationship with the Board of Directors' Audit Committee. Companies (Accounts) Rules, 2014, clearly requires that the Audit Committee or the Board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. This new requirement is designed to emphasize the role of audit committee in supervising the internal audit process in the company. It is very important for the internal audit function to have the full support of the Board and the Audit Committee, and also equally important for it is to understand their expectations. Through the audit committee, the internal audit function is accountable to the board for maintaining ongoing, constructive relationships and for regular reporting of assurance related issues.

The Audit Committee should exercise an active oversight role with respect to internal audit activities, and determine that the internal auditors are performing reviews of financial and accounting records, reports and systems. It should also monitor the organizational framework of the internal audit activity and its procedures to ensure that the internal audit function is fully aware of the emerging risks that face the company. This direct contact with the Audit Committee would surely help internal audit to maximize its contribution to good governance and exhibit high quality of professionalism and quality in its work. The objective is to set up an effective internal audit function which would assist the audit committee in discharging its responsibilities in light of its limited time and oversight capacity. As internal audit's role evolves, transparency by the audit committee regarding its relationship with and responsibility to the internal audit function could offer valuable insight to stakeholders and help confirm that the committee's responsibilities are being executed effectively.



Internal Control Systems And Compliances

Internal audit's scope is expanding because the expectations that the boards and management place on it grow more numerous every day. In the new regulatory environment, responsibility and liability have been elevated to an unprecedented level and demand for heightened accountability resonates especially clearly for Directors.

Section 134 of the Companies Act, 2013, has added the following two new requirements to be included in "Directors' Responsibility Statement":

"134 (5) The Directors' Responsibility Statement referred to in clause (c) of sub-section (3) shall state that –

...(e) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Explanation – For the purpose of this clause, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively."

An effective internal audit function can help the Directors' in fulfilling these newly introduced requirements by objectively validating the effectiveness of internal control system and compliance function. Effective Internal Financial Controls (IFC) helps to assure that companies produce reliable financial statements that investors can use in making investment decisions. IFC is one element of broader concept of internal control. The board's oversight of IFC is delegated to the audit committee, which has specific responsibility of overseeing financial reporting under the Act. The audit committee's activities usually include review of the assessment of financial reporting risk; discussion with management of significant



control deficiencies and their potential impact on financial reporting; and the evaluation of the quality of financial reporting and related disclosures. Internal auditors can play an active role by testing controls and informing the audit committee of its findings relative to IFC. Further, it can also provide support by examining the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.

As far as compliance is concerned, internal audit can review the adequacy and effectiveness of the functioning of controls implemented by the management to ensure compliance with applicable laws and regulations. Compliance is the act of adhering to, and the ability to demonstrate adherence to, mandated requirements as defined by laws and regulations, as well as voluntary requirements resulting from contractual obligations and internal policies. Internal auditors must understand the specific roles and mandates of the compliance groups in the organization, the frameworks they use, and their plans and reports. In broader terms, it can assist the directors in auditing compliance and the compliance function by providing valuable inputs.

The new regulations also specifically require, as per Section 177, for the Audit Committee to evaluate internal financial controls and risk management systems. Section 177 (5) of the Act clearly states as follows:

“Section 177 (5) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.”

It may also be clarified that under the provisions of the Act, the Board of Directors and the Audit Committee is solely responsible for establishing an efficient system of internal control. Internal audit may serve in many capacities, including advisory, testing, training and development, so long as that should not cross the line into a decision-making role.

Risk Management

The profession of internal audit is fundamentally concerned with evaluating an organisation's management of risk. In fact, risk management and internal control are two sides of the same coin, as risk management focuses on the identification of threats and opportunities, and controls are designed to effectively counter threats and take advantage of opportunities. Successful organizations seek to integrate risk management and internal control into all activities, through a framework of risk identification, risk assessment and risk response. **Section 134 of the Companies Act, 2013, has introduced the following new requirement to be included in the Report by the Board of Directors presented before a company in general meeting:**



“134 (3)(n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company,”

The Board is at the top of the assurance chain, seeking the assurance to discharge its accountabilities to the organization's external stakeholders. Internal audit is a key source of assurance. An internal auditor's knowledge of the management of risk enables them to act as consultant and catalyst for improvement in an

organization's practices. In addition to ensuring that the risks are identified, internal auditors should review the process for assessing the level of inherent and residual risk. The Board of Directors require relevant and reliable information on risk management for decision making and control processes. In other words, it requires a skilled team of internal auditors who can act independently and report back objectively to the board of directors on risk management. Internal audit function, thus, can provide objective assurance to the board on the effectiveness of the company's risk management activities to help ensure key business risks are being managed appropriately.

Chartered Accountants-World Class Internal Auditors

Internal audit related activities have been prime focus for the Institute of Chartered Accountants of India. Accordingly, the Institute had constituted a Non-Standing Committee, Committee on the Internal Audit on 5th February 2004. The prime objective of the Committee, as approved by the Council in its terms of reference, is to reinforce the primacy of the Institute of Chartered Accountants of India as a promoter, source and purveyor of the knowledge of internal audit in the country. The basic idea was to enable the members of the Institute to provide more effective and efficient value added services related to the field of internal audit so as to enable the clients to systematize and strengthen their governance process by systematizing and strengthening their control and risk management process. Considering the important role being played by the Committee on Internal Audit in growth and development of the internal audit profession in India, the Committee had been converted into “Internal Audit Standards Board” in November 2008.

Objectives of the Internal Audit Standards Board

The objectives of the Internal Audit Standards Board are as follows:

- to review the existing internal audit practices in India.
- to develop Standards on Internal Audit (SIAs) to be issued under the authority of the Council of the Institute.
- to develop Guidance Notes on the issues relating to internal audit, including those arising from the SIAs, to be issued under the authority of the Council of the Institute.
- to formulate and issue Technical Guides, Practice Manuals, Studies and other papers on the areas relating to internal audit, under its own authority for guidance of the members, in the cases felt appropriate by the Board.
- to issue Clarifications on the issues arising from the SIAs, to be issued under the authority of the Council of the Institute.
- to develop studies, reports, etc., on the issues arising from the SIAs, to be issued under the authority of either the Council of the Institute or of the Board.
- to undertake research in the field of internal audit.
- to organise/ provide technical assistance in, conferences, workshops, etc., on the topics related to internal audit organised by the Institute.

- to conduct training programmes on internal audit for the members and other stakeholders.
- to conduct Certificate Courses on topics related to internal audit, as approved by the Council of the Institute.

The Board, under the authority of the Council has till date brought out eighteen Standards on Internal Audit on the important areas of internal audit such as, terms of engagement, reporting, quality assurance in internal audit, internal control evaluation, enterprise risk management, compliance with laws and regulations, etc. The Standards represent a codification of the best practices for internal auditors. These Standards will go along way in strengthening the position and building up the performance benchmarks for internal auditors. They are intended to provide a framework for internal audit activities, establish the basis for evaluation of internal audit performance, and foster improved organizational processes and operations. The Board also issues Generic Guides and Technical Guides providing contemporary and industry specific guidance in internal audit. Further, the Board also conducts Certificate Course on Concurrent Audit of Banks, Certificate Course on Internal Audit and Certificate Course on Enterprise Risk Management with a focus to deliver programs to the members that dives into timely issues that impact the internal audit profession now and in the near future. To enable greater diffusion of the knowledge generated among the members, the Board also conducts various CPE programmes, covering issues of contemporary relevance to internal auditors.

Further, The Institute of Chartered Accountants of India as a regulator of the profession of Chartered Accountancy plays an important role in creating an institutional framework for its members. This framework covers all the four aspects which are necessary for regulating any profession with social accountability, viz., education standards, internal audit standards, ethical standards and disciplinary actions. As included in the code of ethics, a distinguishing mark of a chartered accountants is his or her recognition of the responsibilities to act in the public interest. Thus, the multi-faceted knowledge a Chartered Accountant enjoys through unique academic program blended with practical training is what the business and industry need in the advent of liberalization, privatization and globalization of Indian economy. Above all, Chartered Accountants are statutorily recognized audit practitioners. Thus, undoubtedly, the degree of chartered accountancy is a well accepted standard by which individuals can demonstrate their competence and professionalism in the internal audit field.

Standards on Internal Audit

The Board has, till date, issued eighteen Standards on Internal Audit (SIAs) and the list is given in **Appendix I**. The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. While formulating SIAs, the Board takes into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India. The Board may also, where it considers appropriate, take into consideration the international practices in the area of internal audit, to the extent they are relevant to the conditions existing in India.

“Preface to the Standards on Internal Audit” issued by the Institute lays down detailed procedure for issuance of the Standards on Internal Audit. Further, *“Framework for Standards on Internal Audit”* has been issued with the objective of promoting professionalism in the internal audit activity. It covers all aspects of an internal audit activity, including planning, gathering evidence, documentation, using the work of other experts, evaluating controls and risk management systems and reporting.

Other Technical Literature

A list of other Technical Literature issued by the Board, both generic as well as industry specific is given in **Appendix II**. It includes explanatory material on the Standards or it details the application of Standards in specific industries or situations in the form of Technical Guides. These Technical Guides provide guidance to internal auditors in resolving professional issues arising during the course of an internal audit while discharging their duties as internal auditors.



Appendix I

Standards on Internal Audit

- SIA 1, Planning an Internal Audit
- SIA 2, Basic Principles Governing Internal Audit
- SIA 3, Documentation
- SIA 4, Reporting
- SIA 5, Sampling
- SIA 6, Analytical Procedures
- SIA 7, Quality Assurance in Internal Audit
- SIA 8, Terms of Internal Audit Engagement
- SIA 9, Communication with Management
- SIA 10, Internal Audit Evidence
- SIA 11, Consideration of Fraud in an Internal Audit
- SIA 12, Internal Control Evaluation
- SIA 13, Enterprise Risk Management
- SIA 14, Internal Audit in an Information Technology Environment
- SIA 15, Knowledge of the Entity and its Environment
- SIA 16, Using the Work of an Expert
- SIA 17, Consideration of Laws and Regulations in an Internal Audit
- SIA 18, Related Parties

Compendium of Standards on Internal Audit (As on July 1, 2013)

Standards on Internal Audit issued by the Board are available for free download at http://icai.org/new_post.html?post_id=597&c_id=145



Appendix II

List of Generic and Industry Specific Publications

Industry Specific Technical Guides on Internal Audit

1. Technical Guide on Internal Audit of Pharmaceutical Industry
2. Technical Guide on Internal Audit of Textile Industry
3. Technical Guide on Business Control, Monitoring and Internal Audit of Construction Sector
4. Technical Guide on Internal Audit of Tendering Process
5. Technical Guide on Risk Based Internal Audit in Banks
6. Technical Guide on Internal Audit in Oil & Gas Refining & Marketing (Downstream) Enterprises
7. Technical Guide on Internal Audit in Aluminium Industry
8. Technical Guide on Internal Audit in Upstream Oil & Gas Companies
9. Technical Guide on Internal Audit in Telecommunications Industry
10. Technical Guide on Internal Audit of Stock Brokers
11. Technical Guide on Internal Audit of Intangible Assets
12. Technical Guide on Internal Audit of Treasury Function in Banks
13. Technical Guide on Internal Audit of Educational Institution
14. Technical Guide on Internal Audit of Sugar Industry
15. Technical Guide on Internal Audit of BPO Industry
16. Technical Guide on Internal Audit of Retail Industry
17. Technical Guide on Internal Audit of Life Insurance Companies
18. Technical Guide on Internal Audit of Mutual Fund
19. Technical Guide on Stock and Receivables Audit
20. Technical Guide on Internal Audit of Not-for-Profit Organisations (NPOs)
21. Technical Guide on Internal Audit of Mining and Extractive Industry
22. Technical Guide on Internal Audit of Infrastructure Industry
23. Technical Guide on Internal Audit of Petrochemical Industry

24. Technical Guide on Internal Audit of Beverages Industry
25. Technical Guide on Auditing Waste Management
26. Technical Guide on Internal Audit of IT Software Industry
27. Compendium of Technical Guides on Internal Audit (As on February 1, 2013)

Industry Specific Technical Guides issued by the Board are available for free download at http://icai.org/post.html?post_id=8916

Generic Guidelines on Internal Audit

1. Guide on Corporate Social Responsibility
2. General Guidelines on Internal Audit
3. Guide on Risk-Based Internal Audit
4. Manual on Concurrent Audit of Banks
5. Guide to Internal Financial Controls
6. Guide to Implementing Enterprise Risk Management
7. Manual on Internal Audit
8. Training Material on Internal Audit
9. Background Material on Due Diligence
10. Study on Co-ordination of Internal Auditor with Functional Heads
11. Handbook on Professional Opportunities in Internal Audit
12. Guide on Environmental Audit
13. Data Analytics and Continuous Control Monitoring
14. Study on Investigative Audits
15. Technical Guide on Social Audit

Generic Guides issued by the Board are available for free download at http://icai.org/post.html?post_id=8918

Knowledge Booklet

1. Enhancing Governance through Internal Audit

Knowledge Booklet issued by the Board is available for free download at http://www.icai.org/new_post.html?post_id=6623&c_id=357

Composition of the Internal Audit Standards Board 2014-15

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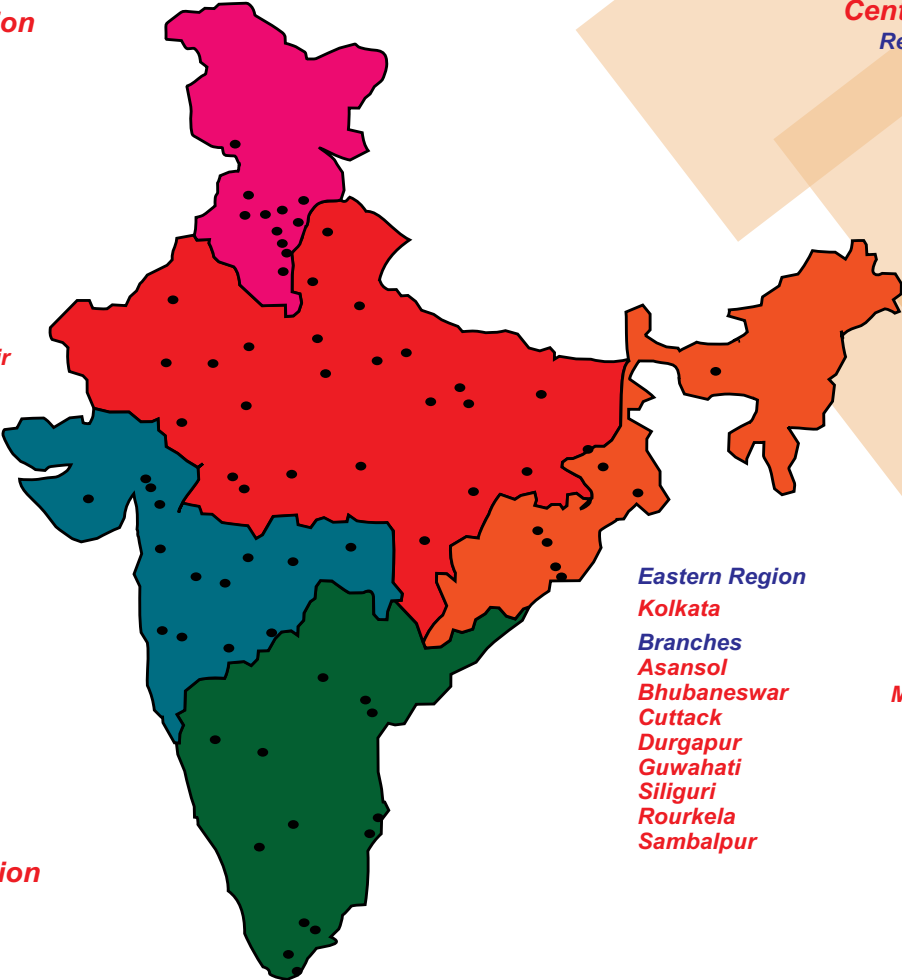
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ICAI Network

NETWORK OF ICAI HEAD OFFICE-NEW DELHI

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Central Region

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Allahabad
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Bareilly
Bhilwara
Bhilai
Bhopal
Dhanbad
Dehradun
Ghaziabad
Gwalior
Indore
Jamshedpur
Jodhpur
Kota

Eastern Region

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Bhubaneswar
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Rourkela
Sambalpur

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Patna
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Udaipur
Varanasi
Jabalpur
Ujjain
Bikaner
Bilaspur
Gorakhpur
Pali
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Western Region

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Kolhapur
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Nashik
Pune
Rajkot
Sangli
Solapur
Surat
Akola
Vasai
Thane

- Akola
Bharuch
Navi Mumbai
Pimpri Chinchwad
Amravati
Vapi
Gandhidham
Bhavnagar
Latur

Southern Region

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Erode
Guntur
Hubli
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Kottayam
Kumbakonam
Madurai
Mangalore
Mysore
Palghat
- Pondicherry
Quilon
Salem
Tiruchirapalli
Tirunelveli
Trichur
Tirupur
Trivandrum
Tuticorin
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