

STUDY MATERIAL

PROFESSIONAL PROGRAMME

**INTERNAL
&
FORENSIC AUDIT**

GROUP 1

ELECTIVE PAPER 4.2



**THE INSTITUTE OF
Company Secretaries of India**

भारतीय कम्पनी सचिव संस्थान

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PROFESSIONAL PROGRAMME

INTERNAL & FORENSIC AUDIT

India is leading its way towards attainment, progress and growth with global recognition as one of the fastest growing economies of the contemporary world. This emerging face of India is indeed a capture of spirited government's reform and initiatives under the realm of Good Governance.

The contemporary lead of good governance, which revolves around five 'E's being '*Effective, Efficient, Easy, Empower, and Equity*' calls for an accountable, transparent and developed face of a globally recognized welfare state.

In this direction, we are adopting a highly collaborative approach and addressing challenges like fraud, deceit, financial misplacement and alike, which are hindering the inclusive growth of India. Inter-alia, where fraud is considered as one of the critical ailments, which not only holdup the corporate organizations where it has been conducted, rather it shakes the entire economy sometimes with temporary effects and sometimes with permanent ones, it has always been the priority of growing economies including India to detect, prevent and regulate the menace of fraud in the larger interest of the nation.

In this selection of timely detection, prevention and regulation over corporate fraud and reference to due investigation, Internal & Forensic Audit is having an imperative role in assisting the corporates for maintaining efficiency and merit. On the larger parameters, Internal & Forensic audit as tool-mix of accounting and investigation is serving all the five E's of good governance and make the corporates to grow and develop on the parameters of being *Effective, Efficient, Easy, Empower, and Equity*'

In this background, where Internal & forensic audit is considered as a need of the hour for enhancing the corporate culture of India, varied roles are played by the Company Secretaries in the field of Internal & Forensic Audit. Further, the present day progressive changes in the Internal & Forensic Audit are expanding the gateway of opportunities for the professionals to guide, advice, operationalize, and appear in the matters related to Internal & Forensic Audit.

The Institute of Company Secretaries of India (ICSI), while persistently playing a pivotal role in building capacities of its members has decided to provide a 360 degree rounded set of learning to the students along with apprising them with the advanced changes in the arena of Internal & Forensic Audit and their directed implementation.

Therefore, this study material has been prepared to provide the students with a wide perspective and in-depth knowledge in Internal & forensic audit to enable them to get solid grounding in the legislative framework, practice and procedure of the Internal & forensic audit. The course contents of this study material have been so designed as to develop specialised skills in the corpus and complexities of the different aspects of the subject besides meeting the requirements of a future career in this area.

The Study Material which is divided in two parts covers in the details the concepts of Internal Audit in Part – I and discusses Forensic Audit in detail under Part-II.

The domain of Internal & forensic audit is vast. Every effort has been made to provide a self- contained material and an integrated approach has been adopted throughout.

The legislative changes made upto May 31, 2025 have been incorporated in the study material. In addition to Study Material students are advised to refer to the updations at the Regulator’s website, supplements relevant for the subject issued by ICSI and ICSI Journal Chartered Secretary and other publications. Specifically, **students are advised to read “Student Company Secretary” e-Journal which covers regulatory and other relevant developments relating to the subject**, which is available at academic portal <https://www.icsi.edu/student-n/academic-portal/>. In the event of any doubt, students may contact the Directorate of Academics at academics@icsi.edu.

The amendments to law made upto 31st May of the Calendar Year for December Examinations and upto 30th November of the previous Calendar Year for June Examinations shall be applicable.

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Group 1
Elective Paper 4.2
INTERNAL & FORENSIC AUDIT

SYLLABUS

OBJECTIVES

Part I: To provide skills and knowledge required to conduct Internal Audit and open new vistas of opportunities for Company Secretaries in the field of internal auditing as well as to add tangible value to their organisations.

Part II: To understand and analyse the concept of Corporate Fraud and Forensics Auditing in the contemporary world along with the legal mechanism to counter the corporate fraud and understanding Forensic Audit and its methods.

Level of Knowledge : Expert Knowledge

Part I : Internal Audit (60 Marks)

- 1. Internal Audit: Introduction & Overview:** Definition, Key Concept, Purpose, Authority and Responsibility of Internal Auditing • Internal Auditor vs. External Auditor • Types of Internal Audit • Qualification and Appointment of Internal Auditor • Strategic and Operational Role of Internal Auditor
- 2. Practices related to Internal Auditing:** Laws, Standards and Regulations on Internal Auditing - National and International • Internal Auditing Practices • Corporate / Organizational Governance Principles • Code of Ethics
- 3. Internal Controls:** Meaning and Definition of Internal Control • Dimensions of Internal Control • Types of Controls (Preventive, detective, input, output) • Internal Control Techniques • Internal Control Frameworks (COSO, Cadbury) • Role of Internal Auditors in Implementation of Internal Controls • Examine the effectiveness and efficiency of internal controls • Fraud Risk Awareness • Risk Management • Recommend controls to prevent and detect fraud and educate to improve the organization's fraud awareness
- 4. Internal Audit Engagements and Planning:** Plan Engagements • Supervise Engagement • Communicate Engagement Results • Monitor Engagement Outcomes • Audit Planning and Stages for Internal Audit Planning
- 5. Internal Audit Tools and Techniques:** Data Gathering • Data Analysis, Interpretation and Reporting • Documentation / Work Papers • Process Mapping including Flowcharting • Steps in evaluation and its techniques • Use of Sampling Techniques and its tests • Flowcharts and Internal Control Questionnaires • Automation
- 6. Internal Audit of Specific Functions:** Internal Audit of Purchase & Inventory Management • Internal Audit of Production and Operations • Internal Audit of Finance and Accounts • Internal Audit of Human Resources • Internal Audit of Sales & Marketing • IT System Audit

- 7 **Special Points relating to Internal Audit in various entities:** Banking Companies • Insurance Companies • Cooperative Societies • Public Sector Undertakings • Partnership • Shipping Companies • Electric Supply Company • Hotels • Hospital • Others
8. **Reporting under Internal Audit:** Observation Formulation • Report Writing • Monitoring Closure of Issues • CARO - Companies (Auditors Report) Order
9. **Emerging Issues and Challenges:** Financial Accounting and Funding Risks • Business related Challenges • Project Management/Organizational Change • In-house vs. Outsourcing Audit Assignments • Emerging Issues

Part II : Forensic Audit (40 Marks)

10. **Basic Concepts of Forensic Audit:** Introduction • Need and Objectives of Forensic Audit • Fundamentals of Forensic Audit • What is Fraud • Kinds of Frauds • Forensic Audit vis-a-vis Audit • Modern Day Scenario
11. **Audit and Investigations:** Tools for handling Forensic Audit • Investigation Mechanism • Field Investigations • Methods of Investigations • Red Flags • Green Flags • Financial Statement Analysis
12. **Forensic Audit: Laws and Regulations:** Information Technology and Business Laws • International Laws and Practices • UK Bribery Act • US Foreign Corrupt Practices Act • Indian Laws • ICSI Anti Bribery Code
13. **Forensic Audit and Indian Evidence Law:** Finding Facts • Relevant Facts • Admission of Evidence • Methods to Prove Cases
14. **Cyber Forensics:** Introduction to Cyber Crime • International Guidance to Cyber Forensics Laws • Digital Forensics and Cyber Laws • Introduction to Data Extraction • Digital Forensics and Cyber Crime • Ethical Hacking • Digital Incident Response • Case Laws: Indian and International
15. **Fraud Detecting Techniques:** Early Warning Indicators of fraud, Money laundering, misconduct • General Audit Techniques • Statistical & Mathematical Techniques • Technology Based/ Digital Forensics Techniques • Data mining techniques • Willful defaults and Corporate Insolvency & Bankruptcy – emerging Forensic audit aspects

ARRANGEMENT OF STUDY LESSONS

INTERNAL & FORENSIC AUDIT

GROUP 1 • ELECTIVE PAPER 4.2

PART I: INTERNAL AUDIT

Sl. No. Lesson Title

1. Internal Audit: Introduction & Overview
2. Practices related to Internal Auditing
3. Internal Controls
4. Internal Audit Engagements and Planning
5. Internal Audit Tools and Techniques
6. Internal Audit of Specific Functions
7. Special Points relating to Internal Audit in various entities
8. Reporting under Internal Audit
9. Emerging Issues and Challenges

PART II: FORENSIC AUDIT

10. Basic Concepts of Forensic Audit
11. Audit and Investigations
12. Forensic Audit: Laws and Regulations
13. Forensic Audit and Indian Evidence Law
14. Cyber Forensics
15. Fraud Detecting Techniques

LESSON WISE SUMMARY

INTERNAL & FORENSIC AUDIT

PART I – INTERNAL AUDIT (60 MARKS)

Lesson 1 – Internal Audit: Introduction & Overview

Audit is the systematic scrutiny of books of accounts of an organization in order to calculate, ascertain or check their accuracy and efficiency. In the same line, Internal Audit is the check to assess the risk management and to ensure that risk management processes are efficient, effective, secure and compliant. It is the basic check of internal control of the organization. An internal audit is an organizational move to check, ensure, monitor and analyze its own business operations in order to determine how well it conforms to a set of specific criteria. The coverage of the lesson includes:

- The concept of Internal Audit and the regulatory provision mandatorily required to conduct Internal Audit
- The purpose or objectives for conducting Internal Audit
- The Role and Responsibilities of Internal Auditor
- The difference between Internal Audit and Statutory Audit
- The various types of Internal Audit such as Operational Audit, Compliance Audit, Environmental Audit, Performance Audit, Special Audit, Information System Audit
- The basics skills required to perform Internal Audit

Lesson 2 – Practices related to Internal Auditing

In this lesson, we will strive to understand the relevant regulations, applicable standards and generally accepted practices in the internal audit activity of an organisation. The coverage of the lesson includes:

- 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
- Standards on Internal Audit 'SIA' in India
- International Standard issued by Institute of Internal Auditor 'IIA'

Lesson 3 – Internal Controls

Internal controls are the mechanisms, rules and procedures implemented by an entity to ensure the integrity and reliability of financial and non-financial records, management information and cost accounting records, promote accountability, prevent and detect errors and frauds. The auditors also rely on the system of internal control for the purpose of audit of the financial accounts.

Internal control comprise internal accounting controls and operational controls. The auditors are primarily concerned with internal accounting controls.

Basic controls include features like control accounts and numerical controls to ensure that all transactions are completely accounted for in the books of account. Disciplines over basic controls include the segregation of incompatible duties, segregation of custody of assets from the accounting responsibilities, physical safeguards to prevent unauthorised access to assets or accounting and other sensitive records and internal check. The coverage of the lesson includes:

- Role of internal auditors in implementation of internal controls
- Examine the effectiveness and efficiency of internal controls
- Fraud risk awareness, Risk Management, Types of Risks, Enterprise Risk Management, Risk Management Plan
- Recommend internal controls to prevent and detect fraud and educate to improve the organisation's fraud awareness
- The role of Internal Control in the New Digital ERA such as Robotic Process Automation (RPA), Artificial Intelligence and Machine Learning, Block chain Technologies, Cloud Computing

Lesson 4 – Internal Audit Engagements and Planning

In the case of Companies under Companies Act, 2013, it is a legal requirement for the Audit Committee or its Board of Directors to formulate the overall internal audit plan of the company. Companies (Accounts) Rule 13(2) of Companies Act, 2013 provides: "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."

As per standard on Internal Audit (SIA) 220 - Conducting Overall Internal Audit Planning, issued by the Institute of Chartered Accountants of India (ICAI), The Audit Committee or the Board takes the active support of the Chief Internal Auditor, to develop the Overall Internal Audit Plan, in consultation with the Executive Management.

The coverage of the lesson includes:

- Audit Plan and how to develop the Audit Plan
- The steps involved in Audit Planning
- Benefits for formulating Audit Plan
- Audit Universe and Factors for developing Internal audit universe
- Supervise Audit Engagement and monitor Audit Engagement Outcomes

Lesson 5 – Internal Audit Tools and Techniques

The coverage of the lesson includes:

- The concepts of documentation, nature and purpose of documentation, Important aspects in Documentation, Form, content and extent of documentation, audit file, Type of File , Permanent File, Current File
- The need for working papers, ownership and custody of working papers, Guidelines for preparation of working papers, Documents Checklist
- Audit evidence, Sources of Audit evidence, sufficiency and appropriateness of audit evidence, types of audit evidence, relevance and reliability of audit evidence. The Importance of written representations and the objectives, External Confirmation and its relevance

- Internal Audit Techniques such as Vouching, Inquiry and Confirmation, Reconciliation, Testing, Physical Verification, Analytical Procedure, Computation, Flowchart, Observation
- Audit Sampling, Application of Audit Sampling Techniques, Sample Selection Methods, Sampling Risk, Evaluating Results of Audit Sampling
- Flowchart and Internal Control Questionnaire, Audit in Automation Environment

Lesson 6 – Internal Audit of Specific Functions

In the previous lesson, we have studied about internal audit tools and techniques, and how they can be used effectively while conducting an internal audit. In this lesson we take the discussion forward and learn about nuances of conducting internal audit of some specific functions or processes which are usually part of most of the organisations. We will strive to understand the practical aspects as well the possible risks and controls which may be audited in such audits. The coverage of the lesson includes:

- Internal Audit of Purchasing Activity
- Internal Audit of Inventory Management
- Internal Audit of Production and Operations
- Internal Audit of Finance and Accounts
- Internal Audit of Human Resources
- Internal Audit of Sales & Marketing
- IT System Audit

Lesson 7 – Special Points relating to Internal Audit in various entities

The coverage of the lesson includes the Major's points / areas to be covered in case of audit of Banking Companies, Insurance Companies, Cooperative Societies, Public Sector Undertakings, Partnership, Shipping Companies, Electric Supply Company, Hotels, and Hospital etc.

Lesson 8 – Reporting under Internal Audit

The essential part of internal audit is the dissemination of the results of internal audit and reports the findings to management, and those charged with governance. The internal audit report of the company is a significant aspect which throws light on any kind of non-compliance with the regulations that are needed to be kept in mind. It also highlights the aspects which need to be improved.

The internal auditor should review and assess the analysis drawn from the internal audit evidence obtained as the basis for his conclusion on the efficiency and effectiveness of systems, processes and controls including items of financial statements.

The coverage of the lesson includes:

- The reporting under Internal Audit and objectives of Reporting under Internal Audit
- Important aspects of quality reporting under Internal Audit
- Layout of Internal Audit Report
- The precautions to be taken care of while drafting Internal Audit Report?
- Communication of outcomes of Internal Audit to Management

- Checklist of Internal Audit Report
- Reporting under various clauses of Companies Audit Report Order 2020 [CARO 2020]

Lesson 9 – Emerging Issues and Challenges

Many businesses have to take risks when it comes to their finances. Whether it's investing in new projects or increasing production, there is always the potential for failure. But with the proper financial accounting and funding risk management techniques, one can minimise their risk and ensure the success of business. Financial accounting and funding risk are two different topics, but they go hand in hand. Financial accounting is the process of recording and summarising financial information, while funding risk is the potential for losses due to inadequate or inappropriate funding. How financial accounts are managed can significantly influence the level of funding risk a company faces.

Poorly managed accounts can lead to insufficient funds, which in turn, can lead to cash flow problems and other financial issues. On the other hand, well-managed accounts enable companies to utilise their resources efficiently and effectively, minimising their exposure to funding risks. Let's explore different ways to manage financial accounting and funding risks. We will also look at how financial accounting and funding risk are related and how organisations should manage their finances to reduce risk exposure.

The coverage of the lesson includes:

- Financial Accounting & the risks involved in Financial Accounting?
- Funding Risks and how it can be avoided?
- Various business related challenges while conducting internal audit
- Prons and Cons of In-house Internal Audit function and of Outsourcing of Internal Audit function
- Prons and Cons of Co-sourcing of audit assignment
- Various emerging areas to be looked in Internal Audit

PART II – FORENSIC AUDIT (40 MARKS)

Lesson 10 – Basic Concepts of Forensic Audit

In the selection of timely detection, prevention and regulation over corporate fraud and reference to due investigation, Forensic Audit is having an imperative role in assisting the corporates for maintaining efficiency and merit. On the larger parameters, Forensic audit as tool-mix of accounting and investigation is serving all the five E's of good governance and make the corporates to grow and develop on the parameters of being Effective, Efficient, Easy, Empower, and Equity'. In this background, where forensic audit is considered as a need of the hour for enhancing the corporate culture of India, this chapter covers the verve of the forensic audit including the meaning, definition, objectives and significance of forensic audit.

In the contemporary era, Government of India is adopting a highly collaborative approach and addressing various challenges like fraud, deceit, financial misplacement and alike, which are a big hindrances in the path of inclusive growth of corporates in India. Among other things, 'fraud' in one of the most critical ailments which not only holdups the corporate organizations where it is conducted, rather it shakes the economy of entire country which has both short term as well as long term impact. In this whole process of timely detection of frauds and reference of such case for due investigation, Forensic Audit has an imperative role in assisting the corporates to maintain efficiency as well as merit at par. In the larger perspective, this lesson aims to apprise the students with modern day scenario of forensic audit, fundamentals of forensic audit along with other related concepts.

Lesson 11 – Audit and Investigations

Right from conducting forensic audit to examining the evidences, from finding the culprit behind the fraud to appearing in the court for submitted the testimony, a Company Secretary is apt in serving his professional excellence as a forensic auditor.

To summarize, where forensic audit is a detailed engagement which requires the expertise of not only accounting and auditing procedures but also expert knowledge regarding the legal framework, and a forensic auditor is required to have an understanding of various frauds that can be carried out and of how evidence needs to be collected.

In this context, Company Secretary is a Catalyst in Upholding Good Governance via Forensic Audit. His role in specific to Forensic audit is the main objective of this lesson. Henceforth, the lesson aims to provide a clear understanding to the matters including Tools for handling Forensic Audit and the Role of Company Secretary; Investigation Mechanism; Field Investigations; Methods of Investigations; Red Flags; Green Flags and alike.

Lesson 12 – Forensic Audit: Laws and Regulations

A forensic audit is an examination and evaluation of a firm's or individual's financial information for use as evidence in the court of law. A forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims. In order to understand the legal consequences that a person attracts on being caught in a forensic audit, it is necessary to know about the various statutes that talk about the implementation of forensic audits in India. Therefore, this lesson aims at providing the basic understanding as to the laws, regulations and statues, nationally as well as internationally, dealing will corporate laws and empowering forensic auditors in performing their duties in its true letter and spirit.

Lesson 13 – Forensic Audit and Indian Evidence Law

In order to prove a case in the court of law and to penalize the wrong doers, the matter must be proved beyond reasonable doubt. For this purpose, one must adduce relevant evidences in the court of law. The similar context is applicable for proving the corporate fraud and the person behind it through the use of forensic audit reports. Therefore, this lesson deals with the concepts of evidence law in reference to forensic audit. In specific, it deals with Finding Facts; Relevant Facts; Admission of Evidence; Methods to Prove Cases.

Lesson 14 – Cyber Forensics

The impact of Information and Communication Technology is very profound. Both Society and the Technology are operating in a way so as to harmonize with the pace of each other's growth. As the World is developing, more technology is emerging with each passing day and thus there is more development taking place in the society. All the facets of human life including education, health, entertainment and communication are being influenced by and have been impacted by the advent of the Information and Communication Technology. This way, Information Technology is rightly called as a boon.

With boon goes the bane, so is the case with Information and Communication Technology. One of the major challenges in this era of ICT is of an increasing number of cyber-crimes taking place in the World today. Corporate Frauds are not the exception to it.

In the light of corporate frauds executed via the means of Information Technology, a new branch of forensic audit called Cyber Forensics audit has emerged in the contemporary world.

In this perspective, this chapter aims to apprise the students with concepts like Cyber Crime; International Guidance to Cyber Forensics Laws; Digital Forensics and Cyber Laws; Introduction to Data Extraction; Digital Forensics and Cyber Crime; Ethical Hacking, Digital Incident Response and alike.

Lesson 15 – Fraud Detecting Techniques

The coverage of the lesson includes:

- The meaning of Fraud, Investigation and Detection
- Early warning indicators of Fraud such as Unusual Financial Activity, Poor Accounting, Unusual behavior, Unexplained Inventory, Employee Turnover, Weak or lack of Internal Controls, Complaints or Tip, Weaknesses in IT Security, Suspicious Emails or Messages
- The term 'Money Laundering' and Techniques used for Fraud Detection in Money Laundering
- Fraud Detection using General Audit Techniques such as Analytical procedures, Inquiry, Observation, Re-performance, Sampling, Inspection etc.
- Statistical and Mathematical Techniques in Fraud Detection
- Technology based Fraud Detection Techniques
- Data Mining Techniques for Fraud Detection

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PART I

INTERNAL AUDIT





Internal Audit: Introduction & Overview

Lesson 1

KEY CONCEPTS

- Internal Audit ■ Statutory Audit ■ Operational Audit ■ Compliance Audit ■ Environmental Audit
- Performance Audit ■ Special Audit ■ Information System Audit

Learning Objectives

To understand:

- The concept of Internal Audit
- The regulatory provision mandatorily required to conduct Internal Audit
- The purpose or objectives for conducting Internal Audit
- The Role and Responsibilities of Internal Auditor
- The difference between Internal Audit and Statutory Audit
- The various types of Internal Audit such as Operational Audit, Compliance Audit, Environmental Audit, Performance Audit, Special Audit, Information System Audit
- Who can be appointed as Internal Auditor?
- What are the basics skills required to perform Internal Audit?

Lesson Outline

- Introduction and Definition
- Applicability of the Provisions of Internal Audit
- Purpose of Internal Audit
- Objectives of Internal Audit
- Authority and Responsibilities of Internal Audit
- *Internal Auditor vs. External Auditor*
- Types of Internal Audit
- Qualification and Appointment of Internal Auditor
- Strategic and Operational Role of Internal Auditor
- Lesson Round-Up
- Test Yourself
- List of Further Readings

INTRODUCTION AND DEFINITION

Audit is the systematic scrutiny of books of accounts of an organization in order to calculate, ascertain or check their accuracy and efficiency. In the same line, Internal Audit is the check to assess the risk management and to ensure that risk management processes are efficient, effective, secure and compliant. It is the basic check of internal control of the organization. An internal audit is an organizational move to check, ensure, monitor and analyze its own business operations in order to determine how well it conforms to a set of specific criteria.

The internal auditing profession evolved steadily with the progress of management science after World War II. It is conceptually similar in many ways to financial auditing by public accounting firms, quality assurance and compliance activities. While some of the audit technique underlying internal auditing is derived from management consulting and public accounting professions, the theory of internal auditing was conceived primarily by Lawrence Sawyer, often referred to as “the father of modern internal auditing” and the current philosophy, theory and practice of modern internal auditing as defined by the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors owes much to Sawyer’s vision.

In the past, internal auditing was constrained to ensure that, the accounting and allied records have been properly maintained, the assets of the organization have been properly safeguarded and that the policies and procedures laid down by the management have been complied with. Thereafter post liberalization of economy, the growth and expansion made it increasingly difficult for organizations to maintain control and operational efficiency. It was difficult for management to observe all the operating areas or be in touch with everybody. This requires companies or the entities to appoint auditing personnel for report on affairs of the company, which are known as ‘Internal Auditors’.

Many modern enterprises have become huge and sophisticated. This has resulted in decentralisation of the activities and consequently, the top management is remotely concerned with the day-to-day activities of the concern. With the changes in the economic conditions, now the scope of internal auditing is not confined to financial transactions it is extended up to the minutest activity of the company, which may or may not be the cost center but have an impact on the efficiency on the company. Accordingly, in the present dynamic business model scenario, the role of internal auditing has a great significance in the performance of the company.

Internal audit is an evaluation and analysis of the business operation conducted by the internal audit staff. It is the part of evaluation of overall system of internal control established in an organization. Internal audit is the independent appraisal activity within an organization for the review of accounting, financial and other business practices as protective and constructive arms of management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of controls.

Some of the definitions of Internal Auditing are appended below:

The Institute of Internal Auditors (IIA) defines Internal Audit as follows: “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”.

The Institute of Chartered Accountants of India (ICAI) defined Internal Audit as “an independent management function, which involves a continuous critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity’s strategic risk management and internal control system”.

According to Professor Walter B. Meigs, Internal Auditing means “Internal auditing consist of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full time salaried employees.”

In a big organization, an internal audit is carried out by the team of professionals in the organization. This provides management an assurance about the control process in the organization and it aids in early detection of inefficiencies/fraud etc. It helps the statutory auditor to conduct the statutory audit effectively.

APPLICABILITY OF THE 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-

- (a) every listed public company;
- (b) every unlisted public company having
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
 - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

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



- Mandatory irrespective of criteria



- paid up share capital of fifty crore rupees or more during the preceding financial year
- turnover of two hundred crore rupees or more during the preceding financial year; or
- 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
- outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and



- turnover of two hundred crore rupees or more during the preceding financial year; or
- 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.

Penalty for Non-Compliance

If a company or any other officer of the company, contravenes the provisions of this section, then the company or any officer of the company who is in default is liable for punishment with a penalty of up to Rs.10,000. In case of continuation of default in complying with the above section further fine of Rs.1,000 per day will be imposed subject to a maximum of Rs. 2,00,000 in case of a company and Rs. 50,000 in case of an officer who is in default or any other person.

CASE STUDY

1. ABC Pvt. Ltd. having Rs. 90 lacs paid-up capital, Rs. 5 crores reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being Rs. 50 crores, Rs. 175 crores and Rs. 300 crores, but does not have any internal audit system. In view of the management, the internal audit system is not mandatory. Comment?

Solution:

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of 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, ABC Pvt. Ltd. is having a turnover of Rs. 300 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the mandatorily statutory requirement to appoint an Internal Auditor and mandatorily conduct an internal audit.*

2. Shree Solution Pvt. Ltd. having a negative net worth of Rs. 120 lacs. However, turnover of last financial years, immediately preceding the financial year under audit, being Rs. 150 crores. Further, borrowing loans from SBI limited were 150 crore on 1st April, 2021. During the FY 2021-22, company has repaid the loan in full. In view of the management, the internal audit system is not mandatory for FY 2022-23. Comment?

Solution:

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of 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, Shree solution Pvt. Ltd. is having a turnover of Rs. 150 crores during the preceding financial year which is less than two hundred crore rupees. However, the company has a outstanding loan of Rs. 150 crore on 1st April, 2021 i.e. during the any point of time in FY 2021-22 which is more than 100 crores.*

Hence, the company has the mandatorily statutory requirement to appoint an Internal Auditor and mandatorily conduct an internal audit for FY 2022-23.

3. Aman Pvt. Ltd. (listed in NSE) having a turnover of last financial years, immediately preceding the financial year under audit, being Rs. 120 crores. Further, borrowing loans from SBI limited were 90 crore on 1st April, 2021. During the FY 2021-22, company has repaid the loan in full. In view of the management, the internal audit system is mandatory for FY 2022-23 as Aman Pvt. Ltd. is listed in NSE. Comment?

Solution:

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of 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, Aman Pvt. Ltd. is having a turnover of Rs. 120 crores during the preceding financial year which is less than two hundred crore rupees. Further, the company has an outstanding loan of Rs. 90 crore on 1st April, 2021 i.e. during the any point of time in FY 2021-22 which is less than 100 crores.

Hence, the company is not mandatorily statutory requirement to appoint an Internal Auditor irrespective of the fact that it is listed in NSE.

4. Will the Partnership firm / Proprietary firm mandatorily required appointing an Internal Auditor?

Solution:

No, the Partnership firm / Proprietary firm is not mandatorily required to appoint an Internal Auditor. However, voluntary the Partnership firm / Proprietary firm can appoint an internal auditor of the organization.

5. Is there any penalty for non-compliance with respect to appointment of internal auditor?

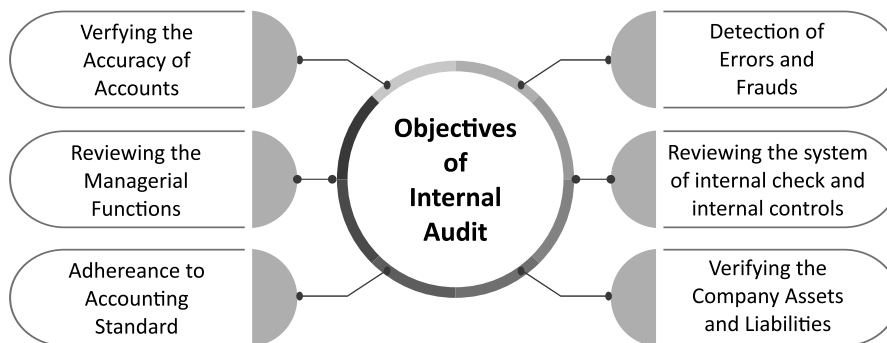
Solution:

Yes, If a company or any other officer of the company, contravenes the provisions of this section, then the company or any officer of the company who is in default is liable for punishment with a penalty of up to Rs.10,000. In case of continuation of default in complying with the above section further fine of Rs.1,000 per day will be imposed subject to a maximum of Rs. 2,00,000 in case of a company and Rs. 50,000 in case of an officer who is in default or any other person.

PURPOSE OF INTERNAL AUDIT

- To verify the correctness, accuracy, and authenticity of the financial accounting and statistical records presented to the management.
- To confirm that the organization has incurred liabilities concerning its valid and legitimate activities.
- To comment on the effectiveness of the internal control system and the internal check system in force and to suggest ways and means to improve these systems.
- To facilitate the early detection and prevention of fraud.
- To examine the protection afforded to the company’s assets and their use for business purposes.
- To identify the authorities responsible for purchasing assets and other items as well as disposal of assets.
- To ensure that the standard accounting practices that the organization must follow are strictly followed.
- To undertake a special investigation for the management.
- To assist management in achieving the most efficient administration of the operation by establishing procedures by complying with the company’s operating policies.

OBJECTIVES OF INTERNAL AUDIT



AUTHORITY AND RESPONSIBILITY OF INTERNAL AUDITING

“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation in accomplishing its objectives by bringing a

systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”

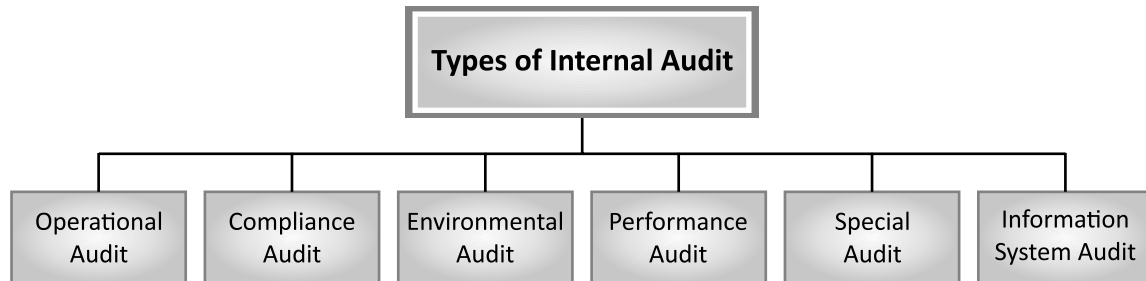
1. To work with board and management to ensure that a system is in place which ensures that all major risks are identified and analyzed. Evaluate and provide reasonable assurance that risk management, control, and governance systems are functioning as intended and will enable the organisation’s objectives and goals to be met.
2. To plan, organize and carry out the internal audit function including the preparation of an audit plan which fulfils the responsibility of the department, scheduling and assigning work and estimating resource needs.
3. Report risk management issues and internal controls deficiencies identified directly to the audit committee and provide recommendations for improving the organization’s operations, in terms of both efficient and effective performance.
4. Evaluation of information security and associated risk exposures. Evaluation of the organisation’s readiness in case of business interruption.
5. Evaluation of regulatory compliance program with consultation from legal counsel.
6. Maintain open communication with management and the audit committee. Team with other internal and external resources as appropriate. Engage in continuous education and staff development. To report to both the audit committee and management on the policies, programmed and activities of the department.
7. Provide support to the company’s anti-fraud programs.
8. To coordinate coverage with the external auditors and ensure that each party is not only aware of the other’s work but also well briefed on areas of concern.
9. To make recommendations on the systems and procedures being reviewed, report on the findings and recommendations and monitor management’s response and implementation.
10. To review and report on the accuracy, timeliness and relevance of the financial and other information that is provided for management.
11. 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.

INTERNAL AUDITOR VS. EXTERNAL AUDITOR

<i>Basis for Comparison</i>	<i>Internal Audit</i>	<i>External Audit</i>
Meaning	It refers to an ongoing audit function performed within an organization by a separate internal auditing department.	It is an audit function performed by the independent body which is not a part of the organization.
Examination	Internal auditor examines the Operational efficiency of the organisation.	External auditor examines the Accuracy and Validity of Financial Statements.
Appointment	Internal auditor is appointed by the Management.	External auditor is appointed by the Members.

Users of Report	User of internal audit report is Management.	User of external audit report is Stakeholders.
Period	Internal audit is a Continuous Process throughout the year.	External audit is done once in a year.
Opinion	Opinion is provided on the effectiveness of the operational activities of the organization.	Opinion is provided on the truthfulness and fairness of the financial statement of the company.
Status of Auditor	Internal auditor could be an employee of the company, thus, less independent.	External auditor is an independent person and not an employee of the company.

TYPES OF INTERNAL AUDIT

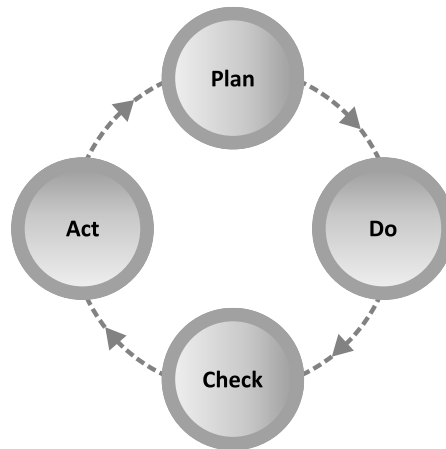


Operational Audit: Operational audit is an audit for the management; it is undertaken at the instance of the management for providing it with information and appraisal of operations and activities. A parallel development in auditing is getting shaped as a management audit. Management audit is an “audit of the management” also.

The scope and content of management audit should cover everything that we know as operational audit and, in addition, it should also include a review of the adequacy and competence of the objectives, plans, policies and decisions of the top management.

IIA publication defines operational auditing as – “A systematic process of evaluating an organisation’s effectiveness, efficiency and economy of operations under management’s control and reporting to appropriate persons the results of the evaluation along with recommendations for improvement.”

Operational Audits involve undertaking a deep analysis of operations to bring out the improvement plan with respect to its overall standard of operation including improvement in effectiveness, efficiency, benefits vis-à-vis cost of operation, and its impact on meeting the objective of the operations and that of the organization.



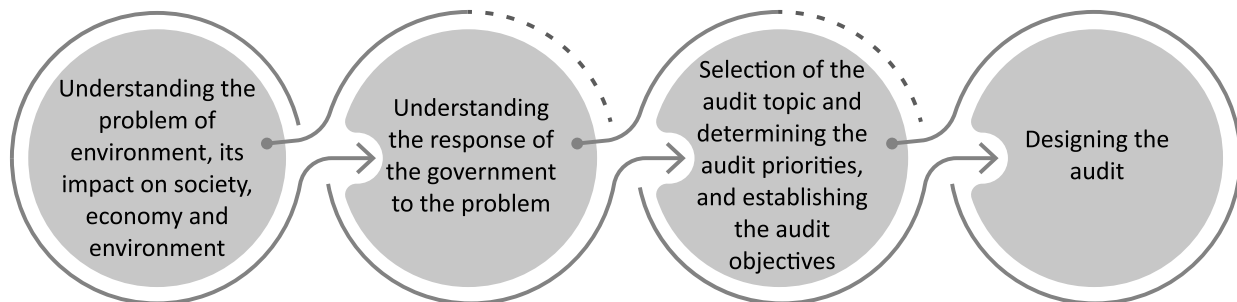
Compliance Audit: Compliance audit is an assessment as to whether the provisions of the applicable laws, rules and regulations made there under and various orders and instructions issued by the competent authority are being complied with. This audit by its very nature promotes accountability, good governance and transparency as it is concerned with reporting deviations, identifying weaknesses and assessing propriety.

ISSAI 4100 defines compliance audit as follows:

“Compliance audit deals with the degree to which the audited entity follows rules, laws and regulations, policies, established codes, or agreed upon terms and conditions, etc. Compliance auditing may cover a wide range of subject matters”.

Environmental Audit: Defined as performance, compliance or financial audit addressing the approach taken by responsible bodies (e.g. government) to a specific environmental problem, or environmental policies, or programmes, as well as their performance in managing environmental issues.

Four Step Process



Performance Audit: Performance audit refers to an independent examination of a program, function, operation or the management systems and procedures of an entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available resources. The examination is objective and systematic, generally using structured and professionally adopted methodologies. The scope of performance audits may include the detection of fraud, waste and abuse.

Performance auditing in the public sector: a case study of Sri Lanka

Purpose – This study aims to investigate as to why the Auditor General’s Department of Sri Lanka (AGD) needs a performance auditing (PA) system to enhance the public sector accountability system of the country. Further it aims to explore the ways and means of implementing a formal PA system. In so doing this study reviews the existing role of the AGD and its contribution to the enhancement of public accountability system of the country and examines the audit management functions and process of the AGD in the social, economic and political context of Sri Lanka within which the AGD operates.

Design/methodology/approach – New institutional sociological (NIS) theory framework, more specifically the institutional rational dynamic model developed by Dillard *et al.* (2004), was adopted to explore the broader social level criteria and forces which influence the auditing practices of the AGD. The case study research approach has been adopted as the research strategy. The data were collected through a total of 30 in-depth interviews using open-ended questionnaires and archival documents. The interviewees were selected from different management levels in the AGD.

Findings – The findings indicate that the practices of the AGD had not changed substantially, along with the social, economic and public administrative changes and developments that took place in the public sector auditing profession around the world. The factors such as the foreign donor’s support for institutional developments in the AGD, lack of political support, bureaucratic influences, insufficient operational independence and traditional organisational culture of the AGD significantly affect the development of PA

practices at the AGD. Also the findings reveal that the audit management failures and resource constraints affected the existing practices of the AGD. The main rationale for implementing a formal PA system in the AGD is to enhance the public accountability system of the country. The findings also suggest that to achieve PA implementation task, the AGD has to depend on international assistance and has to negotiate with the political and public administrative authorities.

<https://www.emerald.com/insight/content/doi/10.1108/jaoc.2010.31506dad.001/full/html>

Special Audit: Special assignment audits are aimed at specific areas and aspects of the company operations which do not require comprehensive inspection of the entire system of accounting. It's a type of internal audit and is conducted only at the initiative of the organizations management and shareholders. The main purpose of this type of audit is the timely detection of errors and irregularities in the accounting and reporting as well as identifying additional possibilities for improving the efficiency of the business process.

Information Systems Audit: Information Systems Auditing or systems audit is an ongoing process of evaluating controls, collecting and evaluating evidence to determine whether a computer system safeguards assets, maintains data integrity, allows organizational goals to be achieved effectively, and uses resources efficiently. Thus, information systems auditing supports traditional audit objectives; attest objectives (those of the external auditor) that focus on asset safeguarding and data integrity, and management objectives (those of the internal auditor) that encompass not only attest objectives but also effectiveness and efficiency objectives. An information systems audit performed in an organization is a comprehensive examination of a given targeted system. The audit consists of an evaluation of the components which comprise that system, with examination and testing in the following areas:

- High-level systems architecture review
- Business process mapping (e.g. determining information systems dependency with respect to user business processes)
- End user identity management (e.g. authentication mechanisms, password standards, roles limiting or granting systems functionality)
- Operating systems configurations (e.g. services hardening)
- Application security controls
- Database access controls (e.g. database configuration, account access to the database, roles defined in the database)
- Anti-virus/Anti-malware controls
- Network controls (e.g. running configurations on switches and routers, use of Access control lists, and firewall rules)
- Logging and auditing systems and processes
- IT privileged access control (e.g. System Administrator or root access)
- IT processes in support of the system (e.g. user account reviews, change management)
- Backup/Restore procedures

QUALIFICATION AND APPOINTMENT OF INTERNAL AUDITOR

Who can perform Internal Audit

As per the provisions of Section 138 of the Companies Act 2013, companies are required to appoint an internal auditor [which may be either an individual or a partnership firm or a body corporate] who needs to be a professional. The said person can be a chartered accountant or a cost accountant, or a Company Secretaries or such other professional as may be decided by the Board.

The term professionals is a wider term which facilitates other professionals such as Company Secretaries or Lawyers to be appointed as internal auditors and to ensure timely compliance checks on a company. *The Internal auditor may or may not be an employee of the company.*

The board may appoint any practicing Chartered Accountant or a Cost Accountant (whether engaged in practice or not) or any other person whom it deems fit to be appointed as its internal auditor. For this purpose, company board may consider the nature and volume of business of company; qualifications, experience and capabilities of such person being appointed as auditor and scope of internal audit.

Note:

- (a) Internal Auditor cannot be appointed by the Board by passing a resolution by circulation.
- (b) Statutory Auditor shall not be appointed as internal auditor of the Company.
- (c) A Cost Auditor of a Company shall not be the internal auditor of a Company for the period for which he is conducting the Cost Audit.

Procedure to be followed by the Company in the appointment of an Internal Auditor:

1. Obtain a written consent of the auditor for being eligible for appointment as an Internal Auditor under Companies Act, 2013.
2. Issuing 7 days' notice for calling a board meeting for appointment of internal auditor.
3. Hold board meeting and appoint internal auditor.
4. Inform the auditor about his appointment as an internal auditor of the company.
5. Filing form MGT-14 for appointment of internal auditor within 30 days of passing board resolution.
6. Send intimation to appointed Internal Auditor

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.

CASE STUDY

1. The Management of XYZ Pvt. Ltd appointed Luthra and Co. (Chartered Accounting Firm) as an internal auditor of the company who is also a statutory auditor of the XYZ Pvt. Ltd. Is the appointment of Luthra and Co. (Chartered Accounting Firm) as an Internal Auditor of XYZ Pvt. Ltd. is valid?

Solution:

- 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. However, Statutory Auditor shall not be appointed as internal auditor of the Company.

Therefore, the appointment of Luthra and Co. (Chartered Accounting Firm) as an internal auditor of XYZ Pvt. Ltd. is not valid as Luthra and Co. is also a statutory auditor of XYZ Pvt. Ltd.

2. Few members of the Board of Directors oppose the appointment of Mr. N, an employee of the company, as an Internal Auditor, stating that Mr. N is not a chartered accountant and further he is an employee of the company

Solution:

Incorrect: As per section 138, 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 internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Illustration:

Internal Auditor is appointed by the _____

- (a) Shareholders of the Company
- (b) Statutory Auditor
- (c) Institute of Internal Auditors of India
- (d) Board of Directors of the Company

Correct Option: d) Board of Directors of the Company

Skill required to perform Internal Audit

The scope of the Internal Audit is continuously changing, transforming and evolving from fulfilling a watchdog function, with a focus on compliance audits, to one that now assesses financial controls for management and is management’s eyes and ears. Internal auditors should possess and demonstrate through their work, actions and communication a number of traits, including, but not limited to:

- A commitment to and demonstration of competence in the field of Internal Auditing
- Strong financial and operational background in accounting, IT, regulatory compliance or the industry in which a company operates
- Honesty and Integrity
- Strong work ethic and attention

In general, internal auditors should develop and maintain a healthy level of professional skepticism and objectivity to assist in evaluating information and making judgments. Internal audit professionals should possess exceptional verbal and written communication skills, and be proficient in negotiating and reasoning with a variety of departments and groups over which internal audit may have no formal authority. Further personal integrity, professional due diligence and curiosity are important traits for individuals tasked with conducting internal audit work.



<i>General Skills</i>	<i>Specific Skills</i>
<p>Technical Standards: The internal auditor should have adequate knowledge of the applicable Indian Accounting Standards and also in-depth knowledge on how to apply them in practice.</p>	<p>Planning Audit Engagements: This involves the ability to plan audit engagements on the basis of a comprehensive risk assessment prior to commencement of audit. The individual has to be experienced in the conduct of a brainstorming discussion on risk assessment. He should also have the necessary experience and capability to be able to preempt significant issues that might come up during the audit, needing greater focus.</p>
<p>Positive Attitude and Interpersonal Skills: The internal auditor should possess positive and objective attitude, free of any prejudice. He should possess good interpersonal and communication skills.</p>	<p>Team Building: This involves collecting people and facilitating coordination among them to ensure that they work as a unified team. It involves identification of team leaders, delegation of authority, motivating the team and communicating to them the results expected.</p>
<p>IT Skills: With the rapid proliferation of information technology (IT) in the accounting and other operational aspects of an entity, it is essential for an internal auditor to be able to work in an IT driven environment. Thus, it is essential that the internal auditor should either have or acquire sufficient knowledge of how information technology has been integrated in the functioning of the organization and also skills that would enable him to effectively use IT tools in carrying out a purposeful internal audit.</p>	<p>Managing Audit Engagements: This involves administration of the audit assignment. It involves the task of meeting auditees, understanding their expectations, communicating the engagement plan to them, selecting the right team, etc.</p>
<p>Interviewing Skills: Interviewing is the process of ascertaining information through verbal interaction with clients. It involves detailed questioning on various processes and procedures to ascertain whether the client's organization complies with the established standard operating procedure and practices and whether there is favorable or adverse variance from the standards, and in case of adverse variance what measures have been initiated by the management to ensure prevention of such adverse variances in future. Further, it is extremely important that the internal auditor and its team must be conversant with interviewing techniques so that appropriate questions could be asked in order to derive conclusion.</p>	<p>Knowledge Management Skills: An internal auditor either has or obtains sufficiently detailed knowledge of the operations of the entity as well as the constituents of the external environment in which the entity operates. For example, the industry, the regulators, the customers, etc. Some of this knowledge might be confidential and critical to the working of the entity. The internal auditor needs to have skills to effectively manage the knowledge, for example, deciding on issues such as:</p> <ul style="list-style-type: none"> ● collating the knowledge. ● how and where to apply the knowledge. ● assessing which team member needs what type and quantum of knowledge. ● assessing when the knowledge has become obsolete and needs updating.

<i>General Skills</i>	<i>Specific Skills</i>
	<ul style="list-style-type: none"> ● establishing the relationships between various pieces of knowledge and assessing how the same affects the internal audit. ● deciding on manner and channels of flow of information. ● Benchmarking Skills.
<p>Audit Documentation Skills: Audit documentation is the process of compiling and filing of the findings of audit. It involves collating requisite documents as evidences for supporting audit findings, filing the analysis and supporting papers in a logical manner and assimilating information for presentation in a structured manner.</p>	<p>Making Professional Presentations: An experienced internal auditor should be able to make effective presentations to the Audit Committee. This would involve selecting and presenting the major issues that warrant senior management attention in a clear and unambiguous manner.</p>
<p>Reporting Skills: Reporting is the result of any audit assignment. It is therefore necessary that the audit report is written in such a manner that all issues are reported objectively and process gaps are addressed properly. It is also necessary that each observation is constructed in a manner that it represents the facts about the issue, its monetary or other impact, the cause of the issue and the suggestions for remedial actions and improvements.</p>	

Besides the above skills, an Internal Auditor should also possess:

1. Analytical/Critical thinking skills
2. Data mining and Analysis Skills
3. Good Business Acumen and the ability to understand different business needs
4. He should have the ability to trace out facts and figures
5. Should be methodical and tactful while dealing with people and processes
6. Should be a hard worker, always cautious, vigilant and inquisitive
7. Should be courageous, assertive and determined with the ability to take independent decisions
8. Should lead by being punctual, reliable and updated with the latest knowledge and skill set.

STRATEGIC AND OPERATIONAL ROLE OF INTERNAL AUDITOR

Role of Internal Audit in Internal Control

The Internal auditor should examine and contribute to the ongoing effectiveness of the internal control system through evaluation and recommendations. However, the internal auditor is not vested with management's primary responsibility for designing, implementing, maintaining and documenting internal control. Internal audit functions add value to an organization's internal control system by bringing a systematic, disciplined approach to the evaluation of risk and by making recommendations to strengthen the effectiveness of risk management

efforts. The internal auditor should focus towards improving the internal control structure and promoting better corporate governance.

The role of the internal auditor encompasses:

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

Role of Internal Audit in Risk Management

Internal auditing professional standards require the function to monitor and evaluate the effectiveness of the organization's Risk management processes. Risk management relates to how an organization sets objectives, then identifies, analyzes, and responds to those risks that could potentially impact its ability to realize its objectives. Under the COSO Enterprise Risk Management (ERM) Framework, risks fall under strategic, operational, financial reporting, and legal/regulatory categories. Management performs risk assessment activities as part of the ordinary course of business in each of these categories. Examples include: strategic planning, marketing planning, capital planning, budgeting, hedging, incentive payout structure, and credit/lending practices. Sarbanes-Oxley regulations also require extensive risk assessment of financial reporting processes. Corporate legal counsel often prepares comprehensive assessments of the current and potential litigation a company faces. Internal auditors may evaluate each of these activities, or focus on the processes used by management to report and monitor the risks identified. For example, internal auditors can advise management regarding the reporting of forward-looking operating measures to the Board, to help identify emerging risks.

In larger organizations, major strategic initiatives are implemented to achieve objectives and drive changes. As a member of senior management, the Chief Audit Executive (CAE) may participate in status updates on these major initiatives. This places the CAE in the position to report on many of the major risks the organization faces to the Audit Committee, or ensure management's reporting is effective for that purpose.

CASE STUDY

1. XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Internal Auditor. Suggest an alternative way to tackle hostile management.

Solution:

While conducting the internal audit of a manufacturing unit, the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations. These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers.

This would defeat the very purpose of the internal audit. The Participative Approach comes to the help of the auditor. In this approach the auditor discusses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the internal audit becomes a co-operative enterprise. This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When the participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal. The proposed recommendations are discussed with the auditee and modifications as may

be agreed upon are incorporated in the internal audit report. With this attitude of the auditor, it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor does not have to force any change on the auditee. Hence, the internal Auditor of XYZ manufacturing unit should adopt the above mentioned participative approach to tackle the hostile management of XYZ.

2. XYZ advisors is a management consulting firm having 250 fortune company client base. The CEO of the company is concerned about high employee attrition rate in his company. He has given assignment to dig out the reason for such high attrition rate as well as way forward. What factors would an Internal Auditor consider in such analysis?

Solution:

The following are the major 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 centers 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?

Practice Question

1. Should the organisation perform an internal audit?

Emerging risk, new regulation and increasing corporate governance demands are continuously adding to the Board's accountability and therefore, Independent, internal auditing can provide the insight – and oversight – a board needs to meet their governance responsibilities.

2. What is the Board's role and responsibility with regards to their Internal Audit?

The Board should approve the appointment of Internal Auditor. There must be open communication, sufficient resources and clarity of expectations for the newly-appointed Internal Auditor. A strategy must be agreed upon – and implemented – through that relationship built to ensure the Internal Audit's function charter.

3. Who is the Internal Audit team reporting to?

An internal auditing team works, most optimally, when it functions independently and objectively of a board. However, reporting to the Board – or, a Board-appointed Internal Audit committee – is another important step for the approval of audit plans and budgets, CAE appointments and all other decisions, including the: people, processes, technology and structure of the function as well as interpreting the Audit findings.

LESSON ROUND-UP

- Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes – Institute of Internal Auditors
- **Applicability:** 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-
 - (a) every listed public company;
 - (b) every unlisted public company having
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
 - (c) every private company having-
 - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.
- Purpose of Internal Audit, Authority and Responsibilities of Internal Audit.
- The difference between Internal and External Audit.
- Types of Internal Audit
 - (i) Operational Audit
 - (ii) Compliance Audit
 - (iii) Environmental Audit
 - (iv) Performance Audit
 - (v) Special Audit
 - (vi) Information System Audit
- **Who could be an Internal Auditor** - As per the provisions of Section 138 of the Companies Act 2013, companies are required to appoint an internal auditor [which may be either an individual or a partnership firm or a body corporate] who needs to be a professional. The said person can be a chartered accountant or a cost accountant, or a Company Secretaries or such other professional as may be decided by the Board.
- Various Skill of Internal Auditor
- Strategic Role of Internal Auditor

TEST YOURSELF

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

1. Explain Internal Audit. How it is differ from Statutory Audit?
2. Who can be appointed as an Internal Auditor of a company?
3. Which types / categories of companies mandatorily required to appoint Internal Auditor?
4. Explain in brief the process to be followed with respect to the appointment of internal auditor?
5. Why Internal Audit is necessary? Does it give additional benefit to the organization already gets it financial audited from Statutory Auditor?
6. What are the basics or general skills required to be an internal auditor of a company?
7. What are the responsibilities of Internal Auditor?
8. Shree Pvt. Ltd. has outstanding loans or borrowings from banks Rs. 200 crores wants to appoint an internal auditor. Please guide him with respect to the applicability of the same.
9. What are the penalties for non-compliance with respect to appointment of internal auditor?
10. Briefly elaborate the role of Internal Auditor in Internal Control.

LIST OF FURTHER READINGS

- **Handbook on Internal Auditing**
Author : CA Kamal Garg
Publishers : Bharat's
- **Compendium of Standards on Internal Audit**
Author: ICAI
Year of Publication: 2022