

Practices related to Internal Auditing

Lesson 2

KEY CONCEPTS

- Standards on Internal Audit 'SIA' ■ Corporate Social Responsibility 'CSR'

Learning Objectives

To understand:

- The Evolution of Internal Audit in India
- Several laws and regulations such as Companies Act, 2013, SEBI, RBI, IRDAI govern internal audit in India
- The laws of foreign government or regulators governing internal audit
- Section 138 of Companies Act, 2013 read along with Rule, 2014 impacting internal audit
- Who can be considered as 'Professional'
- Standards on Internal Audit 'SIA' in India
- The principles and governing framework of SIA
- International Standard issued by Institute of Internal Auditor 'IIA'
- Checklist for Corporate Social Responsibility 'CSR'

Lesson Outline

- Introduction
- Laws by Indian Government or Regulators Govern Internal Audit
- Laws by Foreign Governments or Regulators
- Specific Provisions under Companies Act, 2013 impacting Internal Audit
- Standards on Internal Auditing in India
- International Standards by Institute of Internal Auditors (IIA)
- Internal Audit Practices
- Corporate Social Responsibility
- Code of Ethics
- Environmental and Societal Safeguards
- Change Management
- Lesson Round-Up
- Test Yourself
- List of Further Readings

INTRODUCTION

In the previous lesson we have discussed about the key concepts and an overview about internal audit. In this chapter we will strive to understand the relevant regulations, applicable standards and generally accepted practices in the internal audit activity of an organisation.

Evolution of Internal Audit

Historically, wherever there has been a need for one person's property or assets being entrusted to another person, there has also been a need to keep some checks and balances upon the fidelity of the person so entrusted, to ensure that interests of the actual owner are protected. Even during the era of Maurya dynasty, Kautilya, a 4th century B.C.E. economist, is believed to have recognized the importance of accounting methods in economic enterprises and emphasised the role and importance of periodic audits.

Audit systems have always been in place in business organisations having a separation between people responsible for management of the day-to-day affairs and people having actual ownership of the organisation. Due to this principle, legal systems in most countries, including India, prescribe specific and detailed provisions in relation to auditing systems to be implemented to review a company's affairs. Thus, various regulations prescribe different audits for a company's affairs with specific scope and objectives from time to time.

With the increase in size and complexity of business activities within corporate organisations, annual statutory audit or tax audits were not perceived as enough to keep the right level of checks and balances. Thus, the Internal Audit systems were introduced in India by some progressive companies.

Recognizing its worth in achieving an independent view on financial information and supporting the assessment of a statutory auditor during financial statement audits, the internal audit in India was first made mandatory for a specific set of companies vide the Manufacturing and Other Companies (Auditor Report) Order, (MAOCARO, 1975). MAOCARO, 1975 required the statutory auditor to report whether the company has an internal audit system commensurate with its size and nature of its business and, whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials including components, plant and machinery, equipment and other assets, and for the sale of goods.

At that time, internal audit was thought to be subservient to statutory auditors having prime focus on the finance function and internal controls related to financial reporting and some legal compliances. The focus of internal audit at that time was to continuously audit financial records and related controls to provide an assurance that the financial controls are adequate and operating effectively. The statutory auditors used to rely on the assertions of the internal auditor.

With subsequent amendments in the law in MAOCARO, 1988 and later in CARO 2003, the mandatory requirement to have an internal audit system were further enhanced to apply to the producer companies in MAOCARO 1988, and later to all listed companies and other specified companies in CARO 2003.

The internal audit got further importance through clause 49 of listing agreement in the year 2005 wherein the audit committee of company was mandated to review the appointment of Chief Internal Auditor and to review internal audit reports related to internal control weaknesses. Further, with the latest requirements of Companies Act 2013, CARO 2020 and other relevant regulations, the importance of Internal Audit activity is increasing day by day. We shall discuss about the latest regulations later in this chapter.

Globally, Mr. Lawrence Sawyer (1911-2002) is often referred to as "the father of modern internal auditing" since he advocated the contemporary theory of Internal Auditing which is reflected in the current philosophy, theory and practice of internal auditing as defined by the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors. He had recommended the internal auditors to differ from classical compliance

auditing and take a different stance and a different state of mind, which is constructed on a foundation of technical excellence, and with the support from the highest levels of management in the organisation. The contemporary idea of internal auditing is thus to help an organisation accomplish its objectives.

LAWS BY INDIAN GOVERNMENT OR REGULATORS GOVERN INTERNAL AUDIT

There are several laws and regulations that govern internal audit related activities in India. Some of the key laws applicable to internal audit in India are:

- **Companies Act, 2013:** Section 138 of the Companies Act, 2013 mandates that certain classes of companies shall appoint an internal auditor who shall conduct an internal audit of the functions and activities of the company. These requirements are defined in Rule 13 of the Companies (Accounts) Rules, 2014.
- **Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), Regulations 2015:** These regulations define requirements for listed companies' audit committee and their interaction with internal audit activity. They cover amongst others, reporting of internal audit, specific items to be reviewed in relation to internal audit, and audit committee interactions with internal auditors.
- **Reserve Bank of India (RBI) Guidelines:** The RBI has issued guidance note on Risk Based Internal Audit for various entities such as banks, non-banking financial companies (NBFCs), and payment system providers. These guidelines were amended in January 2021 and their applicability was extended to NBFCs, and UCBs also in February 2021.
- **Insurance Regulatory and Development Authority of India (IRDAI) regulations** has issued Guidelines for Corporate Governance for Insurers in India in 2009, which have been updated in 2016. These guidelines define the requirements for Board to lay down policy framework for control functions such as internal audit department, audit committee oversight on internal audit activity, and responsibilities of internal auditors.

While above are some of the key laws and regulations applicable to internal audit in India, there may be other laws and regulations specific to certain industries or sectors that may require internal audit.

Further, specific provisions in Companies Act 2013 and underlying Rules specify the requirements about stating whether the internal controls were adequate and effective during a financial reporting period by various corporate governance stakeholders such as Board, Audit Committee, Statutory Auditors etc., thus indirectly requiring an internal audit of internal controls on regular basis. We will discuss about these provisions in later sections of this chapter.

LAWS BY FOREIGN GOVERNMENTS OR REGULATORS

United States

In the United States, there is no specific law that mandates companies to conduct internal audits. However, there are various regulations and guidelines that require companies to have effective internal control systems in place. The Sarbanes-Oxley Act of 2002 (SOX) is one such regulation that mandates publicly traded companies to have a system of internal controls over financial reporting, and to evaluate and report the effectiveness of those controls.

The Public Company Accounting Oversight Board (PCAOB) is a regulatory body set up by the Sarbanes-Oxley Act 2002, that oversees the auditing profession and establishes auditing standards for public companies. The PCAOB requires statutory auditors to evaluate the effectiveness of a company's internal controls over financial

reporting during an audit and has defined a specific standard AS 2605 (Consideration of Internal Audit Function) to be adhered to by the statutory auditors. This standard lays down specific clauses defining the role of the auditor and the internal auditors, competence and objectivity of internal auditors, and effect of internal auditor's work on the statutory audit.

In addition to these regulations, many other regulations, such as the Health Insurance Portability and Accountability Act (HIPAA), Foreign Corrupt Practices Act (FCPA), Dodd-Frank Wall Street Reform & Consumer Protection Act, etc. mandate that companies have adequate internal controls, and they should be evaluated from time to time for effective implementation. Thus, indirectly internal audit's scope is drawn out by these regulations also.

Notably, the Securities and Exchange Commission (SEC) does not have any specific rules or regulations related to internal audit and it does not specifically regulate internal audit. The Institute of Internal Auditors has however given a framework of IPPF (International Professional Practices Framework) which is used by internal auditors to be able to demonstrate that their internal audit practices are in line with the global standards.

Japan

In Japan, the Companies Act does not specifically require companies to have an internal audit function, but it does require them to have an internal control system. Many companies in Japan choose to establish an internal audit function as part of their internal control system.

A KK (kabushiki kaisha) is the most common form of corporate entity in Japan. As of 31 July 2021, 92.1% of Japanese corporate entities were KJs. KJs are generally classified according to the transfer restrictions imposed on their shares: Close KJs (private companies) and Open KJs (public companies). In Japan, corporate governance and directors' duties are regulated by the Companies Act and a Company's articles. Further, in case of listed KJs, The Financial Instruments and Exchange Law and Securities Listing Regulations published by the securities exchanges (including the Corporate Governance Code) are also applicable.

The Financial Instruments and Exchange Act (popularly known as J-SOX) is the set of Japanese standards for evaluation and auditing of internal controls over financial reporting also referred to as "the Standards", were finalized on February 15, 2007. Based on the Standards' requirements, all listed companies in Japan are to perform risk assessments and prepare and submit internal control reports on a consolidated basis. J-SOX requirements are the Japanese equivalent to U.S. SOX. This entails that controls need to be tested thoroughly, and internal audit departments are usually helping the management in doing so.

Generally, in Japan the Corporate governance and directors' duties are regulated by:

- The Companies Act
- A company's articles.

In addition, for listed KJs below regulations are also applicable:

- The Financial Instruments and Exchange Law.
- Securities Listing Regulations published by the securities exchanges (including the CG Code).

The Ministry of Justice is the administrative authority in charge of the Companies Act and The Financial Services Agency (FSA) is the authority in charge of the Financial Instruments and Exchange Law, and regulation of listed KJs.

France

In listed companies, the chairperson of the Board states about internal control and risk management procedures

put in place by the company in the annual report. Specific focus on the controls related to the preparation of accounting / financial information is required. The legal auditors (statutory auditors) must also provide their observations on the chairperson's report. Thus, internal audit functions are usually set up in all listed companies, although not required mandatorily.

The corporate governance legislation in France is the French Commercial Code (Commercial Code), which provides rules covering the composition, powers, remuneration, duties and liabilities of a company's governing bodies.

The main corporate governance code referred to by the listed companies in France is the Afep-Medef Code (A-M Code), published by the two main French business federations (*French Association of Private Enterprises and French Enterprise Movement*) - (*Association Française des Entreprises Privées and Mouvement des Entreprises de France*) - (*Afep and Medef*). Another corporate governance code, the Middlednext Code, is mainly used by small and medium-sized listed companies.

The body responsible for monitoring the implementation of the A-M Code is the High Committee for Corporate Governance (*Haut Comité de gouvernement d'entreprise*) (HCGE), which publishes a practice guide for the A-M Code and an annual report on compliance by French listed companies in the SBF 120 with the A-M Code.

The main representative body for shareholders in France that monitors corporate governance is the Association for the Defence of Minority Shareholders (*Association de défense des actionnaires minoritaires*) (ADAM).

China

Listed companies in the People's Republic of China (PRC) are required to establish internal control systems in accordance with the stock exchange rules and Basic Internal Control Norms for Enterprises (BICNE) within a fixed timetable. The directors of listed companies are responsible and liable for information disclosed in the various reports, including fiscal reports. Thus, although there are no specific requirements for internal audit, the role of internal audit is derived by the assurance needed by the directors. Internal audits are thus applicable for listed companies, state-owned enterprises (SOEs), and governmental agencies.

While relatively new in comparison to guidelines recognized globally, China has an evolving regulatory framework for internal controls and audit. China-SOX (Basic Standard) which is China's version of the US Sarbanes-Oxley Act of 2002 was issued in 2008, with supporting guidelines issued in 2010. The Basic Standard for Enterprise Internal Control (*caikuai* [2008] No. 7, "Basic Standard") mirrors its US counterpart mostly. Further, to implement the Basic Standard, in April 2010, the five Chinese governmental departments issued the Supporting Guidelines for Internal Control of Enterprises (*caikuai* [2010] No.11, "Supplementing Guidelines").

The Supplementing Guidelines consist of three guidelines:

- Application Guidelines
- Evaluation Guidelines
- Audit Guidelines

The Supplementing Guidelines require listed companies and non-listed large and medium-sized enterprises governed by the Basic Standards and the Supplementing Guidelines to disclose an annual self-evaluation report on the effectiveness of their internal control as well as engage an accounting firm to issue an auditor's reports on the effectiveness of their internal control in financial reporting.

Currently the main legislations in China with respect to overall Corporate Governance are as follows:

- The Foreign Investment Law of the PRC, which applies to all foreign-funded enterprises.
- The Company Law, which applies to all corporate entities.

- The Securities Law of the PRC, which mainly applies to public companies, whether listed or not.
- Measures for the Supervision and Administration of State-owned Equities of Listed Companies, to regulate changes in state-owned shares of listed companies.
- Various regulations, measures and guiding opinions, including but not limited to the CG Code, issued by the CSRC and other authorities, which apply to listed companies.
- Various laws and regulations governing corporate governance of state-owned enterprises (SOEs).
- Various Stock Listing Rules issued by Shenzhen/Shanghai Stock Exchange to regulate the listing and information disclosure etc. of CLSs.

SPECIFIC PROVISIONS UNDER COMPANIES ACT, 2013 IMPACTING INTERNAL AUDIT

This section discusses the provisions of Companies Act, 2013 with respect to Internal Auditing in detail.

To start with, Section 138 of the Companies Act read along with Rule 13 of The Companies (Accounts) Rules, 2014 lays down that:

- (1) Prescribed class or classes of companies shall be required to appoint an internal auditor, who shall either be a chartered accountant (whether in practice or not) or a cost accountant (whether in practice or not), or such other professional as may be *decided by the Board* to conduct internal audit of the functions and activities of the company. These companies are:
 - every listed company.
 - every unlisted public company having-
 - paid up share capital of 50 crore rupees or more during the preceding financial year, or
 - turnover of 200 crore rupees or more during the preceding financial year; or
 - outstanding loans or borrowings from banks or public financial institutions (PFIs) exceeding 100 crore rupees or more at any point of time during the preceding financial year; or
 - outstanding deposits of 25 crore rupees or more at any point of time during the preceding financial year; and
 - every private company having-
 - turnover of 200 crore rupees or more during the preceding financial year; or
 - outstanding loans or borrowings from banks or PFIs exceeding 100 crore rupees or more at any point of time during the preceding financial year.
- (2) The internal auditor so appointed may be either an individual or a partnership firm or a body corporate. Further, internal auditor may or may not be an employee of the company.
- (3) The Audit Committee of the company (where it exists) or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

The word '**professional**' is defined in Black's Law Dictionary [9th Edition, Page 1329] as "A person who belongs to a learned profession or whose occupation requires a high level of training and proficiency". Further, 'profession' is defined [9th Edition, Page 1329] as "A vocation requiring advanced education and training". A reading of this definition along with the above given legal provisions indicate that professionals such as qualified company secretaries, postgraduates in finance, etc. can be appointed as the internal auditors by the Board. However, it has to be kept in view that the necessary skills and knowledge needs to be evaluated by the Board before such appointment.

Given the fact that Section 138 is placed within Chapter IX (Accounts of Companies) and the Rule 13 is placed under The Companies (Accounts) Rules, 2014, through harmonious reading of provisions it appears that a good level of knowledge about finance and accounting is a reasonable expectation for the appointment of an internal auditor. This, however does not mean that internal audit is required to focus on financial aspects only. Especially with advancement in the newer technologies such as AI/ML, the expectations of the regulators may change in recent future.

As mentioned above, the scope, functioning, periodicity and methodology of the internal audit needs to be formulated by Audit Committee or by the Board, in consultation of the Internal Auditor, a reference is required to be made to the good practices / standards of the internal audit profession, so that the Audit Committee or Board can rely upon such good practices / standards to deliver their responsibility in an effective manner. We will discuss about such good practices and standards in later sections of this chapter.

Further to above, the Companies Act also defines specific requirements with respect to Internal Financial Controls in various sections which have a bearing on the internal audit activity indirectly, some of them are discussed below:

1. Section 134(3)(q) read with Rule 8(5) (IFCoFR) - Chapter IX-The Companies (Accounts) Rules, 2014

These rules require the details in respect of adequacy of internal financial controls with reference to the Financial Statements to be included in the Board's Report of all companies. These controls are usually known as Internal Controls on Financial Reporting - IFCoFR and form a subset of overall Internal Financial Controls of a company.

2. Section 134(5) (Director's Responsibility Statement)

As per Explanation to Section 134(5)(e), for the purposes of this clause, the term internal financial controls (IFC) means the policies and procedures adopted by the company for ensuring the *orderly and efficient* conduct of its business, including adherence to company's policies, the safeguarding of its *assets*, the prevention and detection of *frauds and errors*, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. This means that IFC covers not just the financial reporting aspects, but also the strategic and operational aspects of business and the efficiency with which those operations are carried out.

Section 134(5)(e) requires the directors of a *listed* company to state whether they had laid down the internal financial controls, and whether these controls were adequate and working effectively during the financial year.

Further, Section 134(5)(f) requires the directors to state if they had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively during the financial year. Note that this requirement is for *all companies*, and not only listed companies.

Board of directors certainly need to review the design and operating effectiveness of internal controls before they can make a statement on their status as required by above given provisions, meaning thereby that testing of internal controls is needed, which is carried out by the internal auditors. Note that internal audit is responsible only for the testing the controls, and the formulation or revision of internal controls is the responsibility of the relevant function heads, and the executive management.

3. Section 177, Subsection (4), (5) - Audit Committee

Section 177(4) requires that every Audit Committee, shall act in accordance with the terms of reference specified in writing by the Board which shall include evaluation of internal financial controls (IFC) and risk management systems.

Thus, in case of companies which are required to have an Audit Committee, the audit committee is required to evaluate the IFC and risk management systems. Notably, every listed public company and every other company covered under rule 4 of the Companies (Appointment and Qualification of Directors) Rules, 2014 is required to constitute an Audit Committee. Further, Section 177(5) requires that the Audit Committee may call for the comments of the statutory 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 auditors and statutory auditors and the management of the company.

Thus, internal auditors as well as statutory auditors are invariably asked to give comments by the audit committee on the IFC and risk management systems of the company. Considering this, evaluation of internal financial controls and risk management systems is assigned to internal auditors in most of the companies.

4. Section 143(3) – Powers and duties of auditors

Section 143(3)(i) of the Companies Act requires that the auditor's report shall also state whether the company has adequate internal financial controls system in place and comment on the operating effectiveness of such controls.

It is worth noting that as per Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by Institute of Chartered Accountants of India (ICAI), consistent with the practice prevailing internationally, the term 'internal financial controls' stated in Section 143(3)(i) would relate to 'internal financial controls over financial reporting' in accordance with the objectives of an audit stated in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

Further, as per the ICAI Guidance note on Audit of Internal Financial Controls Over Financial Reporting, the statutory auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. SA 610 "Using the Work of Internal Auditors" and SA 620 "Using the Work of an Auditor's Expert" apply in a combined audit of internal financial controls over financial reporting and financial statements. Further, irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the auditor when expressing an opinion on financial statements and internal financial controls over financial reporting. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of the internal auditors.

5. Section 143(11) – Companies (Auditor's Report) Order, 2020

Companies (Auditor's Report) Order, 2020 is issued under Section 143(11) and is also popularly known as CARO 2020. It applies to all companies including foreign companies except:

- a banking company as defined in section 5(c) of Banking Regulation Act, 1949
- an insurance company as defined under the Insurance Act, 1938
- a company licensed to operate under section 8 of the Companies Act
- a One Person Company as defined in section 2(62) of the Companies Act
- a small company as defined in section 2(85) of the Companies Act; and
- a private limited company,
 - not being a subsidiary or holding company of a public company, having a paid-up capital *and*

- reserves and surplus not more than 1 crore rupees as on the balance sheet date *and*
- which does not have total borrowings exceeding 1 crore rupees from any bank or financial institution at any point of time during the financial year *and*
- which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding 10 crore rupees during the financial year as per the financial statements.

As per CARO 2020 Rule 3(xiv), the statutory auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matters, namely:

- whether the company has an internal audit system commensurate with the size and nature of its business.
- whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

ICAI has issued a Guidance Note on The Companies (Auditor's Report) Order, 2020. As per this Guidance Note, the auditor needs to examine the following aspects to evaluate whether the internal audit system is commensurate with the size of the company and the nature of its business :

- (i) **The size of the internal audit department** considering the nature of the business of the company, the number of operating locations, the extent to which internal controls are decentralised, the effectiveness of other forms of internal control, etc.
- (ii) **Qualifications of the persons who undertake the internal audit work** is a necessary aspect to be reviewed to ensure that there are adequate number of qualified personnel. In cases where external agencies are appointed, the auditor would need to evaluate their competency, objectivity and the independence. The auditor may do this by assessing the qualifications, experience and the professional standing.
- (iii) **Reporting responsibility of the internal auditor:** It is expected that the internal auditor would report to those charged with governance. Under Companies Act, 2013, the internal auditor reports to the Board/ Audit Committee as per section 138. In case of listed companies, compliance of provisions of SEBI LODR Regulations with regards to review of internal audit function by audit committee, presence of head of internal audit in the audit committee meetings, audit committee involvement in appointment, removal and terms of remuneration of the chief internal auditor, a direct communication link between the internal auditor and audit committee, etc. shall be verified by the auditor.
- (iv) **Involvement of Board or Audit Committee in formulation of scope, functioning, periodicity and methodology of Internal Audit** shall be examined by the auditor. As per guidance note, it is a good practice that statutory auditors are also involved by the internal auditor/ those charged with governance in determining the scope of work and periodicity of reporting.
- (v) **Technical assistance to the internal auditor:** In companies where the operations are highly technical or automated in nature, an internal auditor cannot function effectively unless he has adequate technical assistance. Statutory auditor shall review the availability of technically qualified persons (either full time or assignment based).
- (vi) **Reports submitted by the internal auditor.**
- (vii) **Existence of adequate follow-up system** to ensure that the deficiencies pointed out are corrected and remedial action taken on the deficiencies are reported upon.
- (viii) **Minutes of the meetings of the Board of Directors and audit committee** to get useful evidence regarding the efficiency and efficacy of the internal audit system.

- (ix) **Existence or otherwise of other forms of internal control:** Internal audit system is a part of the overall internal control system. Therefore, the scope of the internal audit and the extent of its coverage will, to some extent, depend upon the existence or otherwise of other forms of internal control. This is also a factor to be considered when evaluating the adequacy of the internal audit system.
- (x) If the statutory auditor determines that the internal audit system is not commensurate with the size and nature of business of a company, then the auditor should communicate with the Audit Committee or Board and seek their inputs as part of “Communication to Those Charged with Governance” and accordingly report the fact under this report.

Similarly, some of the other aspects that a statutory auditor needs to consider while reporting whether the reports of the Internal Auditors for the period under audit were duly considered by him / her are given below:

- (i) Internal audit is completed as per the plan and the reports are made available sufficiently in time. In case required, a meeting with internal auditor to discuss the observations to independently evaluate the impact of the observations on the financial statements has been done.
- (ii) All internal audit observations having a financial impact are considered by the management and control deficiencies pointed out by the internal auditors are rectified.
- (iii) Impact of the control deficiencies, if any, pointed by the internal auditors on internal financial controls over financial reporting (IFCoFR) have been assessed by auditor.
- (iv) Since auditor is vested with the right to receive the full-fledged internal audit reports (including draft audit reports) together with annexures and not merely the executive summary / power point presentations, whether the same were made available when requested.

Considering the above requirements, *it becomes obligatory for a company to implement robust internal audit system, and demonstrate the same to statutory auditors*, failing which an adverse communication can be reported in the auditor’s report. Thus, these requirements need to be kept in mind by the company when devising the policies and procedures in relation to internal audit system.

STANDARDS ON INTERNAL AUDITING IN INDIA

Since the law has left the task of formulation of scope, functioning, periodicity, and methodology for conducting an internal audit to audit committees or the board of directors in consultation with internal auditor, there is a clear need for adoption of uniformly acceptable practices in this regard.

This is required to ensure that internal auditor as well as the board or audit committee can demonstrate the effectiveness of internal audit activity to various stakeholders such as regulators, statutory auditors etc. in a confident and objective manner, by following a set of minimum requirements that are followed widely by the industry within internal audit fraternity.

Considering that none of the internal audit related standards are mandated by law in India, the audit committee or the board needs to decide on which standards they plan to use. There are two standards that are widely used by companies in India:

- Standards on Internal Audit (SIAs), issued by Institute of Chartered Accountants of India.
- International Standards for the professional practice of Internal Auditing, issued by the Institute of Internal Auditors, USA.

Both these standards are based on similar principles about the concept of internal auditing. However, there are aspects which can be different from each other. Thus, an internal auditor needs to understand these standards well before making a proposal to adopt any of them by the audit committee or board.

Below is an overview of the national standards as formulated by ICAI. These standards are recommendatory for all the members of the Institute of Chartered Accountants of India. However, once a standard is adopted by a company's board or audit committee, then it becomes mandatory for that specific company.

National Standards: SIAs by ICAI

- **Preface** to the Framework and Standards on Internal Audit
- **Framework** Governing Internal Audits
- **Basic Principles** of Internal Audit
- **100 Series – Standards on Key Concepts**
 - SIA 110 – Nature of Assurance
 - SIA 120 – Internal Controls
 - SIA 130 – Risk Management
 - SIA 140 – Governance
 - SIA 150 – Compliance with Laws and Regulations
- **200 Series – Standards on Internal Audit Management**
 - 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
- **300 – 400 Series – Standards on Conduct of Audit Assignments**
 - 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
- **500 Series – Standards on Specialised Areas**
 - SIA 520 – Internal Auditing in an Information Technology Environment
 - SIA 530 – Third Party Service Provider

The SIA standards are similar in nature to the International Standards for the Professional Practice of Internal Auditing (IIA standards). However, the SIA standards have been tailored to the specific needs of the Indian environment and take into account the legal and regulatory requirements in India.

As per the Preface of SIAs, the Council of ICAI has decided that the Standards will be made mandatory in a

phased manner. The mandatory status of a SIA implies that while carrying out an internal audit, it shall be the duty of the members of the Institute to ensure that they comply with the SIAs read with the Preface, Framework Governing Internal Audits and Basic Principles of Internal Audit.

If, for any reason, a member is unable to comply with any of the SIAs requirements, or if there is a conflict between the SIA and other mandates, such as a regulatory requirement, the internal audit report (or such similar communication) should draw attention to the material departures therefrom along with appropriate explanation.

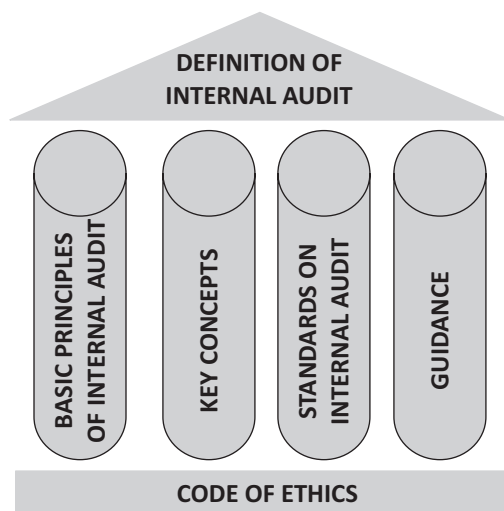
SIAs are principle based and clearly outline the objective of issuing the Standard along with the essential requirements for its compliance. Internal Auditors shall apply their best professional judgement in the implementation of SIAs on a “substance over form” basis. Implementation and Technical guides issued by the Board would help to provide the necessary guidance and clarification in this regard.

Every SIA is divided into following 5 sections:

- (1) Introduction: brief background, scope, applicability.
- (2) Objective: Reasons for issuing the Standard
- (3) Requirements: The desired outcome and what is essential to ensure compliance with the Standard.
- (4) Explanatory Comments on Implementation and Application: Certain parts of the Standard which needs to be elaborated, including defining key words and terms.
- (5) Effective Date: Date from which the Standard is to be applied and made mandatory.

The **Governing Framework of SIAs** defines four components / pillars:

- (i) Basic Principles of Internal Audit
- (ii) Key Concepts
- (iii) Standards on Internal Audit (SIAs)
- (iv) Guidance.



Source: Governing Framework on SIAs by ICAI

As per the Governing Framework of SIAs, every Internal Auditor is bound by a written Code of Ethics, issued by an organisation and/or the professional institution of which he is a member. This commits the Internal Auditor to ethical Standards applied with utmost integrity and sincerity.

Thus, in case a company's board or audit committee decides to adopt SIAs as the standards for their organisation, the Internal Audit Manuals should reflect the requirements of not only the organisation, but also the above requirements as part of code of ethics of the Internal Audit department.

The Governing Framework of SIAs further defines the basic principles of Internal Audit, which is a set of core principles fundamental to the function and activity of internal audit. The Basic Principles are critical to achieve the desired objectives as set out in the Definition of the Internal Audit, and therefore, apply to all internal audits.

The principles can be summarised as follows:

Principles establishing the credibility of the internal auditor:

1. Independence
2. Integrity and Objectivity
3. Due Professional Care
4. Confidentiality
5. Skills and Competence

Principles outlining the elements which are essential for performance of internal audit activities:

6. Risk Based Audit
7. Systems and Process Focus
8. Participation in Decision Making
9. Sensitive to Multiple Stakeholder Interests
10. Quality and Continuous Improvement.

Let us understand these principles in brief now:

1. Independence:

- 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.
- 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.
- The reporting of the Internal Auditor shall be to the Board of Directors, or the Audit Committee, who are responsible to appoint the Internal Auditors as per Rule 8 of "The Companies (Meetings of Board and its Powers) Rules, 2014". Many times, the Internal Auditor has a dual reporting responsibility, wherein the administrative reporting is to an executive officer (e.g., MD or CEO), but functional reporting to the Chairman of the Audit Committee, which is the acceptable norm. Therefore, the internal audit function shall be positioned outside the functions which are subject to internal audit (e.g., Finance and Accounts) and the Internal Auditor shall report directly to the highest governing body of the Company as stated above.

- 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 basic assurance and advisory inputs, the Internal Auditor is assigned certain operational responsibilities (such as risk management, compliance, system automation, process re-engineering, etc.). Although some limited operational role may be acceptable with due approvals, and for a short duration, the Internal Auditor shall do so only after communicating his limitations along the following lines:
 - (a) Unable to assume ownership or accountability of the process; and
 - (b) Inability to take operational decisions which may be subject to an internal audit later on.

An argument may be made that an internal auditor, being an employee of the company cannot be independent since there may be occasions where pressures from management or conflicts of interest could arise, impacting the independence. Essentially, the concept of independence in a statutory audit and internal audit is different. While a statutory auditor needs to be completely independent of the company he is auditing, an internal auditor needs to be independent of the activities or departments that he is auditing. To ensure this independence the SIAs have recommended the position and reporting structure which makes internal audit reporting to the highest levels of governance in a company. Further, where the management asks internal auditor to assume additional roles and responsibilities that may impair, or appear to impair, the organizational independence of the internal audit activity, the same should be reported to the audit committee and board as well.

2. Integrity and Objectivity

- 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.
- 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.

3. Due Professional Care

- The Internal Auditor shall exercise due professional care and diligence while carrying out the internal audit. “Due professional care” signifies that the Internal Auditor exercises reasonable care in carrying out the work to ensure the achievement of planned objectives.
- The Internal Auditor shall pay particular attention to certain key audit activities, such as establishing the *scope* of the engagement to prevent the omission of important aspects, recognizing the *risks and materiality* of the areas, having required *skills* to review complex matters, establishing the extent of testing required to achieve the objectives within specified deadlines, etc.
- “Due Professional Care”, however, neither implies nor guarantees infallibility, nor does it require the Internal Auditor to go beyond the established scope of the engagement. Where an internal auditor can demonstrate that the SIAs were followed while conducting the internal audit activity, due professional care is taken care of.

4. Confidentiality

- The Internal Auditor shall at all times, maintain utmost confidentiality of all information acquired during the course of the audit work.

- He shall not disclose any such information to a party outside the internal audit function and any disclosure shall be on a “need to know basis”.
- The Internal Auditor shall keep confidential information secure from others. Under no circumstance any confidential information shall be shared with third parties outside the company, without the specific approval of the Management or Client or unless there is a legal or a professional responsibility to do so (e.g., to share information with Statutory Auditors).
- Internal audit reports shall be addressed to specified internal auditees and distributed to only those who appointed or engaged the Internal Auditor and as per their directions.

Compliance to above requirements of SIAs is both behavioural and process driven. For instance, while it is up to individuals to ensure confidentiality of information acquired during internal audit, the internal audit manual should specify the procedures to identify the people to be included in the distribution list of an internal audit report.

5. Skills and Competence

- The Internal Auditor shall have sound *knowledge*, strong *interpersonal skills*, practical *experience* and professional *expertise* in certain areas and other competence required to conduct a quality audit. He shall undertake only those assignments for which he has the requisite competence.
- The Internal Auditor shall either have, or shall obtain, such skills and competencies, as necessary for the purpose of discharging his responsibilities. Continuing Professional Education is a key part of this exercise.
- In addition to the basic technical skills, the Internal Auditor shall have the softer skills (such as interpersonal and communication skills) required to engage with a multitude of stakeholders.
- Where the Internal Auditor lacks certain expertise, he shall procure the required skills either through in-house experts or through the services of an outside expert, provided independence is not compromised.
- The objective is to ensure that the audit team, as a whole, has all the expertise and knowledge required for the area under review.

Compliance to above Principles of SIAs can be ensured by continuous upgradation of knowledge about the relevant laws, auditing related tools or technologies, and also the knowledge about the changes in company organisation, processes, IT systems etc. As a good practice, internal auditors should have an allocated annual budget for their training and skills enhancement. Interpersonal skills play a very important role in the internal audit activity, and thus developing these skills is necessary for every internal auditor. This principle also lays down that internal auditor should take help from other experts where he lacks expertise. For instance, while doing an internal audit of a construction project, including a civil engineer as part of the internal audit team is very much in line with SIAs requirement.

6. Risk Based Audit

- The Internal Auditor shall identify the important audit areas through a risk assessment exercise and tailor the audit activities such that the detailed audit procedures are prioritised and conducted over high-risk areas and issues, while less time is devoted to low risk areas through curtailed audit procedures.
- Additionally, this approach shall ensure that risks under consideration are more aligned to the overall strategic and company objectives rather than narrowly focused on process objectives.

- A risk-based audit shall ensure the following three-fold objectives:
 - a) Audit procedures need not cover the whole process and can be limited only to the important controls in the process;
 - b) Establish linkage to the aspects relevant and connected with company and functional objectives; and
 - c) Findings and issues highlighted are significant and important and time is not devoted to areas with low probability of significant observations.

7. System and Process Focus

- An Internal Auditor shall adopt a system and process focused methodology in conducting audit procedures. This methodology is more sustainable than the one adopted to test transactions and balances as it goes beyond “error detection” to include “error prevention”.
- It requires a root cause analysis to be conducted on deviations to identify opportunities for system improvement or automation, to strengthen the process and prevent a repetition of such errors.
- Deployment of Information Technology by companies is widely prevalent and should be understood for effective internal audits. This is a more sustainable approach as this helps the Internal Auditor to move away from “people to process” and from “detection to prevention”.

8. Participation in Decision Making

- In conducting internal audit assignments, the Internal Auditor shall avoid passing any judgement or render an opinion on past management decisions.
- As part of his advisory role, the Internal Auditor shall avoid participation in operational decision making which may be subject of a subsequent audit.
- The focus of the Internal Auditor shall remain with the quality and operating effectiveness of the decision-making process and how best to strengthen it, such that the chance of flawed or erroneous decisions is minimised.
- However, the Internal Auditor is at full liberty to present the lessons which can be learnt from such past decisions.

This Principle lays down the boundaries or safeguards for internal auditors so that they are not perceived to have participated in the management decision making.

9. Sensitive to Multiple Stakeholder Interests

- The Internal Auditor shall evaluate the implications of his observations and recommendations on multiple stakeholders, especially where diverse interests may be conflicting in nature. In such situations, the Internal Auditor shall remain objective and present a balanced view.
- This would permit senior management to make a decision using all the information and balance the strategy and objectives of the company with the expectations and interests of its multiple stakeholders.

10. Quality and Continuous Improvement

- The quality of the internal audit work shall be paramount for the Internal Auditor since the credibility of the audit reports depends on the reliability of reported findings.
- The Internal Auditor shall have in place a process of quality control to:
 - a) ensure factual accuracy of the observations;

- b) to validate the accuracy of all findings; and
- c) continuously improve the quality of the internal audit process and the internal audit reports.
- The Internal Auditor shall ensure that a self-assessment mechanism is in place to monitor his own performance and also that of his subordinates and external experts on whom he is relying to complete some part of the audit work.
- A peer review mechanism for quality control shall be followed to adhere to all aspects of the pronouncements issued by the ICAI.

Above discussion on the Preface, Governing Framework and Basic Principles of Internal Audit gives the required conceptual clarity and foundation to an internal auditor while performing his tasks. The specific standards (100 ~ 500 series) further elaborate and bring clarity on how to deal with various real-life situations as an internal auditor.

STANDARDS ON INTERNAL AUDIT ISSUED BY ICAI

100 Series: Standards on Key Concepts

Standard on Internal Audit (SIA) 110- Nature of Assurance

Deals with those assignments performed by internal auditors where an opinion is required, and it clarifies the minimum requirements to be in place before an audit opinion report can be issued.

This Standard covers only those assignments where an opinion is expressed through an internal audit report. An audit rating of an individual audit observation (e.g. for severity of outcome) or a risk rating of the audit observation, is not considered an audit opinion for the purpose of this SIA. An assurance assignment may be part of another project, for example, a Certification on Internal Controls over Financial Reporting. In such circumstances, this Standard is relevant only to the assurance portion of the assignment.

Standard on Internal Audit (SIA) 120- Internal Controls

This Standard applies to all internal audits conducted where internal controls are subject of audit review, and are being assessed, evaluated and reported upon.

The purpose of this Standard is to:

- (a) Provide a common terminology on Internal Controls to prevent ambiguity or confusion on the subject matter;
- (b) Define Internal Controls, how they mitigate risks, and also how they are viewed from a legal perspective;
- (c) Explain the responsibilities of management and auditors with regard to Internal Controls, as mandated by law and regulations; and
- (d) Specify certain requirements which need to be met to be able to provide an independent assurance on Internal Controls in the organisation under review.

The overall objective of this Standard is to clarify the responsibilities of management and auditors over Internal Controls and how certain requirements need to be met to assess, evaluate, report and provide an independent assurance over Internal Controls.

200 Series: Standards on Internal Audit Management

Standard on Internal Audit (SIA) 210- Managing the Internal Audit Function

The objectives of this Standard on Managing the Internal Audit Function are to ensure the following:

- (a) The achievement of overall objectives of internal audit (as outlined in the Internal Audit Charter or Engagement Letter).

- (b) Adequate skilled resources and expertise are in place and deployed well, to provide the required level of assurance.
- (c) Internal audit assignments are undertaken in a systematic, disciplined and professional manner.
- (d) Quality of the work performed forms a sound basis for reporting and is supported by evidence and documentation.
- (e) Work is conducted in conformance with the Standards on Internal Audit and other related pronouncements issued by the ICAI.

Standard on Internal Audit (SIA) 220- Conducting Overall Internal Audit Planning

The objectives of an Overall Internal Audit (Engagement) Plan are to:

- (a) ensure that the planned internal audits are in line with the objectives of the internal audit function, as per the internal audit charter of the entity (and terms of engagement, where it is an outsourced engagement) and also in line with the overall objectives of the organisation.
- (b) align the organisation's risk assessment with the effectiveness of the risk mitigation implemented through internal controls.
- (c) confirm and agree with those charged with governance the broad scope, methodology and depth of coverage of the internal audit work to be undertaken in the defined time-period.
- (d) ensure that overall resources are adequate, skilled and deployed with focus in areas of importance, complexity and sensitivity.
- (e) ensure that the audits undertaken conform at all times with the applicable pronouncements of the Institute of Chartered Accountants of India.

Standard on Internal Audit (SIA) 230- Objectives of Internal Audit

The purpose of defining the Objectives of Internal Audit are to:

- (a) Document the formation and functioning of the Internal Audit activity and the terms of the out-sourced internal audit arrangement;
- (b) Provide clarity to the Internal Auditor and its stakeholders regarding the nature of the internal audit set-up and its working;
- (c) Ensure linkage between what is expected of the Internal Auditor and how those expectation can be met within the Framework governing Internal Audits; and
- (d) Promote better understanding on key operational areas, such as, accountability and authority, roles and responsibility, and such other functional matters.

The Objectives of Internal Audit and other terms of engagement of the external service provider are documented in a formal agreement referred to as the Engagement Letter. The Engagement Letter is signed by the Engagement Partner along with the appointing authority of the Company. An indicative list of terms of engagement, covered in an Engagement Letter is provided in this SIA.

Standard on Internal Audit (SIA) 240- Using the Work of an Expert

The overall objective of using the work of an Expert is to allow the Internal Auditor to place reliance on the technical work completed in the most informed manner so as to form an opinion on the outcome of the audit procedures and to add further credibility and reliability to the findings of the internal audit.

Where the findings of the Expert will form part of the assurance report to be issued by the Internal Auditor, the Internal Auditor shall participate in defining the scope, approach, and work to be conducted by the Expert. Otherwise, the Internal Auditor shall not incorporate the finding of the Expert in his Internal Audit report.

300–400 Series: Standards on the Conduct of Audit Assignments**Standard on Internal Audit (SIA) 310- Planning the Internal Audit Assignment**

The purpose of defining the Planning the Internal Audit Assignment are to:

- a. Ensure its alignment with the objectives of the Overall Internal Audit (Engagement) Plan and in line with stakeholder expectations.
- b. Ensure that the scope, coverage, and methodology of the audit procedures will form a sound basis for providing reasonable assurance.
- c. Allocate adequate time and resources to important aspects of the assignment and assign appropriate skills to complex areas and issues.

Standard on Internal Audit (SIA) 320- Internal Audit Evidence

The overall objective of obtaining appropriate and reliable evidence is to allow the Internal Auditor to form an opinion on the outcome of the audit procedures completed.

All audit evidence shall be recorded in such a manner that it can be reproduced (if in digital form) and reviewed independently of the Internal Auditor. Details of these quality standards, the manner in which audit evidence shall be gathered, reviewed for sufficiency and appropriateness, validated for authenticity and reliability and stored as part of internal audit documentation, shall be written in the form of an internal audit process (as part of the Internal Audit Manual).

Standard on Internal Audit (SIA) 330 - Internal Audit Documentation

The overall objective of preparing audit documentation is to allow the internal auditor to form an opinion on the outcome of the assignment. The internal audit documentation must stand on its own and not require any follow-up clarifications or additional information to arrive at the same conclusions.

The ownership and custody of the internal audit work papers shall remain with the Internal Auditor. – The internal audit work paper files shall be completed prior to the issuance of the final internal audit report. Any pending administrative matters shall also be completed within sixty days of the release of the final report.

Standard on Internal Audit (SIA) 350 - Review and Supervision of Audit Assignments

The overall objective of review and supervision of an audit assignment is to ensure the effective and efficient performance of the audit procedures in line with quality standards and to accomplish the objectives of the audit.

- a. The periodicity and extent of the review shall be planned and documented at the audit planning stage considering the overall audit objectives, time, and budget constraints, as per the professional judgement of the Chief Internal Auditor or Engagement Partner.
- b. The documentation shall record the evidence of the supervision and review conducted, including the performance of any audit procedures subsequent to the review.

Standard on Internal Audit (SIA) 360- Communication with Management

The objectives of this Standard to ensure the following:

- (a) There is clarity and consensus between the Internal Auditor and the management with regard to the scope, approach, objectives and timing of an internal audit.
- (b) To help inform, persuade and act on matters important to the conduct of an internal audit by promoting a continuous dialogue and free flow of information between the Internal Auditor and management.
- (c) To help resolve any conflicts in a timely manner.

It explains the importance of two-way communication, both while managing IA function & while conducting an IA assignment. The Internal Auditor shall establish a written communication process and protocol with management including essential exchange of information, cross reference to the internal audit program, where appropriate, and the same is shared and agreed with them.

Standard on Internal Audit (SIA) 370- Reporting Results

On completion of work, IA shall issue a clear, well documented Internal audit report which includes following key elements,

- a. Overview of objective, scope, and approach of the audit assignment,
- 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,
- e. Nature of assurance, if any, which can be derived from the observations.

Standard on Internal Audit (SIA) 390- Monitoring and Reporting of Prior Audit Issues

The specific objectives of this standard are to ensure:

- a. Proper monitoring and closure of open issues from prior audits.
- b. Independent validation of corrective actions taken by the auditee.
- c. Escalation of any concerns in case of delays in closure of issues.
- d. Timely reporting of status to those charged with governance.

The overall objective of this Standard is to ensure that the auditee mitigate the risks highlighted in the audit observations through timely corrective actions or that a conscious decision is taken to accept the risks, in case recommendations are delayed or not implemented.

500 Series: Standards on Specialised Areas

Standard on Internal Audit (SIA) 520 - Internal Auditing in an Information Technology Environment

The objectives of this standard are to define the essential requirements for auditing in an IT environment so that:

- a. Audits are undertaken after due study and understanding of the Organisation's ITE, including the IT strategy, operating procedures, the risk and governance mechanism in place to manage the ITE;
- b. An independent risk assessment, along with an evaluation of the controls required to mitigate those risks, forms the basis of the audit procedures; and
- c. The audit procedures designed and executed are sufficient to allow an independent assurance, especially in the areas of (indicative list):
 - Security and reliability of information.
 - Efficiency and effectiveness of information processing.

- Analysis and reporting of the information.
- Continuous access and availability of the information.
- Compliance of the ITE with laws and regulations.

The overall objective of performing internal audits in an ITE is provide independent assurance and help make improvements in the ITE, thus enabling the achievement of business objectives.

Standard on Internal Audit (SIA) 530 - Third Party Service Provider (TPSP)

The primary objective of this standard is to outline the key requirement for providing independent assurance over information residing with third party service providers. These requirements are in the nature of:

- a. Assessment of risks associated with securing and protecting the information;
- b. Evaluation of adequacy of controls to address risk of errors and irregularities from financial, operational processing and reporting requirements;
- c. Cost and operational efficiencies in the collection, storage and processing of company information; and
- d. Ensuring compliance with IT policies and standards, as well as contractual, statutory, and regulatory requirements.

One objective is to issue an independent audit report on TPSP's Controls. These reports are designed to help the User Entity to build trust on the controls at the TPSP. Conversely, these reports also help to build confidence with the TPSP in their own service delivery processes and controls.

Another objective of this standard is to outline requirement of the Internal Auditor in evaluating the TPA report provided by Independent auditor covering outsourced processes of TPSP.

INTERNATIONAL STANDARDS BY INSTITUTE OF INTERNAL AUDITORS (IIA)

Now that we have discussed the national standards, let us also have a look at the international standards defined by the IIA. IIA stands for the Institute of Internal Auditors, headquartered in USA, which is an international professional association of internal auditors. IIA has established a set of standards that provide guidance and best practices for internal auditing. These standards are known as the International Standards for the Professional Practice of Internal Auditing (or IIA standards).

The IIA standards are divided into three categories:

- 1. Attribute Standards:** These standards deal with the characteristics of organizations and individuals performing internal auditing. They cover areas such as independence, objectivity, and proficiency.
- 2. Performance Standards:** These standards deal with the nature of internal auditing work and how it should be performed. They cover areas such as planning, execution, reporting, and follow-up.
- 3. Implementation Standards:** These standards provide guidance on how to implement the attribute and performance standards. They cover areas such as quality assurance and improvement programs, governance, risk management, and control processes.

The IIA standards provide a framework for internal auditors to carry out their work in a professional and effective manner. They help to ensure that internal audit activities are performed with integrity, objectivity, and due professional care. Compliance with the IIA standards is also a key factor in ensuring that internal audit activities meet the expectations of stakeholders, such as management and external auditors.

A quick snapshot of IIA standards is given below:

**International Standards for the Professional Practice of Internal Auditing (Standards) -
Issued by The Institute of Internal Auditors, USA**

- Attribute Standards
 - 1000 – Purpose, Authority, and Responsibility
 - 1010 – Recognizing Mandatory Guidance in the Internal Audit Charter
 - 1100 – Independence and Objectivity
 - 1110 – Organizational Independence
 - 1111 – Direct Interaction with the Board
 - 1112 – Chief Audit Executive Roles Beyond Internal Auditing
 - 1120 – Individual Objectivity
 - 1130 – Impairment to Independence or Objectivity
 - 1200 – Proficiency and Due Professional Care
 - 1210 – Proficiency
 - 1220 – Due Professional Care
 - 1230 – Continuing Professional Development
 - 1300 – Quality Assurance and Improvement Program
 - 1310 – Requirements of the Quality Assurance and Improvement Program
 - 1311 – Internal Assessments
 - 1312 – External Assessments
 - 1320 – Reporting on the Quality Assurance and Improvement Program
 - 1321 – Use of “Conforms with the International Standards for the Professional Practice of Internal Auditing”
 - 1322 – Disclosure of Nonconformance
- Performance Standards
 - 2000 – Managing the Internal Audit Activity
 - 2010 – Planning
 - 2020 – Communication and Approval
 - 2030 – Resource Management
 - 2040 – Policies and Procedures
 - 2050 – Coordination and Reliance
 - 2060 – Reporting to Senior Management and the Board
 - 2070 – External Service Provider and Organizational Responsibility for Internal Auditing

- 2100 – Nature of Work
- 2110 – Governance
- 2120 – Risk Management
- 2130 – Control
- 2200 – Engagement Planning
- 2201 – Planning Considerations
- 2210 – Engagement Objectives
- 2220 – Engagement Scope
- 2230 – Engagement Resource Allocation
- 2240 – Engagement Work Program
- 2300 – Performing the Engagement
- 2310 – Identifying Information
- 2320 – Analysis and Evaluation
- 2330 – Documenting Information
- 2340 – Engagement Supervision
- 2400 – Communicating Results
- 2410 – Criteria for Communicating
- 2420 – Quality of Communications
- 2421 – Errors and Omissions
- 2430 – Use of “Conducted in Conformance with the International Standards for the Professional Practice of Internal Auditing”
- 2431 – Engagement Disclosure of Nonconformance
- 2440 – Disseminating Results
- 2450 – Overall Opinions
- 2500 – Monitoring Progress
- 2600 – Communicating the Acceptance of Risks
- Implementation Guidance
 - Guide for IIA Code of Ethics
 - Guide for each of the standards

Latest version of IIA standards can be downloaded from the website of IIA by its members

While ICAI & IIA aim to improve the quality and effectiveness of internal audits, there are some differences between the standards they set. The ICAI sets out guidelines for its members who may be working in India or any other country. The latest revised standards cover most of the contemporary issues faced by the internal audit professionals.

On the other hand, IIA standards are more globally recognised. These standards have been made keeping the global issues and challenges faced by internal audit profession and may not be able to cater to the specific local regulations in all matters. Yet, they are comprehensive and widely respected.

While choosing to adopt a particular set of standards, the audit committee or the board may consider the relevance of operations of the company, perception of relevant stakeholders, and the opinion of the internal auditor. For instance, the board of a multi-national company headquartered in USA, and having its operations in India shall be more willing to adopt the IIA standards instead of SIAs. On the other hand, a company head quartered in India having international operations may like to adopt SIAs, being the standards which are more aligned to the regulations in India. The past experiences and perception of board members as well as internal auditor may also impact this decision.

INTERNAL AUDIT PRACTICES

Internal Audit Manual

While the fundamental principles for internal audit activity are detailed in the standards, we need to imbibe the same in the day-to-day operations of a company by translating the requirements into the policies and procedures related to internal audit activity. Putting in place an internal audit manual is a good practice which is followed by most organisations.

A typical internal audit manual has below given contents:

- Definition of internal audit as adopted by audit committee / board (e.g., SIAs or IIA)
- Scope, objectives, and any exclusions from internal audit activity
- Reporting and Review responsibility (functional and administrative)
- Authority
- Rules of conduct / Code of Ethics
- Procedural aspects
 - Planning and approval
 - Audit Universe
 - Audit Planning Methodology
 - Frequency of Internal Audits
 - Engagement Planning
 - Audit Performance process (audit notifications, kick off meetings, working paper requirements, audit records, draft report and final report circulation etc.)
 - Monitoring Progress
 - Categorization of Audit Findings

This document needs to be drawn out clearly in line with the standards adopted by the company, and then reviewed and approved by the audit committee or the board. While an extract of internal audit manual defining all the aspects except the procedural parts (usually known as Internal Audit Charter) is normally made available to all the employees of the organisation on mediums such as Intranet of the company, the detailed internal audit manual containing procedural part is usually made available to all the members of the internal audit team. The internal auditor should seek guidance from the board or audit committee about circulation of these documents.

In case there is no internal auditor on the rolls of the company, the external firm appointed by the board or audit committee may make such a manual and get it approved from the board or audit committee. The auditor

so appointed may decide the circulation of such manual to relevant stakeholders, as per the directions of the board or audit committee.

Further, documentation of any exclusions to the scope of internal audit activity is important for the audit committee or boards. Thus, the same should be clearly brought out in the internal audit manual. For instance, in some companies the management audits are done by a separate department, and in such case, it is important to put these audits as an exclusion in internal audit manual. Similarly, the health and safety audits, secretarial audits, statutory audits, and ISO audits may or may not be under the scope of internal audit and thus a clarity on the same should be brought out in the internal audit manual. In the absence of such exclusions, the internal auditor may be perceived to be responsible for such activities as well.

CORPORATE SOCIAL RESPONSIBILITY

Corporate Social Responsibility is the way companies manage their businesses to produce an overall positive impact on society through economic, environmental and social actions. Corporate social responsibility (CSR), also called corporate conscience, corporate citizenship, social performance, or sustainable responsible business/ businesses. Business depends for its survival on long term prosperity of the society

CSR has been defined by different people giving it a varied dimension. According to Michel Hopkins “Corporate Social Responsibility is concerned with treating the stakeholders of a company or institution ethically or in a responsible manner. ‘Ethically or in a responsible manner’ refers to treating key stakeholders in a manner deemed acceptable according to international norms.”

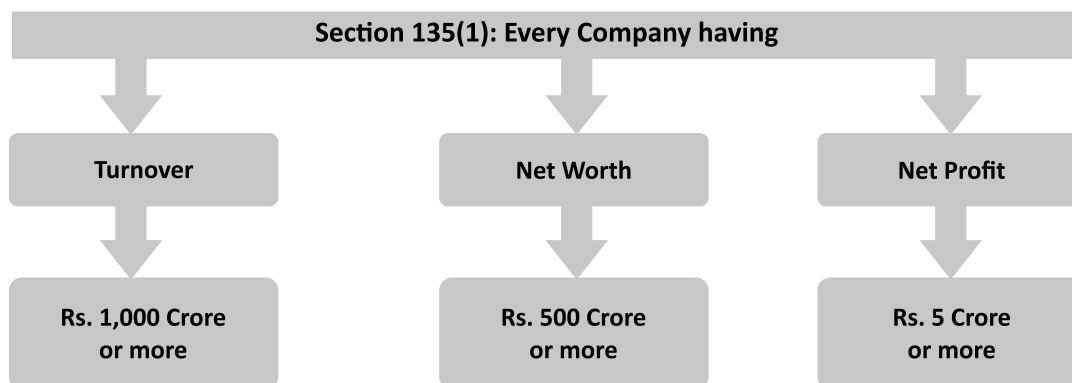
Corporate social responsibility is basically a new business strategy to reduce investment risks and maximise profits by taking all the key stakeholders into confidence. The proponents of this perspective often include corporate social responsibility in their advertising and social marketing initiatives. It is a tool to increase the reputation of the company in the eyes of society.

The concept of Corporate Social Responsibility was introduced in India within legal framework by the Companies Act, 2013.

Applicability under Companies Act, 2013

Section 135 (1) read with rule 3 of Companies (Corporate Social Responsibility Policy) Rules, 2014, mandates that every company which fulfils any of the following criteria during the immediate preceding financial years shall constitute a CSR Committee –

- Companies having net worth of rupees five hundred crore or more, or
- Companies having turnover of rupees one thousand crore or more, or
- Companies having a net profit of rupees five crore or more



Illustrative Checklist for Corporate Social Responsibility provisions under Companies Act, 2013

1. Check if the constitution of CSR Committee is applicable to company.
2. If yes, whether the company has constituted CSR committee of the board consisting of three or more directors, out of which at least one director is an independent director.

In case where a company is not required to appoint an independent director under sub-section (4) of 149, it shall have in its CSR Committee two or more directors.
3. Whether the company has CSR policy approved by the CSR Committee.
4. Whether the CSR committee has recommended list of CSR projects or programme within the purview of schedule VII.
5. Whether the monitoring process of such projects or programme has been established by the company.
6. The composition of CSR committee is disclosed in the board's report.
7. Check whether the CSR activities were under taken as per CSR policy and projects, programs or activities excludes activities undertaken in pursuance of its normal course of business.
8. Corporate social responsibility committee has recommended the amount of expenditure to be incurred on the activities referred in the Corporate Social Responsibility policy.
9. The company has instituted a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.
10. The company has disclosed the contents of the policy in board's report and at its website, if any.
11. The board's report includes an annual report on CSR containing prescribed particulars.
12. In case the company does not spend the specified amount (i.e. at least two percent of the average net profits made during the three immediately preceding financial years), Board's report specifies the reason for not spending the amount.
13. Check if the net profits of the company are in accordance with the provisions section 198 of the Companies Act, 2013 or not.
14. In case the company has built CSR capacities of their own personnel, check whether the expenditure including expenditure on administrative overheads shall not exceed five percent of total CSR expenditure of the company in one financial year.
15. The company has complied with all other requirement of the CSR Rules.

Role of Internal Auditor in Corporate Governance

An effective internal audit function can play a significant role within the corporate governance framework of a company. Over the last decade, internal audit has developed and grown in importance. Efficient internal audit functions provide objective assurance/assessments to the board (and to the audit committee) about the adequacy and effectiveness of the processes by which risks are identified and prioritised; managed, controlled, and mitigated. In most countries and business sectors internal audit reports professionally to an audit committee and managerially to the chief executive or chief financial officer. Internal audit is an independent and objective appraisal function; it supports senior management and the (management) board. Internal audit activities are performed in diverse legal and cultural environments; within organisations that vary in size and structure. Internal audit functions should comply with the relevant professional standards.

CODE OF ETHICS

The primary purpose of a code of ethical conduct for a professional organisation is to promote an ethical culture among professionals who serve others. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about governance, risk management and control.

A code of ethical conduct worded so as to reduce the likelihood of members being sued for substandard work would not earn the confidence of the public. A code of ethical conduct can help establish minimum standards of competence, but it is impossible to require equality of competence by all members of a profession. To be effective, the code must provide for disciplinary action for violators.

ENVIRONMENTAL AND SOCIETAL SAFEGUARDS

Internal Audit has become an important management tool for the following reasons

1. Internal Auditing is a specialized service to look into the standards of efficiency of business operation.
2. Internal Auditing can evaluate various problems independently in terms of overall management control and suggest improvement.
3. Internal Audit's independent appraisal and review can ensure the reliability and promptness of MIS and the management reporting on the basis of which the top management can take firm decisions.
4. Internal Audit system makes sure the internal control system including accounting control system in an organization is effective.
5. Internal Audit ensures the adequacy, reliability and accuracy of financial and operational data by conducting appraisal and review from an independent angle.
6. Internal Audit is an integral part of "Management by System".
7. Internal Audit can break through the power ego and personality factors and possible conflicts of interest within the organization.
8. It ensures compliance of accounting procedures and accounting policies.
9. Internal Auditor can be of valuable assistance to management in acquiring new business, in promoting new products and in launching new projects for expansion or diversification of business.

CHANGE MANAGEMENT

Organisations are always involved in a variety of change, and this is not just confined to internal projects. For example, it could also encompass interaction with suppliers and customers. The change being undertaken by organizations now is inherently complex and often impacts diverse stakeholder groups both internally and externally. As the change portfolio grows the level of complexity grows with it. With many organizations now find it difficult to understand and track the plethora of change initiatives underway. An added complexity is a reduction in manpower and the availability of skilled resources.

The term change refers to an alteration in a system whether physical, biological or social. Thus organization change is the alternation of work environment in the organization. It implies a new equilibrium between different components of the organization i.e., technology, structural arrangement, job design, and people. An organization change may have following features:

- (i) Any change may effect the whole organization;

- (ii) When change occurs in any part of the organization, it disturbs the old equilibrium necessitating development of a new equilibrium;
- (iii) Organization change is a continuous process.

LESSON ROUND-UP

- There are several laws and regulations that govern internal audit related activities in India. Some of the key laws applicable to internal audit in India are:
 1. **Companies Act, 2013:** Section 138 of the Companies Act, 2013 mandates that certain classes of companies shall appoint an internal auditor who shall conduct an internal audit of the functions and activities of the company. These requirements are defined in Rule 13 of the Companies (Accounts) Rules, 2014.
 2. **Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), Regulations 2015:** These regulations define requirements for listed companies' audit committee and their interaction with internal audit activity. They cover amongst others, reporting of internal audit, specific items to be reviewed in relation to internal audit, and audit committee interactions with internal auditors.
 3. **Reserve Bank of India (RBI) Guidelines:** The RBI has issued guidance note on Risk Based Internal Audit for various entities such as banks, non-banking financial companies (NBFCs), and payment system providers. These guidelines were amended in January 2021 and their applicability was extended to NBFCs, and UCBs also in February 2021.
 4. **Insurance Regulatory and Development Authority of India (IRDAI)** regulations has issued Guidelines for Corporate Governance for Insurers in India in 2009, which have been updated in 2016. These guidelines define the requirements for Board to lay down policy framework for control functions such as internal audit department, audit committee oversight on internal audit activity, and responsibilities of internal auditors.
- There are two standards that are widely used by companies in India:
 1. Standards on Internal Audit (SIAs), issued by Institute of Chartered Accountants of India
 2. International Standards for the professional practice of Internal Auditing, issued by the Institute of Internal Auditors, USA.
- Both these standards are based on similar principles about the concept of internal auditing. However, there are aspects which can be different from each other. Thus, an internal auditor needs to understand these standards well before making a proposal to adopt any of them by the audit committee or board.
- **SIAs are principle based** and clearly outline the objective of issuing the Standard along with the essential requirements for its compliance. Internal Auditors shall apply their best professional judgement in the implementation of SIAs on a "substance over form" basis.
- The Governing Framework of SIAs defines the basic principles of Internal Audit, which is a set of core principles fundamental to the function and activity of internal audit. The Basic Principles are critical to achieve the desired objectives as set out in the Definition of the Internal Audit, and therefore, apply to all internal audits.

- The IIA standards are divided into three categories:
 1. Attribute Standards: These standards deal with the characteristics of organizations and individuals performing internal auditing. They cover areas such as independence, objectivity, and proficiency.
 2. Performance Standards: These standards deal with the nature of internal auditing work and how it should be performed. They cover areas such as planning, execution, reporting, and follow-up.
 3. Implementation Standards: These standards provide guidance on how to implement the attribute and performance standards. They cover areas such as quality assurance and improvement programs, governance, risk management, and control processes.
- The primary purpose of a code of ethical conduct for a professional organisation is to promote an ethical culture among professionals who serve others. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about governance, risk management and control.

TEST YOURSELF

(These are meant for recapitulation only. Answers to these questions are not to be submitted for evaluation)

1. Briefly explain the provisions of Companies Act, 2013 governing Internal Audit?
2. Explain briefly the clause stated in CARO 2020 relating to Internal Audit.
3. What are the role of Audit Committee in terms of evaluation of Internal Financial Controls (IFC)?
4. What are the Basic Principles governing Internal Audit?
5. Briefly explain the Governing Framework of Standard of Internal Audit (SIA).
6. How do you define the term “Independence” with respect to carry out Internal Audit Function?
7. What do you mean by the term “Due Professional Care”?
8. State the Skill & Competence required by the Internal Auditor?
9. Explain the SIA 310 relating to planning the Internal Audit?
10. Briefly narrate the SIA 240 relating to using the work of an Expert.
11. Explain the SIA 330 which talks about Internal Audit Documentation?
12. Short Note on -
 - SIA 390 - Monitoring and Reporting of Prior Audit Issues
 - SIA 370 - Reporting Results
 - SIA 530 - Third Party Service Provider

