

Knowledge Booklet III

AUDIT COMMITTEE

MONITORING EFFECTIVENESS OF INTERNAL AUDIT



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 66 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, 150 Branches covering the length and breadth of the country and 26 Chapters and an overseas office in Dubai. Founded about sixty six years ago with just seventeen hundred members, the Institute has grown to cross the mark of 2,37,000 members and 8,50,000 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 endeavoring 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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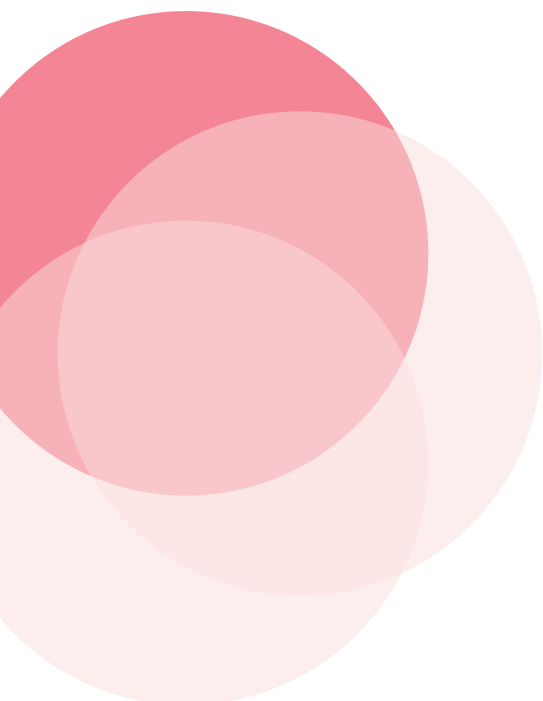
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CA. Amit Gupta, FCA

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INTRODUCTION

Audit Committees are primarily entrusted with responsibility of oversight of the company's financial reporting process, system of internal control and risk management, audit process and audit quality, and compliance with laws and regulations. However, accelerating speed and complexity of business and risks are stretching audit committees agenda to include other major areas of risk, like, technology risk, cyber risk, reputational risk and others. The primary role of the Audit Committee is that of assisting Board of Directors in overseeing the:

- Company's financial reporting process and disclosure of it's financial information to ensure that the financial statements are correct, understandable, sufficient and credible;
- Discuss and review, with the management and auditors, the annual/ quarterly financial statements before submission to the Board;
- Compliance with legal and regulatory requirements and company's code of conduct;
- Qualification and independence of external auditors;
- Appointment, Definition of Scope and Review of Reports of the company's external auditors and the internal audit function;
- Adequacy and reliability of the internal control and risk management system;
- Effectiveness of Vigil Mechanism;
- Review of Cost audit;
- Review of Related Party Transactions

The Audit Committee acts as a link among the Management, the Statutory Auditors, Internal Auditors and the Board of Directors to oversee the financial reporting process of the Company. Audit Committee and Internal Auditor provide objective, independent advice to improve oversight, governance and help to mitigate risks of the organization. It is of utmost importance that the key activities of internal audit function aligns with the expectations of the audit committee and management, and are flexible enough to meet the changing business strategies and needs of the organization. For internal audit to be successful, it is necessary that an effective relationship is maintained between the audit committee and internal audit.



LEGAL FRAMEWORK



COMPANIES ACT, 2013

Section 177 (1) of The Companies Act, 2013, states that the Board of Directors of every listed company and the following classes of companies, shall constitute an Audit Committee and a Nomination and Remuneration Committee of the Board:

- (i) All public companies with a paid up capital of ten crore rupees or more;
- (ii) All public companies having turnover of one hundred crore rupees or more;
- (iii) All public companies, having an aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

The paid up share capital or turnover or outstanding loans or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purpose of this rule*.

Section 177(2) of the Companies Act, 2013, states that the Audit Committee shall consist of a minimum of three directors, with independent directors forming a majority.

Section 177(4) of the Companies Act, 2013, states that every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall *inter alia* include:

- (i) The recommendation for appointment, remuneration and terms of appointment of auditors of the company;
- (ii) Review and monitor the auditor's independence and performance, and effectiveness of audit process;
- (iii) Examination of the financial statement and the auditor's report thereon;
- (iv) Approval or any subsequent modification of transactions of the company with related parties;
- (v) Scrutiny of inter-corporate loans and investments;
- (vi) Valuation of undertakings or assets of the company, wherever it is necessary;
- (vii) Evaluation of internal financial controls and risk management system;
- (viii) Monitoring the end use of funds raised through public offers and related matters.

Section 177(5) of the Companies Act, 2013 lays down following:

"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."

*Companies (Meetings of Board and its Powers) Rules, 2014.



COMPANIES (ACCOUNTS) RULES, 2014

Companies (Accounts) Rules, 2014 came into effect from April 1, 2014. **Clause 13 of the said Rules** deal with “Companies required to appoint internal auditor”. **Clause 13 (2) states** that “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.”

CLAUSE 49 OF THE EQUITY LISTING AGREEMENT

Clause 49 (III)(D) of the Listing Agreement *inter alia* lays down as follows:

“The role of the Audit Committee shall include the following:

.....

2. Recommendation for appointment, remuneration and terms of appointment of auditors of the company;

.....

12. Reviewing, with the management

- Performance of statutory and internal auditors
- Adequacy of the internal control systems;

13. Reviewing the adequacy of internal audit function, if any, including

- The structure of the internal audit department,
- Staffing and seniority of the official heading the department,
- Reporting structure coverage and frequency of internal audit;

14. Discussion with internal auditors of any significant findings and follow up thereon;

15. Review the findings of any internal investigations by the internal auditors into matters where

- there is suspected fraud or irregularity or
- a failure of internal control systems of a material nature and reporting the matter to the board;

.....”

Clause 49(III) (E) of Listing Agreement deals with “Review of Information By Audit Committee”

This Clause *inter alia* includes that the Audit Committee shall mandatorily review the following information:

- Internal audit reports relating to internal control weaknesses; and
- The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.



INTERNAL AUDIT



The Audit Committee must ensure that the charter, independence and activities of the internal audit function are clearly understood and respond to the objectives of the organization and the legal framework. Responsibilities of the Audit Committee with regard to internal audit as prescribed in The Companies Act, 2013 and Clause 49 of the Equity Listing Agreement have been discussed above.

The audit committee and internal auditors are interdependent and so should be mutually accessible. Regular review of functional and administrative reporting lines of the internal auditor would ensure that the organizational structure is consistent with the principles of independence and accountability. Following are important areas where audit committee should support internal audit:

- Review and approve the internal audit charter, including internal audit strategic plan;
- Confirm that the annual audit plan makes provision for critical risk areas in the organization;
- Advise the organization on resources allocated to give effect to the work outputs of the internal audit function;
- Ensure that there is support for the internal auditors from senior management;
- Confirm with management that internal audit findings are submitted to the audit committee on a quarterly basis;
- Confirm actions taken by management in relation to the internal audit plan;
- Consider and review reports relating to difficulties encountered during the course of the internal audit engagement, including any scope limitation or access to information reported to the management that remain unresolved;
- Evaluate the performance of internal audit activity in terms of the agreed goals and objectives as captured in the internal audit plan;
- Ensure that the head of internal audit has reasonable access to the chairperson of the audit committee;
- Conduct a high-level review of internal audit on an annual basis, to ascertain whether the internal audit unit complies with the applicable Standards;



It is important that the internal auditor possesses superior business acumen, dynamic communication skills, unflinching integrity and ethics, excellent grasp of business risks and rich experience. Internal audit function is responsible to the audit committee as follows:

- Maintain open and effective communication with the audit committee;
- Develop a flexible annual internal audit plan using a risk based methodology, addressing any weaknesses in risks or controls identified;
- Submit the internal audit plan to the audit committee for review and approval;
- Report on the implementation and results of the annual internal audit plan including special tasks requested by management and the audit committee;
- Assist in drafting the agenda and documentation, and facilitate the distribution thereof to the audit committee in advance of meetings

Some specific areas where internal audit should provide their insight to the Audit Committee are as follows:

I. INTERNAL CONTROL

The Audit Committee is responsible for reviewing the adequacy of the entity's internal control environment to ensure that the entity's key controls are designed appropriately and are operating as intended. Internal auditor can help in fulfilling this responsibility by examining the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness. Role of internal auditor encompasses:

- Evaluation of the efficiency and effectiveness of controls.
- Recommending new controls where needed – or discontinuing unnecessary controls
- Using control frameworks
- Developing control self-assessment





II. ENTERPRISE RISK MANAGEMENT

The Audit Committee shall report to the entire Board of Directors, at least annually, with respect to matters related to enterprise risk and risk management. Internal auditor plays an important role by providing assurance to management on the effectiveness of risk management. The scope of the internal auditor's work in assessing the effectiveness of the enterprise risk management would, normally, include:

- Assessing the risk maturity level both at the entity level as well as the auditable unit level;
- Assessing the adequacy of and compliance with the risk management policy and framework.

The internal audit plan, which should be approved by the audit committee, should also be based on risk assessment as well as on issues highlighted by the audit committee and senior management.



III. COMPLIANCE OVERSIGHT RESPONSIBILITIES

The Audit Committee should obtain assurance that the internal auditor has reviewed the compliance management system, and has informed of any illegal act that the internal auditors becomes aware of to the Audit Committee. Internal auditor should review management's anti-fraud programs and controls, including management's identification of fraud risks and implementation of anti-fraud measures. The audit committee should also discuss with management and internal auditors any correspondence with regulators or governmental agencies, and any published reports that may arise material issues regarding the company's financial statements or accounting policies. Internal auditor should also assist the management in identifying the significant impact of non-compliance with laws and regulations on the functioning of the entity.

IV. WHISTLE BLOWING/ VIGIL MECHANISM

The Audit Committee shall review the company's arrangements for its employees to raise concerns, in confidence, about possible wrongdoing in financial reporting, accounting or related matters. The committee shall ensure that these arrangements allow independent investigation of such matters and appropriate follow up action. **Section 177(10) of the Companies Act, 2013** requires that the vigil mechanism shall provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. Internal auditor should provide assurance on the effectiveness of the whistle blowing system and procedures to the Audit Committee, and assist in promoting whistle blowing best practices. Further, all whistle blowing reports should be informed to the internal auditor so that he can consider impact that they have on it's overall opinion concerning risk management and internal control.



LIST OF STANDARDS ON INTERNAL AUDIT

Preface to the Standards on Internal Audit

Framework for 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://www.icaai.org/new_post.html?post_id=597&c_id=145



LIST OF INDUSTRY SPECIFIC INTERNAL AUDIT GUIDES, GENERIC INTERNAL AUDIT GUIDES & KNOWLEDGE BOOKLETS

Industry Specific Internal Audit Guides

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 in Oil & Gas Refining & Marketing (Downstream) Enterprises
5. Technical Guide on Internal Audit in Aluminum Industry
6. Technical Guide on Internal Audit in Upstream Oil & Gas Companies
7. Technical Guide on Internal Audit in Telecommunications Industry
8. Technical Guide on Internal Audit of Stock Brokers
9. Technical Guide on Internal Audit of Treasury Function in Banks
10. Technical Guide on Internal Audit of Educational Institutions
11. Technical Guide on Internal Audit of Sugar Industry
12. Technical Guide on Internal Audit of BPO Industry
13. Technical Guide on Internal Audit of Retail Industry
14. Technical Guide on Internal Audit of Life Insurance Companies
15. Technical Guide on Internal Audit of Mutual Fund
16. Technical Guide on Stock and Receivables Audit
17. Technical Guide on Internal Audit of Not-for-Profit Organizations (NPOs)
18. Technical Guide on Internal Audit of Mining and Extractive Industry
19. Technical Guide on Internal Audit of Infrastructure Industry
20. Technical Guide on Internal Audit of Petrochemical Industry
21. Technical Guide on Internal Audit of Beverages Industry
22. Technical Guide on Internal Audit of IT Software Industry
23. Technical Guide on Auditing Waste Management
24. Compendium of Industry Specific Internal Audit Guides *(As on January 1, 2015)*

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



Generic Internal Audit Guides

1. Guide on Corporate Social Responsibility (CSR) Audit
2. General Guidelines on Internal Audit
3. Guide on Risk-Based Internal Audit
4. Manual on Concurrent Audit of Banks
5. Guide to Internal Controls over Financial Reporting
6. Manual on Internal Audit
7. Training Material on Internal Audit
8. Background Material on Due Diligence
9. Study on Co-ordination of Internal Auditor with Functional Heads
10. Handbook on Professional Opportunities in Internal Audit
11. Guide on Environmental Audit
12. Data Analytics and Continuous Control Monitoring
13. Study on Investigative Audits
14. Technical Guide on Social Audit
15. Technical Guide on Internal Audit of Tendering Process
16. Technical Guide on Internal Audit of Intangible Assets
17. Guide on Risk-Based Internal Audit Plan
18. Compendium of Generic Internal Audit Guides *(As on January 1, 2015)*

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

Knowledge Booklets

1. Knowledge Booklet I “Enhancing Governance Through Internal Audit”
2. Knowledge Booklet II “A New Era in Internal Audit- Companies Act, 2013”

Knowledge Booklets issued by the Board are available for free download at http://www.icaai.org/post.html?post_id=11112

ICAI Network

NETWORK OF ICAI HEAD OFFICE-NEW DELHI

Northern Region

Regional Office

New Delhi

Branches

- Ambala*
- Amritsar*
- Bhatinda*
- Chandigarh*
- Faridabad*
- Gurgaon*
- Hisar*
- Jalandhar*
- Jammu & Kashmir*
- Ludhiana*
- Panipat*
- Patiala*
- Rohtak*
- Shimla*
- Sonepat*
- Yamunanagar*
- Karnal*
- Sangrur*

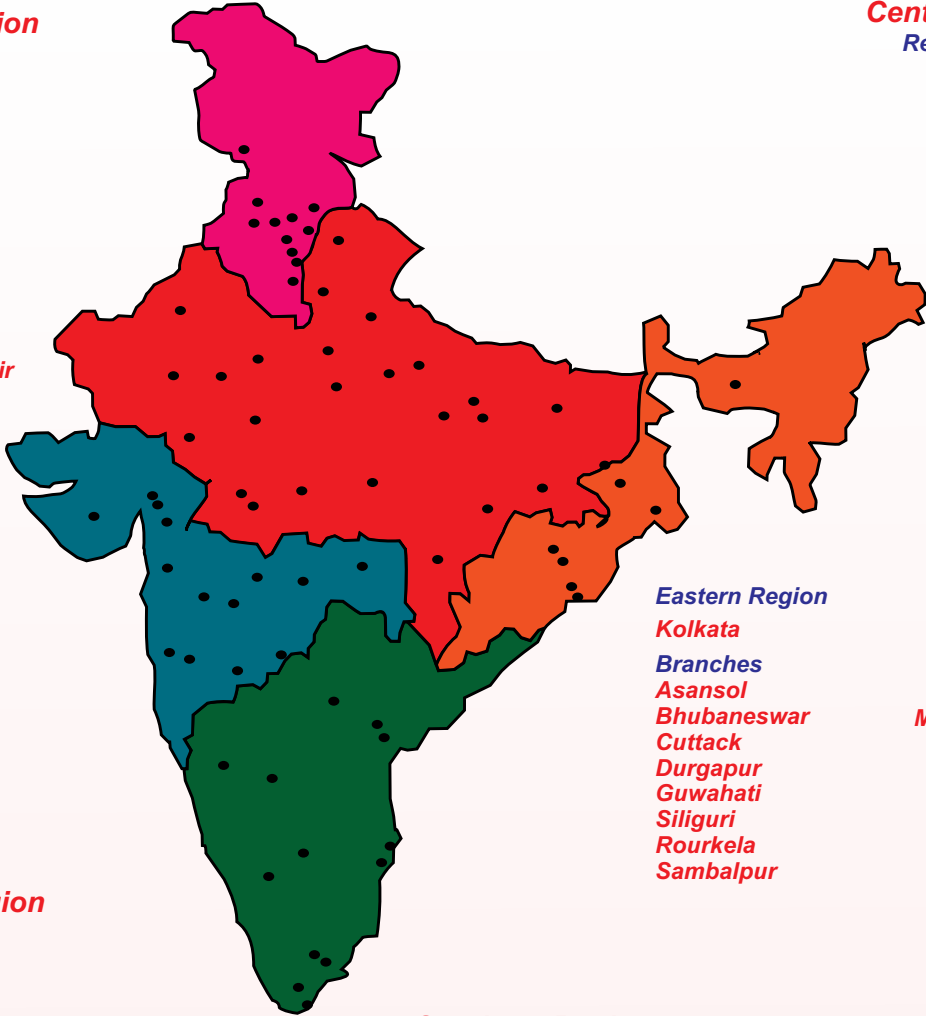
Central Region

Regional Office

Kanpur

Branches

- Agra*
- Ajmer*
- Allahabad*
- Alwar*
- Bareilly*
- Bhllwara*
- Bhilai*
- Bhopal*
- Dhanbad*
- Dehradun*
- Ghaziabad*
- Gwalior*
- Indore*
- Jamshedpur*
- Jodhpur*
- Kota*



Eastern Region

Kolkata

Branches

- Asansol*
- Bhubaneswar*
- Cuttack*
- Durgapur*
- Guwahati*
- Siliguri*
- Rourkela*
- Sambalpur*

- Lucknow*
- Mathura*
- Moradabad*
- Merrut*
- Muzaffarnagar*
- Noida*
- Patna*
- Raipur*
- Ranchi*
- Saharanpur*
- Udaipur*
- Varanasi*
- Jabalpur*
- Ujjain*
- Bikaner*
- Bilaspur*
- Gorakhpur*
- Pali*
- Sriganganagar*
- Ratlam*

Western Region

Regional Office

Mumbai

Branches

- Ahmedabad*
- Ahmednagar*
- Anand*
- Aurangabad*
- Baroda*
- Goa*
- Jalgaon*
- Jamnagar*
- Kolhapur*
- Nagpur*
- Nashik*
- Pune*
- Rajkot*
- Sangli*
- Solapur*
- Surat*
- Akola*
- Vasai*
- Thane*

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

Southern Region

Regional Office

Chennai

Branches

- Alleppey*
- Bengaluru*
- Belgaum*
- Calicut*
- Coimbatore*
- Ernakulam*
- Erode*
- Guntur*
- Hubli*
- Hyderabad*
- Kottayam*
- Kumbakonam*
- Madurai*
- Mangalore*
- Mysore*
- Palghat*
- Pondicherry*
- Quilon*
- Salem*
- Tiruchirapalli*
- Tirunelveli*
- Trichur*
- Tirupur*
- Trivandrum*
- Tuticorin*
- Udupi*
- Vellore*
- Vijayawada*
- Visakhapatnam*

- Bellary*
- Kakinada*
- Nellore*
- Tirupati*



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