

# INTERNAL AUDIT



## LEARNING OUTCOMES

**After studying this chapter, you will be able to:**

- Know the meaning and scope of Internal Audit.
- Gain the knowledge of the internal audit as per provisions of the Companies Act, 2013.
- Gain understanding of basic steps and activities involved in internal audit.
- Gain understanding of drafting of internal audit report.
- Analyse the relationship between Internal and External Auditors.
- Understand the Audit Trail.
- Acquire the knowledge of basics of the Standards on Internal Audit issued by the ICAI.

## CHAPTER OVERVIEW



Meaning and Scope of Internal Audit

Integrity, Objectivity and Independence of Internal Auditor

Qualities of Internal Auditor

Steps involved in performing Internal Audit Engagement

Drafting of Internal Audit Report

Relationship between Internal and External Auditors

### Internal Audit

Try and Scale Limited, a listed company, has advertised for the position of “*Chief Internal Auditor*” of the company in few prominent pink newspapers. CA P is offered the position after duly vetting his credentials. The offer letter of the company states that Chief Internal Auditor is required to report to the CFO of the company. On going through contents of letter, he finds it weird. What is unusual about it and why?

Since internal audit is an independent function, the Internal Auditor has to be free from any undue influences which force him to deviate from the truth. Also, the internal auditor has to resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported findings, particularly if they deviate from set objectives. The independence of internal auditor within the company plays a large part in establishing his independence.

CA P immediately flagged this issue to the company, pointing out that reporting to the CFO could compromise his independence as the Internal Auditor. He advised that to ensure independence of internal audit function, he should be positioned outside the functions which are subject to internal audit (e.g., Finance and Accounts) and he should report directly to the Audit Committee.

Besides, the offer letter also hinted at his role in “system automation” and “process re-engineering” in the company. Assuming proposed roles in above areas can also mar his independence. He was confused. “System automation” and “process re-engineering” are in nature of operational responsibilities. How he can accept responsibilities in this regard? Considering above, he thought it worthwhile to give a caveat to the company that he would not be in a position to assume accountability of these areas. He informed the company that

he would not be able to take operational decisions in these areas that could later fall within the scope of an internal audit. He would be able to accept only limited operational role and that too for a short duration.

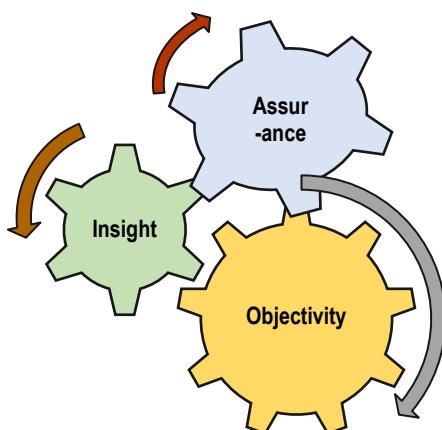
The company agreed to both the issues flagged by him and accepted the position.

After accepting appointment, he adopted a risk-based approach for identifying important audit areas. The company's operations were numerous and diversified. It made sense to him to adopt a system and process focused approach in conducting audit procedures. Such an approach would go a long way in "error prevention." His focus remained on preventing errors at the first place. Such an approach strengthens company's internal systems leading to improvement in governance mechanisms.



## 1. INTERNAL AUDIT

The operation of many modern organisations have become complex with high volume of transactions carried out at multiple locations with increasing dependency on technology. This has caused further



more delegation of authorities and decentralisation of activities. Consequently, key stakeholders including Board of Directors, top management, shareholders, lenders, investors and government are concerned with the propriety of the day-to-day affairs of the organization and reliability of the various financial and non-financial information being recorded and reported to the stakeholders. Accordingly, the stakeholders get internal audit conducted to obtain report on the deficiency in internal control system and

underlying transactions for better governance of organization and take timely remedial actions wherever needed.

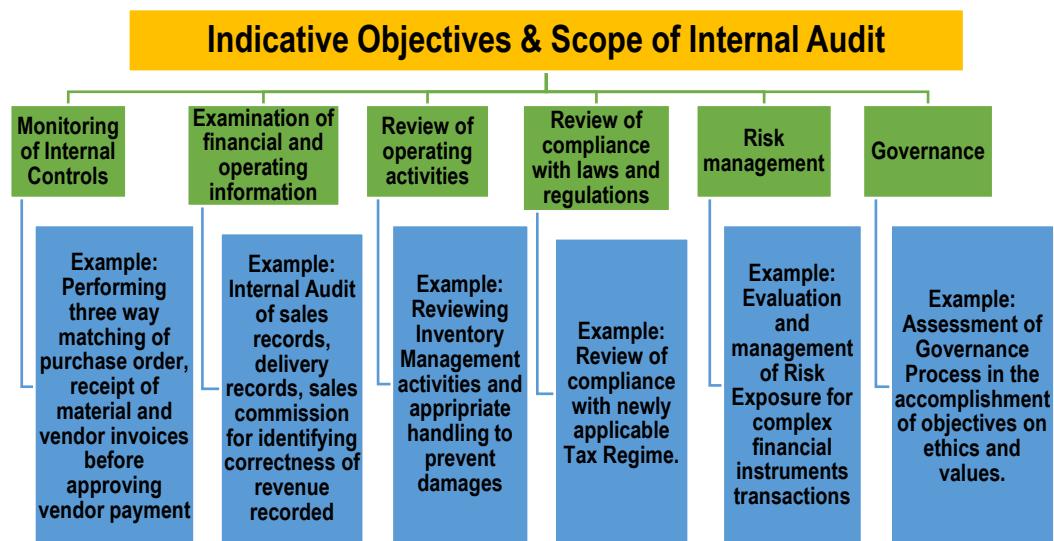
The Institute of Chartered Accountants of India constituted the Internal Audit Standards Board (IASB) as a non-standing technical board on February 5, 2004. The Internal Audit Standard Board (earlier known as the Committee on Internal Audit) is constituted with the object of formulating Standards on Internal Audit (SIAs), Guidance Notes on Internal Audit, continuously review the Standards and Guidance Notes, and to formulate and review Implementation Guides, Technical Guides, Practice Manuals, Studies and other papers, which may be issued under its own authority

for guidance of the members, as felt appropriate by the Board. Besides, the IASB also undertakes research and promote knowledge dissemination in the field of internal audit.

**Definition of Internal Audit:** As defined in Framework Governing Internal Audits, “Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.”

The Framework also indicates the nature of internal audit services may go beyond assurance to include an advisory (consulting) role to help an organization achieve its objectives, provided this does not compromise the independence of the internal auditor. The internal auditing is not confined to financial transactions only and include review of operational activities, underlying internal controls, compliance to applicable laws and regulations. The objectives and scope of Internal Audit Function as per SA 610, “Using the Work of an Internal Auditor” may include:

• Monitoring of internal controls;	• Review of compliance with laws and regulations
• Examination of financial and operating information	• Risk management
• Review of operating activities	• Governance



**Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013, following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor which may be either an individual or a partnership firm or a body corporate, namely-

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|---|
| <b>(a) every listed company;</b>  |
| <b>(b) every unlisted public company having-</b>  |
| (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   |
| <b>(c) every private company having-</b>  |
| (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.     |

It is provided that when an existing company gets covered under any of the above criteria it shall comply with the requirements within six months of commencement of such applicability.

#### CASE STUDY 1

JKT Pvt. Ltd. is having ₹ 40 lacs paid-up capital, ₹9.50 crores reserves and turnover of the last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, the internal audit system is not mandatory. Comment.

**Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013, read with rule 13 of the Companies (Audit and Auditors) Rules, 2014, every private company shall be required to appoint an internal auditor or a firm of internal auditors, 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.

**Conclusion:** In the instant case, JKT Pvt. Ltd. is having a turnover of ₹ 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory requirement to appoint an Internal Auditor and mandatorily conduct an internal audit.

### Who can be Appointed as an Internal Auditor?

- ◆ As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.
- ◆ The internal auditor may or may not be an employee of the company.
- ◆ To be effective, the internal auditor must be regarded as a part of the management and not merely as an assistant thereto. Furthermore, he or she must have the authority to investigate every organisational activity to meet the objectives and scope of the internal audit.



1. AB Pvt. Ltd. company, having outstanding loans and borrowings from banks exceeding one hundred crore rupees, wants to appoint Mr. X, a practicing cost accountant, as an internal auditor. Is the appointment of Mr. X valid?

**Provision & Conclusion:** According to the provision given in section 138 of the Companies Act, 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the companies. Thus, Appointment of

**Conclusion:** Thus, appointment of Mr. X as an internal auditor of AB Pvt. Ltd. is valid.

As per Standard on Internal Audit (SIA) 210 Managing the Internal Audit Function, the Internal Audit Function performs a number of activities to achieve its objectives as outlined in its Charter (or Terms of Engagement). A few of the critical activities are as follows:

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|-----|---|
| (a) | Define the overall plan, scope and methodology of the Internal Audit Function on a periodic basis.  |
| (b) | Oversee and monitor various audit assignments, their proper planning, execution, reporting of findings and subsequent closure of reported observations. |
| (c) | Plan, acquire, engage and review the performance, training and development of professional staff, talent and other resources to achieve its objectives. |
| (d) | Identify, source, engage and manage external experts and technical solutions, if required.  |

- (e) Communicate and engage with all key stakeholders regarding progress and achievement of objectives.
- (f) Develop and maintain a quality evaluation and improvement program.

With respect to the accounting function and financial records of the organisation, the responsibilities of an Internal Auditor include:

to ascertain adequacy of system of internal control by a continuous examination of accounting procedures, receipts and disbursements, and to provide adequate safeguards against misappropriation of assets.

to operate independently of the accounting staff and must not in any way divest with any of the responsibilities placed upon him.

Not to involve in the performance of executive functions in order that the objective outlook does not get obscured by the creation of the vested interest.

to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected.

to associate closely with management and keep knowledge up to date by being informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies.

At all times, the internal auditor must enjoy an independent status.

At times, the Internal Auditor is exposed to a different type of risk to independence, whereby management seeks active business support from the Internal Auditor.

Apart from providing assurance on internal controls over the operational activities of the organization, the Internal Auditor may be sometimes assigned responsibility to provide advisory inputs on governance activities such as risk management, framework of monitoring statutory compliances, automation of activities, avenues of process re-engineering with increase operational efficiency, code of ethics etc.



## 2. MANAGEMENT FUNCTIONS AND SCOPE OF INTERNAL AUDITING

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. To achieve optimum utilisation of resources management should determine the goals and objectives of the concern, quantify them to the extent possible, develop major policies and plans, implement them and exercise control over such implementation.

In the case of Companies required to appoint an Internal Auditor as per Section 138 of the Companies Act, 2013, Rule 13(2) of Companies (Accounts) Rules 2014, states: "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." Hence, in this class of companies, the Audit Committee or the Board, in conjunction with management and the Chief of Internal Audit, is expected to exercise the responsibility to formulate the objectives of internal audit. In the case of other organisations not covered under Rule 13, those who appoint the Internal Auditor (e.g., the owners, the promoters, the Board of Trustees, etc.) would generally define the objectives of internal audit.

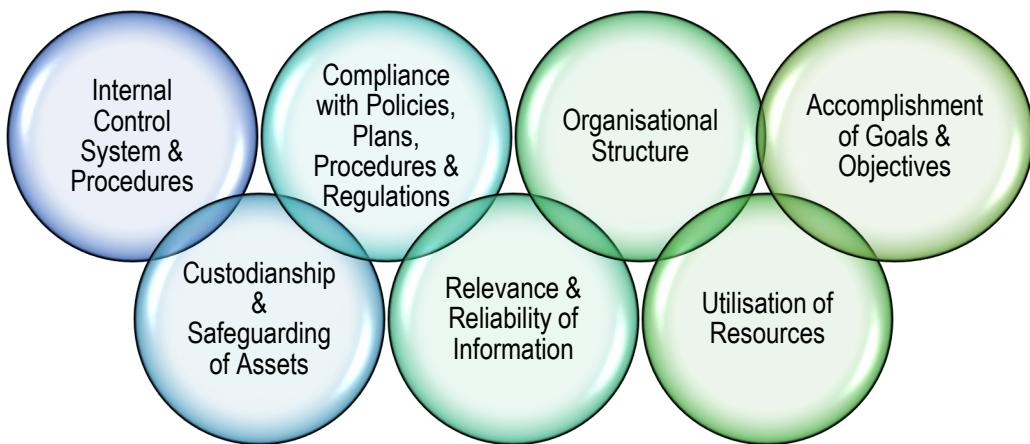
The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

Internal audit plan should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made, and adequate balance is ensured to the following:

- ◆ Risk underlying the business process
- ◆ Value that the internal audit can provide to the organization
- ◆ Effort involved in conducting the internal audit for a particular business process
- ◆ Risk Appetite of the organization
- ◆ Coverage of all auditable areas within the defined time range

In addition, each of the managerial functions should be reviewed by the internal auditor.

The scope of internal auditor's work should also include a review of-



On the basis of such review, the internal auditor should in his report, highlight the weaknesses observed and give suggestions for improvement. We may now have a brief description of each of the above areas of review:

**(i) Review of Internal Control System and Procedures -**

- (a) The review of internal control system and procedures involves assessing the design and operational efficiency and effectiveness of the internal control system to strengthen the overall internal control environment of the entity. The objective to review is to minimise the overall residual risk by suggesting the appropriate controls to reduce the inherent risk.



2. Review of three-way matching internal control involves matching of Purchase Orders, Goods Receipt Notes and Invoice to ensure all the ordered quantity of the intended goods have been received and invoiced accordingly. The failure of this internal control may involve over-invoicing, over-payment, non-receipt, or under-receipt of goods.

As far as possible, controls should be in-built in the operating functions for prevention or timely detection of the fraud and errors and minimize the cost of control.



**3.** The establishment of a separate credit control department would not be justified if the objective of reducing credit risk and minimising debt recovery period could be met through controls in-built in the accounting and sales systems, especially in smaller and medium-sized concerns.

- (b) Internal Control System should be reviewed considering the limitations of internal controls, i.e., cost-benefit comparison, human errors, collusion, and abuse by process owners.



**4.** Collusion of payment authorizer and payment maker to overpay a related party; those charged with governance themselves overriding the internal controls with malafide intention, etc.

It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal controls for a specific portion of intended reliance would need special attention.

**(ii) Review of Custodianship and Safeguarding of Assets -**

- This involves verifying the existence of the assets.
- The internal auditor should review the segregation of duties is in place.
- The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses e.g. fire, improper or negligent activity, theft and illegal acts, etc.
- He should review the control systems for intangible assets e.g. the procedures relating to credit control. Where an enterprise uses electronic data processing equipment, the physical and systems control on processing facilities as well as on data storage should be examined and tested.



**5.** The existence of intangible assets could be only an annual subscription in the name of an entity, for example, an annual ERP subscription.

**(iii) Review of Compliance with Policies, Plans, Procedures and Regulations -** It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in a coordinated manner. He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By

combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.

- (iv) **Review of Relevance and Reliability of Information** - The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, investors, trade organisations, labour unions, etc. He should examine the accuracy and reliability of financial and operational records. The usefulness of the reports as well as of the records should be evaluated with reference to their costs. The internal auditor should examine whether the reporting is by exception i.e. the reports highlight the significant and distinctive features. In case of automated management information system, where relevant information used for critical decision making is generated from the computer system, then adequacy of the controls build in the system should be reviewed to ensure data integrity and reliability of such information.
- (v) **Review of the Organisation Structure** - The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:
- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
  - The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
  - He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between the authority and responsibility of important executives.
  - The internal auditor should examine the reasonableness of the span of control of each executive (the number of subordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.

- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- He should review adequate segregation of duties is considered while defining the organization structure.
- Finally, he should evaluate the process of managerial development in the enterprise.

**(vi) Review of Utilisation of Resources –**

- The internal auditor should check whether proper operating standards and norms have been established for measuring the economical and efficient use of resources.
- They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance.
- The internal auditor should review the methods of establishing operating standards and norms. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate and necessary.
- Where there is a wide divergence between actual performance and the corresponding standards, reasons may be considered. As a part of evaluating resources utilisation, identifying the facilities which are under-utilized is an important function of the internal auditor.



**6. For example,** it may consist of under-utilized machines, unoccupied storage space, huge cash or bank balances, idle manpower, etc. While commenting on staffing, the internal auditor should pay special attention to non-productive work being performed. This would require an inquiry into the job descriptions of employees combined with an intelligent observation of the work being done.

**(vii) Review of Accomplishment of Goals and Objectives -** The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable. The internal auditor should examine whether, to the extent possible, objectives are expressed in precise quantifiable terms (both monetary and non-monetary) to facilitate detailed planning to be made for achieving them. Budgeting forms an important part of such planning. This will ensure that plans anticipate the problem areas. There should also be sufficient flexibility in the plans to permit such improvements in their implementation, as would benefit the enterprises as a whole.



### 3. INTEGRITY, OBJECTIVITY AND INDEPENDENCE OF INTERNAL AUDITOR

There is a set of core principles fundamental to the internal audit function and activities. These basic principles of internal audit are critical to achieving the desired objectives as set out in the Definition of Internal Audit. The basic principles of Internal Audit are a set of core principles fundamental to the function and activity of internal audit.

1. The Internal Auditor shall be free from any undue influences which force him to deviate from the truth. This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives.

The independence of the internal audit function as a whole, and the Internal Auditor within the organisation, plays a large part in establishing the independence of the Internal Auditor. The overall organisation structure of key personnel, the position and reporting of the Chief Internal Auditor within this structure, along with the powers and authority which is derived from superiors further establishes the independence of the Internal Auditor.

2. The Internal Auditor shall be honest, truthful and be a person of high integrity. He shall operate in a highly professional manner and seen to be fair in all his dealings. He shall avoid all conflicts of interest and not seek to derive any undue personal benefit or advantage from his position.
3. The Internal Auditor shall conduct his work in a highly objective manner, especially in gathering and evaluation of facts and evidence. He shall not allow prejudice or bias to override his objectivity, especially in arriving at conclusions or reporting his opinion.



7. **For example**, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference.



8. **For example**, in the case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. The internal auditor

should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.

### TEST YOUR UNDERSTANDING 1

After an illustrious career in Indian Audit & Accounts Service for about 25 years, Parteek, a postgraduate in law, has taken voluntary retirement from government service. Being in fine spirits, he wants to take responsibility as Chief internal auditor in the corporate sector. On looking at attractive compensation packages, he applied for such position in a leading listed company engaged in oil refining business. The Board of company is keen on him due to his impressive credentials.

Can he be appointed in this leading position of said company?

### TEST YOUR UNDERSTANDING 2

CA Deva is an internal auditor of a listed company. The company wants to make sure that it is in compliance with SEBI requirements at all times and it is never on the wrong side of the law. It asks its internal auditor to manage its compliance tracking system including directly corresponding with regulator in this regard. The profile and scope of internal audit agreed at time of appointment included “*compliance with laws and regulations.*”

Can he perform such type of activities in capacity of internal auditor of company?



## 4. QUALITIES OF INTERNAL AUDITOR

Internal auditor is required to objectively review overall governance and operational functions of the organization and, is required to interact with various stakeholders and other employees of the organisation. To perform his duties effectively, he is required to possess good knowledge of the subject matter, underlying information system and good soft skills.

Some of the specialised knowledge and expertise that Internal Auditor should obtain are:

1. The internal auditor should have the special expertise necessary for evaluating management control systems, especially financial and accounting controls.
2. Accounting and finance functions provide basic data for management control of an enterprise. Therefore, the internal auditor must have accounting and financial expertise to be able to discharge his duties.

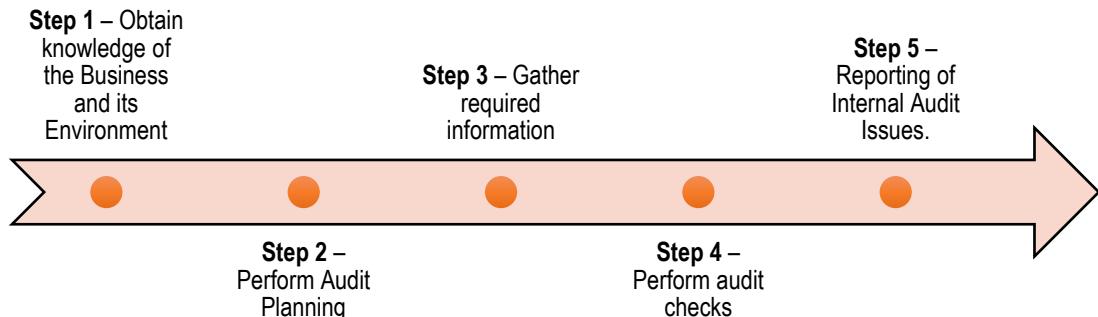
3. The internal auditor is also expected to evaluate both financial and operational controls. This requires a good knowledge of the operations of the organization, technology and commercial practices of the enterprise.
4. He should also have a good knowledge of commerce, laws, taxation, cost accounting, economics, quantitative methods and EDP systems.
5. An understanding of the accounting software, ERP system and other applications being used by the organization along with the knowledge of the basic controls related to Information Technology.
6. An understanding of management principles and techniques is another essential qualification of an internal auditor as also the ability to deal with people.
7. By his conduct the internal auditor should provide an assurance to the management that the confidentiality of such information would be maintained





## 5. PERFORMING INTERNAL AUDIT ENGAGEMENT

Typical internal audit engagement comprises of following five steps:



All of these steps are required to be performed while performing any Internal Audit engagement in the same sequence. Let us see some of the major activities to be performed under each of these steps:

### Step 1 – Obtain Knowledge of the Business and its Environment

Internal Auditor must conduct meetings with key stakeholders, Board of Directors and Key management personals to obtain understanding of the organization's business environment, its operations, organization's vision, mission and top management's expectations from the audit functions.

Internal auditor must obtain understanding of various business documents – Standard Operating Procedures and Financial Statement Etc.

Internal auditor must also obtain understanding of the underlying Information Technology landscape, various applications and ERP systems of the organization and Management Information System of the organization.

Internal auditor must also obtain understanding of the regulatory landscape and various laws and regulations that are applicable to the organization.

### Step 2 – Perform Audit Planning

Internal Auditor must plan the audit engagement as per the Standard on Internal Audit (SIA) 310, Planning the Internal Audit Assignment. Audit scope must be approved by Audit Committee and Board of Directors.

Once approved, Internal Auditor must share detailed Audit Plan with the key managerial personals and plan in advance the detailed schedule of the Internal Audit to be conducted.

Internal Auditor must conduct the opening meeting with key stakeholders before start of audit engagement and share details of Information and System Access required to perform the audit.

Detailed work plan must be prepared by the audit managers and approved with Head of Internal Audit / Chief Internal Auditor. The work plan must be prepared after performing the evaluation of all major underlying risks in the process being reviewed and the audit checks to be performed to assess the adequacy of the control environment to mitigate such risks.

### **Step 3 – Gather Required Information**

Internal Auditor must obtain the required information and perform checks to ensure correctness and integrity of information received. To the extent possible, Internal Auditor must obtain the information directly from the source.

Adequate planning should be done and advance intimation should be made for any interim information needed for performing audit checks.

### **Step 4 – Perform Audit Checks**

Internal Auditor should collate all data and perform analytical procedures to identify key trends and outliers. Analytical procedures should be performed in accordance with the Standard on Internal Audit (SIA) 6, Analytical Procedures. To the extent possible, relevant analytical tools may be used to perform review of the complete data for the audit period.

Wherever needed, Internal Auditor must select the sample in accordance with Standard on Internal Audit (SIA) 5, Sampling.

Detailed audit testing must be performed as per the audit work plan. Internal Auditor must ensure adequate evidence must be collected and stores in accordance to Standard on Internal Audit (SIA) 320, Internal Audit Evidence

Internal Auditor must prepare detailed list of the Identified audit issues and controls gaps. Interim reports may be issued after proper review of the work performed as per the Standard on Internal Audit (SIA) 350, Review and Supervision of Audit Assignments.

Adequate document of the internal audit work papers needs to be ensured as per Standard on Internal Audit (SIA) 330, Internal Audit Documentation.

### Step 5 – Reporting of Internal Audit Issues

Internal Auditor must prepare a draft report of Internal Audit issues comprising of the business process/ function reviewed as per scope, detailed audit coverage and exclusions, if any, audit period covered during the audit, summary along with detailed issues over the gaps noted along with implication of the business and recommendation to mitigate the identified gaps.

Management Action Plan should be agreed along with responsibility of action and timelines for actions. Internal Auditor must also review the status of actions taken by the management against the actions agreed during previous audits and report the status of such follow up in the audit report.

Internal Auditor should thereafter circulate Final Report and presentation his findings to the Audit Committee. Internal auditor must adhere to Standard on Internal Audit (SIA) 360, Communication with Management and Standard on Internal Audit (SIA) 370, Reporting Results while sharing the result of internal audit with the stakeholders.



## 6. INTERNAL AUDIT REPORT

The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, it would be more appropriate for him to bring the same immediately to the attention of the management.

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

*At the end of a particular audit assignment, an “Internal Audit Report” covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.*

*On a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.*

This Standard on Internal Audit (SIA) deals with the internal auditor's responsibility to issue only the first type of reports, the Internal Audit Report pertaining to specific audit assignments and not to the periodic (e.g. Quarterly) reporting for the whole entity as per the Annual/Quarterly audit plan.

On the basis of the internal audit work completed, the Internal Auditor shall issue a clear, well documented Internal Audit Report which includes the following key elements:

- (a) An overview of the objectives, scope and approach of the audit assignments;
- (b) The fact that an internal audit has been conducted in accordance the Standards of Internal Audit;
- (c) An executive summary of key observations covering all important aspects, and specific to the scope of the assignment;
- (d) A summary of the corrective actions required (or agreed by management) for each observation; and
- (e) Nature of assurance, if any, which can be derived from the observations.

The content and form of the Internal Audit Report are to be established by the Internal Auditor based on his best professional judgement, in consultation with the auditee and, if necessary, with inputs from other key stakeholders. No internal audit report shall be issued in final form unless a written draft of the report has previously been shared with the auditee.

The internal audit report shall be issued within a reasonable time frame from the completion of the internal audit work.

**1. Basis of Internal Audit Report:** Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted. Controls operating effectively have their own importance and should be acknowledged, while the risk and significance of observations noted have a role to play in prioritising the matters to be reported.

**2. Conducted in Accordance with SIAs:** Where the internal audit is conducted in compliance with the Standards of Internal Audit, (within the Framework governing Internal Audits), and the internal auditor can substantiate the same with supporting evidence and documentation, the internal audit report shall include a statement confirming that "the internal audit was conducted in accordance with the Standards of Internal Audit issued by the Institute of Chartered Accountants of India".

**3. Content and Format of Internal Audit Report:** The manner in which the internal audit report is drafted and presented is a matter of professional judgment and choice and could be influenced by the preferences of the recipients. The SIA does not mandate any particular format or list of contents since the Internal Auditor is expected to exercise his best professional judgement on matters regarding how and what to report. Where some level of assurance is being provided, the form and content of the report shall be as per SIA 380, "Issuing Assurance Reports". A typical internal audit report should include the following:

- ◆ Audit Scope performed
- ◆ Audit period Covered
- ◆ Executive Summary
- ◆ Summary of the critical findings
- ◆ Detailed audit findings with elaboration on business impact and root cause of such issues
- ◆ Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee
- ◆ Audit recommendation to improve control environment and address the highlighted finding
- ◆ Response received from the responsible functional authority containing action plan and target timelines for action

**4. Documentation:** To confirm compliance of audit procedures with this SIA, the list of documents required is as follows:

(a) Copies of draft and final internal audit reports to be maintained, appropriately cross referenced to specific observations.

(b) If appropriate, management action plans may be counter signed by respective management personnel.

## 6.1 Follow-up

As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management.

In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an “Action Taken Report (ATR) of previous audits”.

**The term “Monitoring and Reporting” used in this Standard refers to the periodic tracking of issues raised during prior audits and evaluation of the corrective actions undertaken by the auditee to resolve them and to report any open and pending matters to the management and those charged with governance (e.g. the Audit Committee).**

The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it. Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons thereof.

Where the management has accepted his recommendations and initiated the necessary action, the internal auditor should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.



## 7. RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

- ◆ The scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. As stated earlier the internal auditor operates in various areas such as review of the accounting system and internal control; examination of financial and operating information for the benefit of management, the examination of the economy, efficiency and effectiveness of operations including non-financial controls of various tangible assets of the entity. While operating in these areas, there is a lot of overlap between the work of internal auditors and external auditors.
- ◆ The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control.

- ◆ It is a statutory requirement too as per section 138 of the Companies Act, 2013 where 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.
- ◆ However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- ◆ The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.
- ◆ The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

#### Difference Between Internal & External Auditors

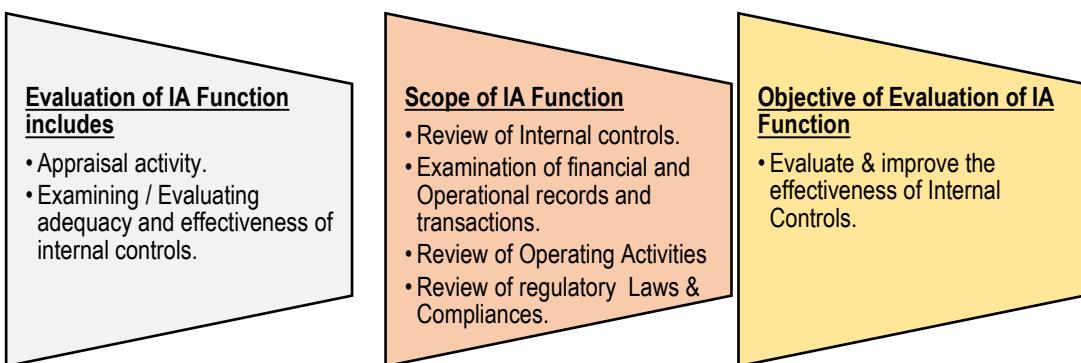
BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
1. Performed by	Internal audit is performed by an independent internal auditing function within the organisation or by external body.	It is an audit function performed by the independent body which is not a part of the organization.
2. Examination	The Internal auditor examines the adequacy of operational controls of the organisation.	The External auditor examines the Accuracy and Validity of Financial Statements.
3. Appointment	The Internal auditor is appointed by the Audit Committee or Board of Directors.	The External auditor is appointed by the Members.
4. Users of Report	Generally, internal audit report is used by top Management and referred by statutory auditor.	The user of external audit report is Stakeholders.
6. Reporting	Internal Audit Report provides weakness in internal controls and	The opinion is provided on the truthfulness and fairness of the

	effectiveness of the operational activities.	financial statement of the company.
7. Status of Auditor	The Internal auditor could be an employee of the company.	The External auditor is mandatorily not an employee of the company.

SA 610, “Using the work of an Internal Auditor” deals with certain aspects of relationship between internal and external auditors.

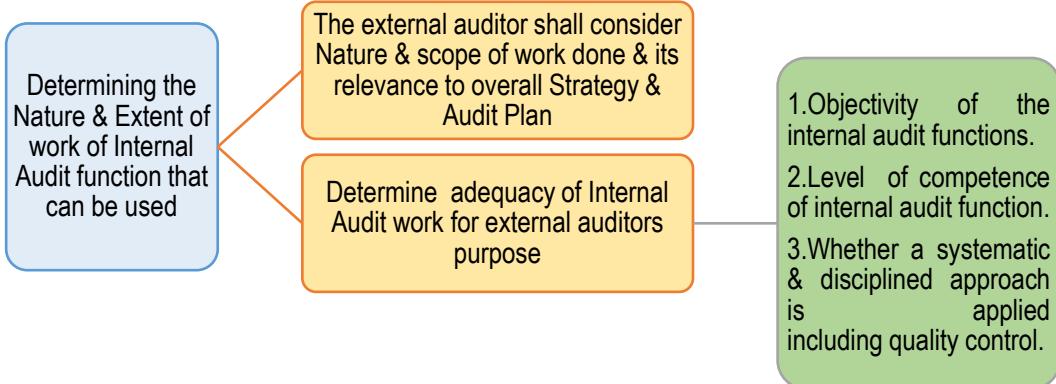
## 7.1 Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function:

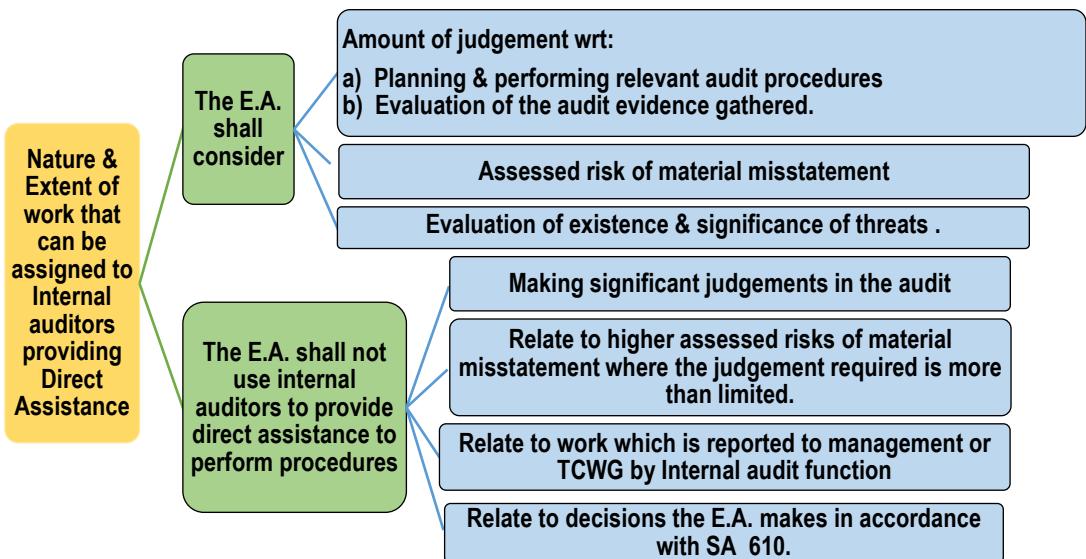


## 7.2 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.



### 7.3 Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance



*(A brief overview of using Direct Assistance from Internal Auditors by External Auditors)*

The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

## 7.4 If the External Auditor uses Internal Auditors to Provide Direct Assistance on the Audit, the External Auditor shall include in the Audit Documentation

- (a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- (b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- (c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230 Audit Documentation;
- (d) The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- (e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Finally, in India, even the statute has now recognised that internal audit is necessary for the efficient running of companies. Thus, a review of the internal audit function in specified companies has become a statutory responsibility for the statutory auditor.

**[Note: Student are advised to refer SA 610 Using the work of Internal Auditor for more details.]**

### Illustration 2

*The Managing Director of X Ltd. is concerned about high employee attrition rate in his company. As the internal auditor of the company, he requests you to analyze the causes for the same. What factors would you consider in such analysis?*

### Solution

**The factors responsible for high employee attrition rate are as under:**

- (i) Job Stress & work life imbalance;
- (ii) Wrong policies of the Management;
- (iii) Unbearable behaviour of Senior Staff;
- (iv) Safety factors;
- (v) Limited opportunities for promotion;

- (vi) Low monetary benefits;
- (vii) Lack of labour welfare schemes;
- (viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?
- (ix) Is the number of people employed at various work centres excessive or inadequate?
- (x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?



## 8. INTERNAL AUDIT AS A MANAGEMENT FUNCTION

Management is a process by which the affairs of an enterprise are conducted in such a manner that its goals and objectives are attained through optimum utilisation of all available resources, within the legal, social, economic and environmental constraints. At the most fundamental level, management functioning is a set of five general functions: planning, organizing, staffing, directing and controlling. While the first five functions of planning, organizing, staffing and leading are critical attributes to create and grow stakeholder's wealth whilst controlling is the critical function that is key to preserve stakeholder's wealth.

As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives". Accordingly Internal Auditor is expected to critically evaluate the management activities and advise them on the areas of improving internal controls and manage business and operational risks effectively by recommending appropriate mitigating controls.

Internal Audit is an important element of management controlling function, it helps management to set up appropriate systems and processes in place to mitigate risk while remaining independent to the operations. Internal Auditor is expected to report on the identified gaps and areas of weak internal control, further he is expected to identify the root cause of the problems and suggest appropriate mitigating steps and strengthen the internal controls environment of the organization.

Accordingly, Internal Audit is seen as an important function that helps management to achieve organization goals and perform its function in an orderly manner.



## 9. AUDIT TRAIL

Audit Trail (or Edit Log) is a visible trail of evidence enabling one to trace information contained in statements or reports back to the original input source. Audit trails are a chronological record of the changes that have been made to the data. Any change to data including creating new data, updating or deleting data that must be recorded.

Records maintained as audit trail may include the following information:

- ◆ when changes were made i.e., date and time (timestamp)
- ◆ who made the change i.e., User Id
- ◆ what data was changed i.e., data/transaction reference; success/failure

Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software.

In order to demonstrate that the audit trail feature was functional, operated and was not disabled, a company would have to design and implement specific internal controls (predominantly IT controls) which in turn, would be evaluated by the auditors, as appropriate. An illustrative list of internal controls which may be required to be implemented and operated are given below:

- ◆ Controls to ensure that the audit trail feature has not been disabled or deactivated.
- ◆ Controls to ensure that User IDs are assigned to each individual and that User IDs are not shared.
- ◆ Controls to ensure that changes to the configurations of the audit trail are authorized and logs of such changes are maintained.
- ◆ Controls to ensure that access to the audit trail (and backups) is disabled or restricted and access logs, whenever the audit trails have been accessed, are maintained.
- ◆ Controls to ensure that periodic backups of the audit trails are taken and archived as per the statutory period specified under the provisions of the Act.

**TEST YOUR UNDERSTANDING 3**

Up Down Limited is concerned about the decline in demand for its products in the last two years. The statutory auditor is of the view that the situation has put into question going concern assumption of the company. Its internal auditor has helped management in devising a strategy to deal with such risks and come out of the situation. The plan includes venturing into different product lines using the same plant with minor modifications. Further, the internal auditor has also prepared estimates of revenue generation along with cash flows.

Can statutory auditor place total reliance on work performed by internal auditor in this regard?

**Key Takeaways**

- ◆ Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.
- ◆ It is mandatory for all listed companies, unlisted public companies/private companies fulfilling certain criteria to appoint internal auditor in accordance with provisions of Section 138 of the Companies Act, 2013 and relevant rules.
- ◆ The internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company in terms of section 138 of the Companies Act, 2013. He may or may not be employee of the company.
- ◆ In such companies specified in section 138 of the Companies Act, 2013, the Audit Committee or the Board, in conjunction with management and the Chief of Internal Audit, is expected to exercise the responsibility to formulate the objectives of internal audit.
- ◆ Basic principles governing an internal audit include independence, integrity and objectivity.
- ◆ Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted.
- ◆ Reporting of internal audit results is generally undertaken in two stages- At the end of a particular audit assignment, an "*Internal Audit Report*" covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. Further, on a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period

is prepared by the Chief Internal Auditor (or the Engagement partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee.

- ◆ The internal auditor should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time he should draw the management's attention to it. Where the management has not acted upon his suggestions or not implemented his recommendations, the internal auditor should ascertain the reasons thereof.
- ◆ The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor.
- ◆ It is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- ◆ The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit.
- ◆ The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures.
- ◆ The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.
- ◆ Standards on Internal audit are recommendatory in nature.

# APPENDIX

The following Standards on Internal Audit are recommendatory in nature. The Standards shall become mandatory from such date as notified by the council:

## **Section I: Preface**

Preface to the Framework and Standards on Internal Audit

## **Section II: Framework**

Framework Governing Internal Audits

## **Section III: Basic Principles**

Basic Principles of Internal Audit

## **Section IV: Standards on Key Concepts (100 Series)**

SIA 110: Nature of Assurance

SIA 120: Internal Controls

**SIA 130: Risk Management**

**SIA 140: Governance**

**SIA 150: Compliance with Laws and Regulations**

## **Section V: Standards on Internal Audit Management (200 Series)**

SIA 210: Managing the Internal Audit Function

SIA 220: Conducting Overall Internal Audit Planning

SIA 230: Objectives of Internal Audit

SIA 240: Using the Work of an Expert

**SIA 250: Communication with Those Charged with Governance**

## **Section VI: Standards on the Conduct of Audit Assignments (300 - 400 Series)**

SIA 310: Planning the Internal Audit Assignment

SIA 320: Internal Audit Evidence

- SIA 330: Internal Audit Documentation
- SIA 350: Review and Supervision of Audit Assignments
- SIA 360: Communication with Management
- SIA 370: Reporting Results
- SIA 390: Monitoring and Reporting of Prior Audit Issues

**Section VII: Standards on Specialised Areas (500 Series)**

- SIA 520:** Internal Auditing in an Information Technology Environment
- SIA 530:** Third Party Service Provider

**Section VIII: Standards on Internal Audit (As on July 1, 2013)**

- SIA 5: Sampling
- SIA 6: Analytical Procedures
- SIA 7: Quality Assurance in Internal Audit
- SIA 11: Consideration of Fraud in an Internal Audit
- SIA 18: Related Parties

**TEST YOUR KNOWLEDGE****Theoretical Questions**

1. Write a short note on the Internal Audit Report.
2. State the important aspects to be considered by the External auditor in the evaluation of the Internal Audit Function.
3. AB Pvt. Ltd. company has outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint an internal auditor. Please guide him for the applicability of the same and who can be appointed as an internal auditor and what work would be reviewed by him.

4. Moon Ltd., of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit.
5. Mr. A is appointed as a statutory auditor of XYZ Ltd. XYZ Ltd. is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. B as its internal auditor. The external auditor Mr. A asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.
  - (a) Discuss whether Mr. A, statutory auditor, can ask direct assistance from Mr. B, internal auditor as stated above in view of auditing standards.
  - (b) Will your answer be different if Mr. A asks direct assistance from Mr. B, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?
6. The XYZ Ltd. has to appoint Mr. A as Chief Internal Auditor to lead the internal audit function for the Company. The Managing Director of the Company has asked the HR head to define the reporting structure of the Chief Internal Auditor, so that he can discharge his duties objectively? Suggest the ideal reporting structure of the Chief Internal Auditor that HR head may propose to the Managing Director?
7. Daksh Ltd. has appointed Mr. Gopal to conduct their internal audit for the new financial year. The Audit committee requested Mr. Gopal to present their Internal Audit plan for next financial year? What approach would Mr. Gopal follow to prepare the internal audit plan for next year?
8. Zero Ltd. has appointed Mr. Shubh to conduct their internal audit for the new financial year. The Audit committee requested Mr. Shubh to perform a detailed analysis of their expenses in the previous year and report on all risks and underlying gaps. **Elucidate the steps Internal Auditor should take to identify such gaps?**
9. Kishore Ltd. has appointed Mr. Anand to conduct their internal audit for the new financial year. The Audit committee requested Mr. Anand to present a detailed report on their findings and areas where immediate action is needed to mitigate critical risks. What should be the content of the internal audit report to address this requirement of the Audit Committee?
10. June Ltd. has appointed Mr. Gaurav to conduct their internal audit for the new financial year. The Audit committee requested Mr. A to present their analysis on the implementation of recommendations of previous audit report and highlight critical areas which need immediate

attention of the Audit Committee? What should be the steps followed by internal auditor to address this requirement of the Audit Committee?

11. ***One of the independent directors sought information regarding the appointment of internal auditors for the following Group Companies in accordance with the Companies Act, 2013 of which certain financial information is given below:***

***Figures are in ₹ crore and correspond to the previous year.***

Name	Nature	Equity Share Capital	Turnover	Loan from Bank and PFI	Public Deposits
XYX Limited	Listed	100	230	20	48
MNM Limited	Unlisted Public	60	100	50	24
GFG Limited	Unlisted Private	70	180	80	-

***You are required to evaluate the requirements regarding the appointment of internal Auditors for the Group Companies. Discuss.***

12. ***Rishi is appointed as internal auditor for SPOM Limited, a medium-sized manufacturing company, while CA Nitin is the statutory auditor of SPOM Limited.***
- (a) ***During the review, Rishi notices several discrepancies in the disbursement records and suspects there might be weaknesses in the internal control system. Additionally, there have been recent changes in the company's business policies that he was not informed about. Rishi is concerned about maintaining his independence and objectivity while ensuring that management is aware of these issues. What are the responsibilities of Rishi as an Internal Auditor with respect to the accounting function and financial records of the organisation?***
- (b) ***CA Nitin asked Rishi to provide direct assistance to him regarding evaluating the appropriateness of management's use of the going concern assumption. In view of Standards on Auditing, whether Nitin can ask direct assistance from Rishi as stated above?***
13. ***CA Sanjana has recently joined as Chief Internal Auditor of Up Scale Limited, a listed company. Her subordinate staff in the internal audit department brings to her knowledge many prior audit issues highlighted in the previous internal audit reports***

*which are still open. Does she have any responsibilities in this regard? How should she proceed in this situation?*

14. *STU & Associates have been the statutory auditors of the listed company "First and Last Ltd.," operating in the petrochemical industry, for the past three years. CA K, the engagement partner, had designed certain substantive procedures on some selected assertions in response to the assessed risk of material misstatements for the year under audit. These assertions were not examined by him in previous years due to materiality or risk considerations.*

*Mr. X leads the internal audit department of the company and reports to the company's audit committee. During the audit, a senior member of the engagement team decides to engage Mr. X to provide direct assistance in performing the above substantive procedures. Comment with respect to the relevant Standards on Auditing.*

*Also, indicate the activities to be performed by the statutory auditor prior to using internal auditor for providing direct assistance.*

15. *The management of High Limited is concerned with the reporting requirement cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 for the financial year 2023-24 with regard to the Audit Trail (edit log). Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software. Consequently, the management of the company approached CA J and asked him to suggest them list of internal controls which may be required to be implemented and operated to demonstrate that the Audit trail (or Edit Log) feature was functional, operated and was not disabled. Guide CA J.*

## Answers to Test Your Understanding

1. As per section 138 of the Companies Act, 2013 the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

The Board can appoint any professional as may be decided by it. The applicant in question is a law post graduate and he has spent 25 years of his career in Indian Audit & Accounts Service. Therefore, he has got the necessary experience and skills required for the said

vacancy. The Board would be in a position to appoint such a competent and experienced person in the field of auditing as its Chief Internal auditor.

2. The Internal Auditor does not assume any responsibility to manage or operate the compliance framework or to take compliance related decisions. It is not responsibility of the Internal Auditor to execute or resolve compliance related risks (e.g., engaging directly with regulators, etc.).

Although internal audit function provides independent assurance to enhance governance (which includes compliance with laws and regulations), it does not assume operational responsibility of its compliance framework. It is the responsibility of the management. He is responsible for auditing the compliance framework and not managing it. Similarly, he does not accept compliance related risks like directly engaging with regulator.

3. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

The appropriate use of going concern assumption requires significant judgment on part of statutory auditor.

Therefore, statutory auditor cannot place total reliance on internal auditor's work in this regard and he should perform more procedures directly.

## Hints /Answers to Theoretical Questions

1. Refer para 6.
2. **Evaluation of Internal Audit Functions by External Auditor:** The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:
  - (a) **Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, his reports to the highest level of management and are free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

- (b) **Scope of Function** - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
- (c) **Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
- (d) **Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

**3. Applicability of Internal Audit:** Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its 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.

In view of the above provisions, AB Pvt. Ltd. is mandatorily required to conduct an internal audit as its loans or borrowings are falling under the prescribed limit.

**Who can be appointed as Internal Auditor-** The internal auditor shall either be a Chartered Accountant or a Cost Accountant, whether engaged in practice or not, or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the companies.

The internal auditor may or may not be an employee of the company.

**Work to be reviewed by Internal Auditor-** Refer Para 2.

- 4.** Refer Para 7.3.
- 5. (a) Direct Assistance from Internal Auditor:** As per SA 610, "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;

- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

In view of the above, Mr. A cannot ask for direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

**(b) Direct Assistance from Internal Auditor in case of External Confirmation**

**Procedures:** SA 610, "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with SA 505, "External Confirmation" the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

6. HR Head needs to evaluate multiple options and identify the most suitable option in light of the relevant provisions, guidance and overall governance of the organization. HR head also needs to evaluate different options for his administrative reporting and various options for functional reporting of Chief Internal Auditor. The possible options to be considered and evaluated include the Board of Directors, Audit Committee, Managing Director of the Company and Chief Executive Officer or Chief Financial Officer.

As per section 138 of the Companies Act 2013, the internal auditor shall either be a Chartered Accountant or a Cost Accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives".

Refer para 3.1, The Internal Auditor shall be free from any undue influences which force him to deviate from the truth. This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives.

As per the requirement of the above stated provision, Chief Internal Auditor needs to be independent of the operational activities and report of Audit Committee / Board of Directors to enjoy his true status of independent auditor. He may administratively report to CEO or Managing Director for his administrative reporting purpose or any other similar authority till the time it is approved by Board of Directors, and it does not impact his independence to be able to perform his duties and report to audit committee / Board of Director independently.

**7. Refer para 2.0.**

The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

Internal audit plans should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made, and adequate balance is ensured to the following:

- Risk underlying the business process
- Value that the internal audit can provide to the organization
- Effort involved in conducting the internal audit for a particular business process
- Risk Appetite of the organization
- Coverage of all auditable areas within the defined time range

**8. Refer para 5.0.**

9. Refer para 6.0.

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

- **At the end of a particular audit assignment**, an “Internal Audit Report” covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.
- **On a periodic basis, at the close of a plan period**, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.

Accordingly, a typical internal audit report should include the following:

- Audit Scope performed;
- Audit period Covered;
- Executive Summary;
- Summary of the critical findings;
- Detailed audit findings with elaboration on business impact and root cause of such issues;
- Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee;
- Audit recommendation to improve control environment and address the highlighted finding;
- Response received from the responsible functional authority containing action plan and target timelines for action.

**10. Refer para 6.1.**

As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management.

In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an “Action Taken Report (ATR) of previous audits”.

To address the requirement of Audit Committee in the given situation, Internal Auditor should assess the action taken against the previous audit findings and report a summary of the action taken by the management. Typical Action Taken Report may include the following:

- Reference to the previous audit reporting containing the reported issues
- Implementation Action agreed by the management along with target implementation date
- Status of action taken by management. The same may be classified under Implemented / Not Implemented
- Residual risk and rating for any unimplemented action
- Audit findings not implemented for long period of time
- Any critical audit finding that requires immediate action for action or implementation.

**11. As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of the Companies (Accounts) Rules, 2014) 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-***

- (1) ***paid up share capital of fifty crore rupees or more during the preceding financial year; or***
- (2) ***turnover of two hundred crore rupees or more during the preceding financial year; or***

- (3) *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*
  - (4) *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-*
- (1) *turnover of two hundred crore rupees or more during the preceding financial year; or*
  - (2) *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.*

*In the given case, XYX Limited is a listed company. As per section 138 of the Companies Act, 2013, every listed company is required to appoint an internal auditor or a firm of internal auditors. Thus, in view of the above, XYX Limited is required to appoint an internal auditor.*

*Further, MNM Limited is unlisted public company. The company is having ₹ 60 crore as equity share capital which is exceeding the prescribed limit of rupees fifty crore as per section 138. Thus, MNM Limited is required to appoint an internal auditor as per section 138 of the Companies Act, 2013.*

*GFG Limited is unlisted private company and having ₹ 70 crore as equity share capital, ₹ 180 crore as turnover and ₹ 80 crore loan from Bank and PFI. In view of provisions of section 138 of the Companies Act, 2013 discussed above, all the limits are below the prescribed limit for a private company. Therefore, GFG Limited is not required to appoint an internal auditor.*

*It can be concluded that XYX Limited and MNM Limited are required to appoint the internal auditor as per the provisions of the Companies Act, 2013 whereas GFG Limited is not required to do the same.*

12. (a) *In the given case, Rishi notices several discrepancies in the disbursement records and suspects there might be weaknesses in the internal control system. He is concerned about maintaining his independence and objectivity while ensuring that management is aware of these issues.*

**Responsibilities of Rishi as an Internal Auditor with respect to the accounting function and financial records of the organisation include:**

- *to ascertain adequacy of system of internal control by a continuous examination of accounting procedures, receipts and disbursements, and to provide adequate safeguards against misappropriation of assets.*
  - *to operate independently of the accounting staff and must not in any way divest any of the responsibilities placed upon him.*
  - *not to involve in the performance of executive functions in order that the objective outlook does not get obscured by the creation of the vested interest.*
  - *to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected.*
  - *to associate closely with management and keep knowledge up to date by being informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies.*
  - *at all times, the internal auditor must enjoy an independent status.*
- (b) As per SA 610, “Using the Work of Internal Auditor”, the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.

*Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make significant judgments in the audit engagement.*

*Significant judgments include the following:*

- *Assessing the risks of material misstatement;*
- *Evaluating the sufficiency of tests performed;*
- *Evaluating the appropriateness of management's use of the going concern assumption;*
- *Evaluating significant accounting estimates; and*
- *Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.*

*In view of the above, CA Nitin cannot ask direct assistance from internal auditors regarding evaluating the appropriateness of management's use of the going concern assumption in accordance with SA 610.*

13. *In the given situation, CA Sanjana has recently joined as Chief Internal Auditor in Up Scale Limited, a listed company. As a Chief Internal Auditor, CA Sanjana is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management. In monitoring and reporting of prior audit issues, the responsibility of the CA Sanjana as internal auditor is usually in the form of an "Action Taken Report (ATR) of previous audits". The term "Monitoring and Reporting" refers to the periodic tracking of issues raised during prior audits and evaluation of the corrective actions undertaken by the auditee to resolve them and to report any open and pending matters to the management and those charged with governance.*

*CA Sanjana should review whether follow-up action is taken by the management on the basis of his report. If no action is taken within a reasonable time, she should draw the management's attention to it. Where the management has not acted upon the suggestions or not implemented the prescribed recommendations, she should ascertain the reasons thereof.*

*Where the management has accepted recommendations of the CA Sanjana and initiated the necessary action, she should periodically review the manner and the extent of implementation of the recommendations and report to the management highlighting the recommendations which have not been implemented fully or partly.*

14. *SA 610, "Using the Work of Internal Auditor" states that in determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the discussion of fraud risks, determination of unannounced audit procedures as addressed in SA 240 etc.*

*In the above case, engagement partner had designed certain substantive procedures on some selected assertions in response to assessed risk of material misstatements in year under audit. Such assertions were not tested by him in the previous years due to materiality or risk considerations. It is being done now for incorporating an element*

*of unpredictability in audit procedures to be performed as individuals within the company who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting.*

*Therefore, in such matters, using an internal auditor to provide direct assistance could prove to be counter-productive and defeat the very purpose of designing such substantive procedures. Hence, decision of senior engagement team member to use Mr. X to provide direct assistance on above said matters is not in accordance with SA 610 and is not proper.*

*Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall: -*

- (a) *Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and*
- (b) *Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.*

15. Refer para 9.0.

