CHAPTER 16

INTERNAL AUDIT



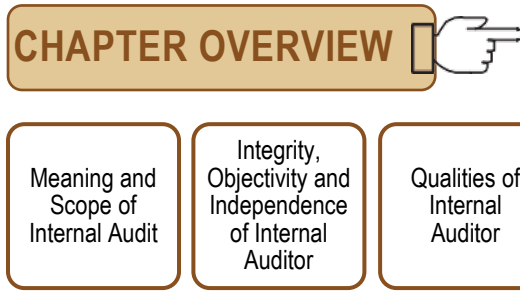
LEARNING OUTCOMES

After studying this chapter, you will be able to:

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

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CHAPTER OVERVIEW



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

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

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

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

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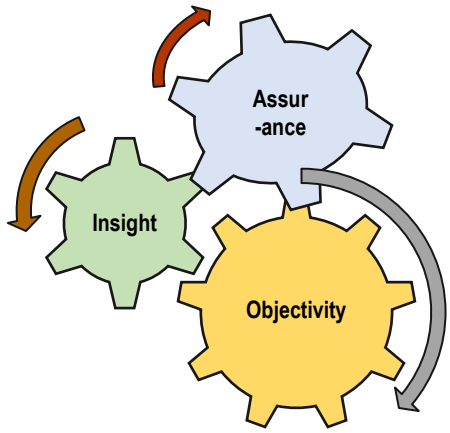
he would not be able to take operational decisions in these areas that could later fall within the scope of an internal audit. He would be able to accept only limited operational role and that too for a short duration.

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

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

1. INTERNAL AUDIT

The operation of many modern organisations have become complex with high volume of transactions carried out at multiple locations with increasing dependency on technology. This has caused further more delegation of authorities and decentralisation of activities. Consequently, key stakeholders including Board of Directors, top management, shareholders, lenders, investors and government are concerned with the propriety of the day-to-day affairs of the organization and reliability of the various financial and non-financial information being recorded and reported to the stakeholders. Accordingly, the stakeholders get internal audit conducted to obtain report on the deficiency in internal control system and underlying transactions for better governance of organization and take timely remedial actions wherever needed.



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

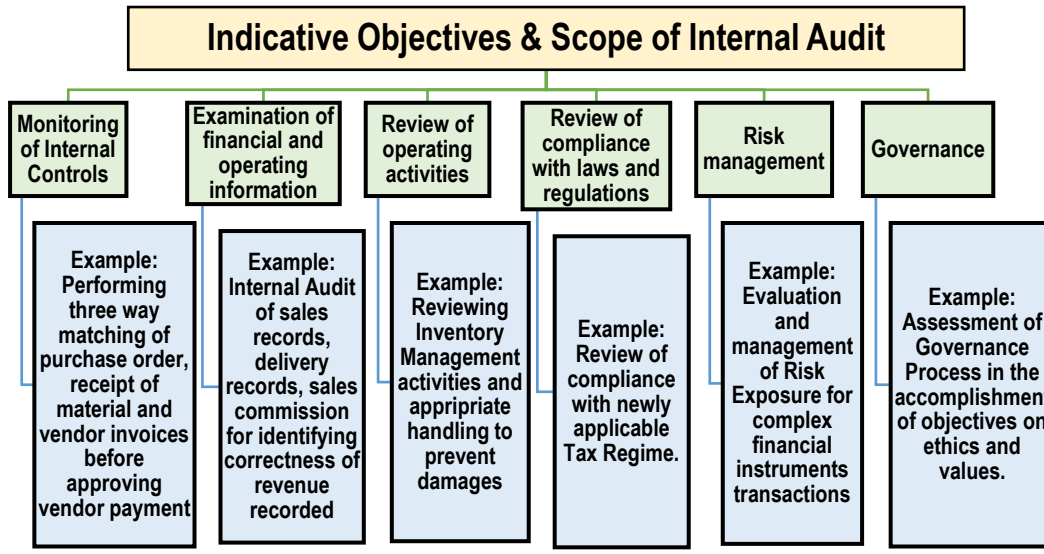
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for guidance of the members, as felt appropriate by the Board. Besides, the IASB also undertakes research and promote knowledge dissemination in the field of internal audit.

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

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

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



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

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

APPLICABILITY OF PROVISIONS OF INTERNAL AUDIT
(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.

CLASS OF COMPANY		CONDITIONS (Any One)
(A)	EVERY LISTED COMPANY	No condition.
(B)	EVERY UNLISTED PUBLIC COMPANY	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
		iiii 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	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.

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

CASE STUDY 1

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

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

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

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

Who can be Appointed as an Internal Auditor?

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



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

Provision & Conclusion: According to the provision given in section 138 of the Companies Act, 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether

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engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the companies.

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

As per Standard on Internal Audit (SIA) 130 Managing the Internal Audit Function, the Internal Audit Function performs a number of activities to achieve its objectives as outlined in its Charter (or Terms of Engagement).

A few of the critical activities are as follows:	
(a)	***Define the overall objective and scope and accordingly devise the strategy of the Internal audit function.***
(b)	***A decision on outsourcing and co-sourcing, either partly or fully, to be made by the Chief Internal Auditor/ Engagement Partner once the objective and scope are defined. The same should be approved by the Board or Audit Committee.***
(c)	***Based on scope and strategy of internal audit, a plan and methodology is devised covering proposed timelines, resources and location(s) on a periodic basis.***
(d)	***Monitor and supervise various audit assignments, with respect to:*** • ***Their adherence to planning along with deviations, if any*** • ***Execution and updation wherever required*** • ***Enquiry and engaging with the auditee to seek clarifications, responses and views*** • ***Assessing and evaluating the implications and impact of observations*** • ***Any scope limitations*** • ***Final conclusions*** • ***Reporting of findings/observations and*** • ***Subsequent closure of reported observations***
(e)	***Review the performance, training and development of professional staff, talent and other resources to achieve its objectives.***
(f)	***Identify, source, engage and manage external experts and technical solutions, if required.***
(g)	***Communicate and engage with all key stakeholders regarding progress and achievement of objectives.***
(h)	***Develop and maintain a quality assessment and improvement program (QAIP).***

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

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

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

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

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

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

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

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

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

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2. MANAGEMENT FUNCTIONS AND SCOPE OF INTERNAL AUDITING

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

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

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

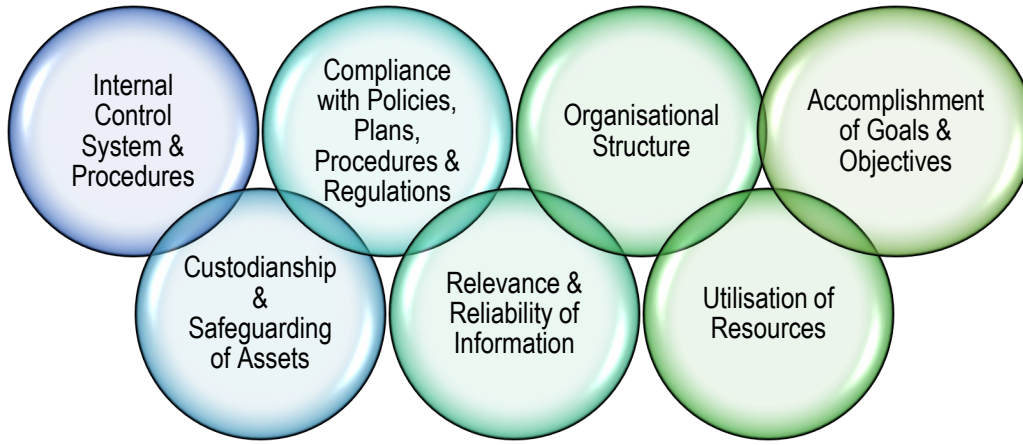
Internal audit plan should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made, and adequate balance is ensured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

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

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

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



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

(i) Review of Internal Control System and Procedures -

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



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

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



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

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



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

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

(ii) Review of Custodianship and Safeguarding of Assets -

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



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

(iii) Review of Compliance with Policies, Plans, Procedures and Regulations - It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in a coordinated manner. He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.

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(iv) **Review of Relevance and Reliability of Information -** The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, investors, trade organisations, labour unions, etc. He should examine the accuracy and reliability of financial and operational records. The usefulness of the reports as well as of the records should be evaluated with reference to their costs. The internal auditor should examine whether the reporting is by exception i.e. the reports highlight the significant and distinctive features. In case of automated management information system, where relevant information used for critical decision making is generated from the computer system, then adequacy of the controls build in the system should be reviewed to ensure data integrity and reliability of such information.

(v) **Review of the Organisation Structure -** The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:

- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
- The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between the authority and responsibility of important executives.
- The internal auditor should examine the reasonableness of the span of control of each executive (the number of subordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.
- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- He should review adequate segregation of duties is considered while defining the organization structure.
- Finally, he should evaluate the process of managerial development in the enterprise.

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(vi) Review of Utilisation of Resources –

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



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

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

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3. INTEGRITY, OBJECTIVITY AND INDEPENDENCE OF INTERNAL AUDITOR

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

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

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

2. The Internal Auditor shall be honest, truthful and be a person of high integrity. He shall operate in a highly professional manner and seen to be fair in all his dealings. He shall avoid all conflicts of interest and not seek to derive any undue personal benefit or advantage from his position.

3. The Internal Auditor shall conduct his work in a highly objective manner, especially in gathering and evaluation of facts and evidence. He shall not allow prejudice or bias to override his objectivity, especially in arriving at conclusions or reporting his opinion.



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



8. In the case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive Officer or the Chief Financial Officer. The internal auditor should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.

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TEST YOUR UNDERSTANDING 1

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

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

TEST YOUR UNDERSTANDING 2

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

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

4. QUALITIES OF INTERNAL AUDITOR

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

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

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

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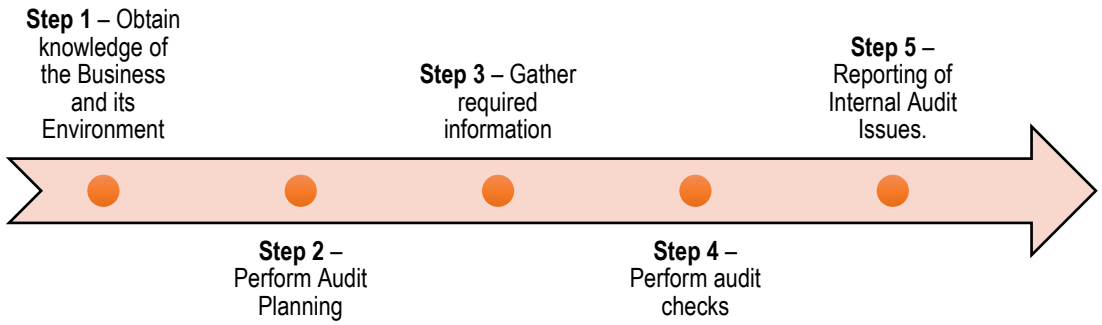
3.	The internal auditor is also expected to evaluate both financial and operational controls. This requires a good knowledge of the operations of the organization, technology and commercial practices of the enterprise.
4.	He should also have a good knowledge of commerce, laws, taxation, cost accounting,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



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5. PERFORMING INTERNAL AUDIT ENGAGEMENT

Typical internal audit engagement comprises of following five steps:



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

Step 1 – Obtain Knowledge of the Business and its Environment

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

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

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

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

Step 2 – Perform Audit Planning

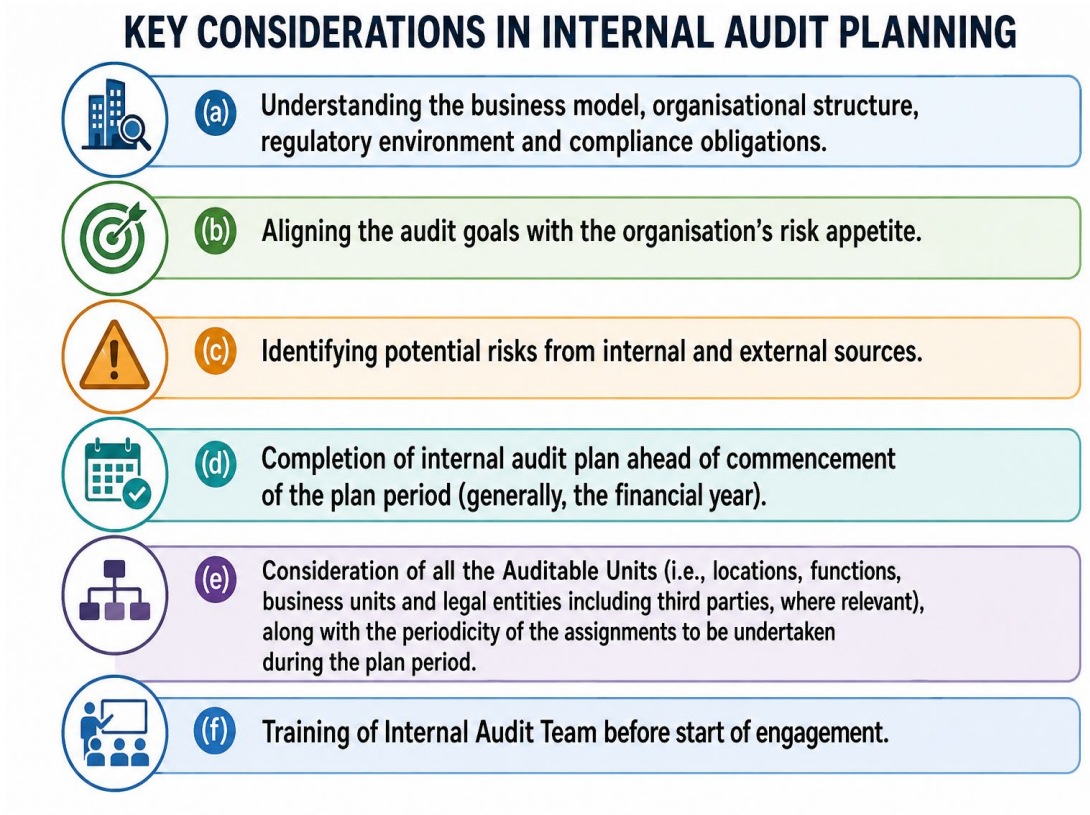
Internal Auditor must plan the audit engagement as per the Standard on Internal Audit (SIA) 220, Internal Audit Planning. Internal audit planning is conducted at two levels:

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(a) An internal audit plan for the entire entity is prepared for a given period of time (usually a year) and presented for approval to the highest governing body responsible for internal audits, normally, the Board of Directors or the Audit Committee.

(b) A number of specific internal audit plans may be prepared for individual assignments to be undertaken covering some part of the entity and presented to the Chief Internal Auditor/ Engagement Partner. Such plan should be prepared in line with the internal audit plan of the entity as a whole.

Where governing law mandates internal audit, its processes, reporting, timing, etc. the some should be observed. Internal audit planning process requires:



Internal Audit Plan is normally prepared by the Chief Internal Auditor/ Engagement Partner (in case of out-sourced internal audit). The internal audit programme should be developed as an integral component of the internal audit planning process. The audit programme should include documentation identifying potential risk scenarios ('what could go wrong') along with the corresponding controls required to mitigate or prevent such risks. It should also outline the audit procedures and activities to be performed.

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Step 3 – Gather Required Information

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

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

Step 4 – Perform Audit Checks

Internal Auditor should collate all data and perform analytical procedures to identify key trends and outliers.. To the extent possible, relevant analytical tools may be used to perform review of the complete data for the audit period. Wherever needed, Internal Auditor must select the sample.

Detailed audit testing must be performed as per the audit work plan. Internal Auditor must ensure adequate evidence must be collected and stores in accordance to ***Standard on Internal Audit (SIA) 230, "Internal Audit Evidence".***

Internal Auditor must prepare detailed list of the Identified audit issues and controls gaps. Interim reports may be issued after proper review of the work performed as per the ***Standard on Internal Audit (SIA) 260, "Review and Supervision of Audit Assignments".***

Adequate document of the internal audit work papers needs to be ensured as per ***Standard on Internal Audit (SIA) 250, "Internal Audit Documentation".***

Step 5 – Reporting of Internal Audit Issues

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

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

Internal Auditor should thereafter circulate Final Report and presentation his findings to the Audit Committee. ***Internal auditor must adhere to Standard on Internal Audit (SIA) 290, Communication with Management and Standard on Internal Audit (SIA) 310, "Presentation and Communication of Internal Audit Report" while sharing the result of internal audit with the stakeholders.***

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6. INTERNAL AUDIT REPORT

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

6.1 PRESENTATION AND COMMUNICATION OF INTERNAL AUDIT REPORT

As per Standard on Internal Audit (SIA) 310, "Presentation and Communication of Internal Audit Report", reporting the results of internal audit activities is a core responsibility of the internal audit function and a key driver of its value to stakeholders. Effective communication of internal audit outcomes enhances transparency, accountability and informed decision-making. It facilitates oversight by management and those charged with governance and supports continuous improvement in governance, risk management and control processes.

The presentation of such reports plays a critical role in ensuring that audit findings, conclusions drawn and recommendations are conveyed effectively, enabling appropriate action by those charged with governance.

6.1.1. General Principles of Reporting:

(a) Effective internal audit reporting focuses on matters that are significant to the achievement of organisational objectives and facilitates timely corrective action.

(b) The form and level of detail of reporting may vary depending on the nature of the engagement, stakeholder expectations and regulatory requirements.

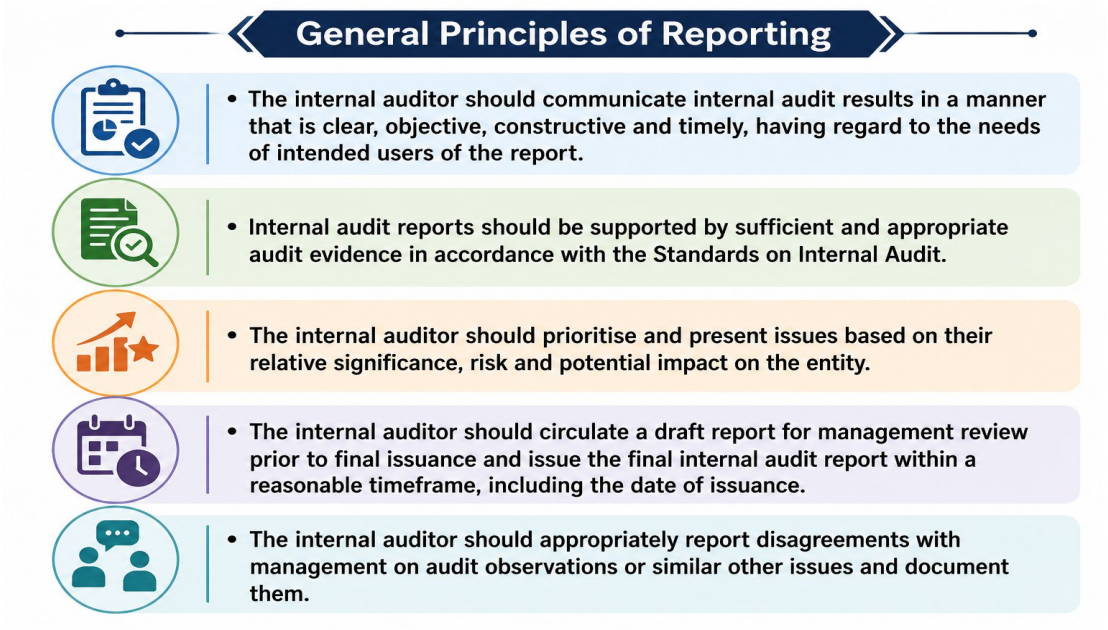
(c) Root cause analysis enhances the usefulness of internal audit reports by addressing underlying issues rather than symptoms alone.

(d) The internal auditor should circulate a draft internal audit report to management for review and feedback prior to final issuance to ensure factual accuracy and agreement on action plans. Where disagreement persists and resolution cannot be achieved, the final report should state both positions along with the reasons for such disagreement.

(e) The internal auditor should document instances where there is a disagreement with management on audit observations, recommendations and/or action plans and should include unresolved matters in the final report for escalation to the appropriate level of governance.

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(f) The internal auditor should issue the final internal audit report within a reasonable timeframe after completion of the engagement and should include the date of issuance.



6.1.2 Report Structure and Minimum Content

The format and tone of the internal audit report should be fit for purpose and tailored to the audience, using professional judgment, while maintaining clarity and objectivity.

The internal auditor may ensure that every internal audit report contains, at a minimum, the following components:
Title and Report Reference: Clearly identifying the report as an internal audit assurance report.
Addressee(s): Indicating the intended recipient(s), typically management or those charged with governance.
Executive Summary: Highlighting key findings, critical risks and high-priority recommendations.
Audit Objectives and Scope: Including the period covered, business areas reviewed and specific focus areas.
Methodology and Criteria: Brief description of the audit approach and benchmarks or standards used.
Detailed Observations and Recommendations: Including categorization of issues by significance (e.g., high/medium/low), root cause analysis and risk implications.
Management Responses and Action Plans: Reflecting agreed corrective actions, responsible owners and implementation timelines.

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Conclusion or Overall Opinion: If required by the engagement terms, an audit conclusion summarizing the overall control environment or risk posture.
Limitations: Disclosing any restrictions encountered that may affect the audit outcome.
Date of the Report and Signature: Duly dated and signed by the Chief Internal Auditor/ Engagement Partner.

6.1.3 Quality and Objectivity of Reporting

Clarity and Readability	*Avoiding AmbiguityBalanced Presentation*	*Independence in Reporting*	*Audit Evidence and Documentation*	*Professional Tone and Responsibility*

(a) ***Clarity and Readability:*** *The assurance report should be designed to communicate effectively with stakeholders who may not have technical expertise in internal auditing. Use of plain language, clear formatting, summarised key points and logical structure enhances readability.*

(b) ***Avoiding Ambiguity:*** *Internal auditors should avoid vague or overly generalized statements. Each observation should be linked to specific criteria, risks and evidence, eliminating room for misinterpretation.*

(c) ***Balanced Presentation:*** *While it is important to highlight deficiencies, reporting should also acknowledge strengths and areas of effective performance, where applicable, to maintain a balanced perspective.*

(d) ***Independence in Reporting:*** *The internal auditor should resist any attempts by management to unduly influence the wording or tone of the report. Any disagreements with management responses should be documented and significant unresolved issues should be escalated to the Audit Committee or those charged with governance.*

(e) ***Audit Evidence and Documentation:*** *Each conclusion and recommendation should be traceable to documented evidence, in accordance with SIA 230 "Internal Audit Evidence". Unsupported or anecdotal commentary undermines the reliability of the report and should be strictly avoided.*

(f) ***Professional Tone and Responsibility:*** *The language of the report should reflect professional decorum, especially when reporting sensitive or high-risk findings. Terms such as "significant control breakdown" or "material risk exposure" should be used only when substantiated and justified by evidence and risk assessment.*

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PRESENTATION AND COMMUNICATION OF INTERNAL AUDIT REPORTS



MODE OF REPORT COMMUNICATION :

While written reports remain the principal means, presentations (e.g., via PowerPoint or dashboards) may be used to facilitate stakeholder discussion.



CONFIDENTIALITY AND COMMUNICATION PROTOCOLS



(a) Delays in reporting may reduce the relevance and effectiveness of audit findings.



(b) Mark reports with appropriate classification labels such as "Confidential," "Restricted Circulation," or "Board Use Only."



(c) Use secure channels (e.g., encrypted emails, controlled access portals) for report transmission.



(d) Maintain an audit trail of all communications, especially where deviations from normal reporting lines are involved.

CONFIDENTIAL

RESTRICTED CIRCULATION

BOARD USE ONLY







CONFORMANCE WITH STANDARDS ON INTERNAL AUDIT :

"The internal audit engagement was conducted in accordance with the Standards on Internal Audit issued by the Institute of Chartered Accountants of India."

DOCUMENTATION

Documentation relating to presentation and communication of internal audit reports may include:



(a) Draft version of the report, cross-referenced to working papers.



(b) The final issued version of the internal audit report and associated presentation materials.



(c) Any formal communication or dispute resolution correspondence related to findings or recommendations.



(d) Records of meetings or presentations conducted, including minutes, discussion points and stakeholder feedback.



(e) Management action plans with responsible persons and timelines.



(f) Evidence of report circulation, discussions and approvals.



(g) Evidence of adherence to confidentiality protocols and circulation controls.

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6.2 ISSUING ASSURANCE REPORTS

As per Standard on Internal Audit (SIA) 320, "Issuing Assurance Reports", an assurance report represents the formal communication of the internal auditor's independent and objective opinion on the subject matter under review based on the evidence obtained during the audit.

Assurance reporting is distinct from routine internal audit reporting. It involves heightened professional judgement, clearly defined subject matter and criteria and is intended for reliance by those charged with governance.

6.2.1 Preconditions for Issuing an Assurance Report :

The internal auditor should issue an assurance report only when:
The engagement mandate or internal audit charter explicitly requires an assurance opinion.
The subject matter is identifiable and capable of consistent evaluation.
Suitable and available criteria exist against which the subject matter can be assessed and
Sufficient and appropriate audit evidence can reasonably be expected to be obtained.

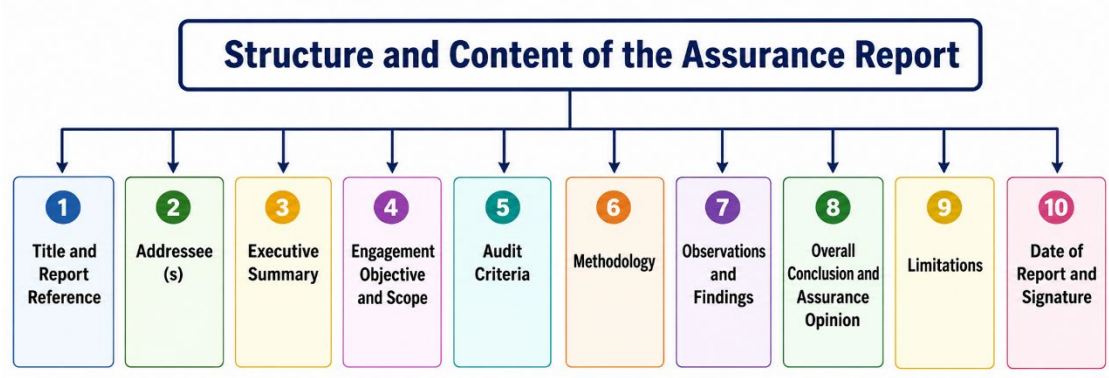
6.2.2 Scope and Planning of Assurance Engagements

(a) The internal auditor should clearly define the scope of the assurance engagement, including the subject matter, criteria, period covered and any limitations, prior to commencement of the engagement.

(b) Assurance engagements should be planned and performed with a level of rigour commensurate with the level of assurance to be provided.

6.2.3 Structure and Content of the Assurance Report

The assurance report should, at a minimum, contain the following key components:



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- *Title and Report Reference: Clearly identifying the report as an internal audit assurance report.*
- *Addressee(s): Indicating the intended recipient(s), typically those charged with governance.*
- *Executive Summary: Summarising key findings, conclusions and overall assurance opinion.*
- *Engagement Objective and Scope: Describing what was audited, the time frame covered and any exclusions or limitations.*
- *Audit Criteria: Outlining the benchmarks or standards against which the subject matter was evaluated.*
- *Methodology: Describing audit techniques, sampling methods and sources of evidence.*
- *Observations and Findings: Presenting significant audit issues, categorized by risk or priority.*
- *Overall Conclusion and Assurance Opinion: Clearly stating the level of assurance provided.*
- *Limitations: Disclosing any restrictions encountered that may affect the audit outcome.*
- *Date of the Report and Signature: Duly dated and signed by the Chief Internal Auditor/ Engagement Partner.*

6.2.4 Quality and Objectivity of Reporting

- *Clarity and Readability: The assurance report should be designed to communicate effectively with stakeholders who may not have technical expertise in internal auditing. Use of plain language, clear formatting, summarised key points and logical structure enhances readability.*
- *Avoiding Ambiguity: Internal auditors should avoid vague or overly generalized statements. Each observation should be linked to specific criteria, risks and evidence, eliminating room for misinterpretation.*
- *Balanced Presentation: While it is important to highlight deficiencies, reporting should also acknowledge strengths and areas of effective performance, where applicable, to maintain a balanced perspective.*

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- *Independence in Reporting: The internal auditor should resist any attempts by management to unduly influence the wording or tone of the report. Any disagreements with management responses should be documented and significant unresolved issues should be escalated to the Audit Committee or those charged with governance.*
- *Audit Evidence and Documentation: Each conclusion and recommendation should be traceable to documented evidence, in accordance with SIA 230 "Internal Audit Evidence". Unsupported or anecdotal commentary undermines the reliability of the report and should be strictly avoided.*
- *Professional Tone and Responsibility: The language of the report should reflect professional decorum, especially when reporting sensitive or high-risk findings. Terms such as significant control breakdown" or "material risk exposure" should be used only when substantiated and justified by evidence and risk assessment. "significant control breakdown" or "material risk exposure" should be used only when substantiated and justified by evidence and risk assessment.*

6.2.5 Expression of Assurance:

The report should explicitly communicate the level of assurance provided, namely, reasonable assurance, limited assurance or no assurance, along with a clear explanation of its basis and scope.

6.2.6 Conformance with Standards on Internal Audit

"The internal audit engagement was conducted in accordance with the Standards on Internal Audit issued by the Institute of Chartered Accountants of India."

6.2.7 Documentation

Working papers should demonstrate how evidence supports the findings and conclusions. Templates and checklists may be used to ensure consistency but should be supplemented with professional judgment. Further, documentation should be maintained in accordance with SIA 250, Internal Audit Documentation.

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7. RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

- The scope and objective of internal audit are dependent upon the size and structure of the entity and the requirements of its management. As stated earlier the internal auditor operates in various areas such as review of the accounting system and internal control; examination of financial and operating information for the benefit of management, the examination of the economy, efficiency and effectiveness of operations including non-financial controls of various tangible assets of the entity. While operating in these areas, there is a lot of overlap between the work of internal auditors and external auditors.
- The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor. The function of an internal auditor is an integral part of the system of internal control.
- It is a statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.
- However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. But so far, the practice of audit being conducted jointly by the internal auditors is of great assistance to statutory auditors.
- The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

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Difference Between Internal & External Auditors

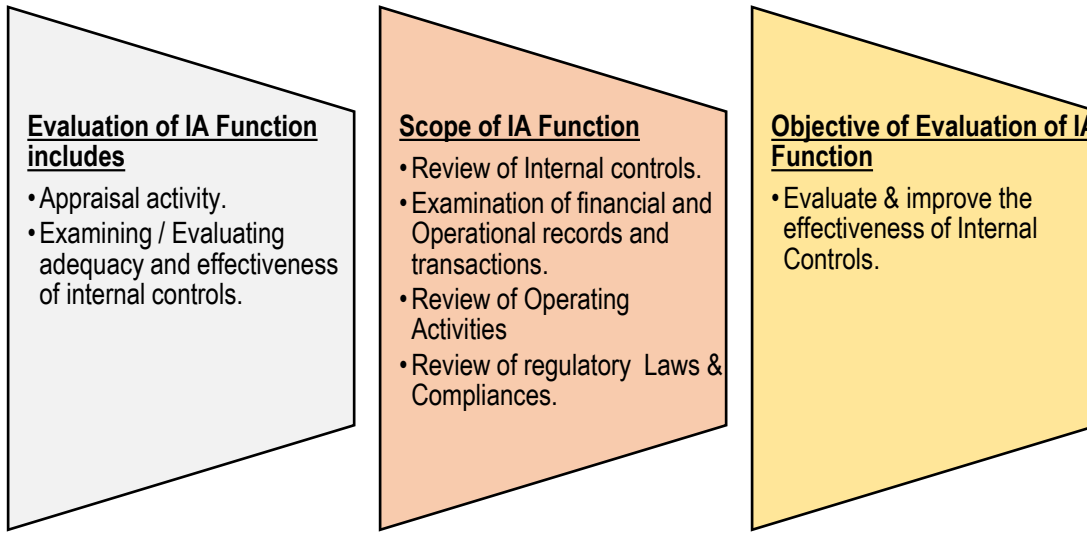
BASIS FOR COMPARISON	INTERNAL AUDIT	EXTERNAL AUDIT
1. Performed by	Internal audit is performed by an independent internal auditing function within the organisation or by external body.	It is an audit function performed by the independent body which is not a part of the organization.
2. Examination	The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

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

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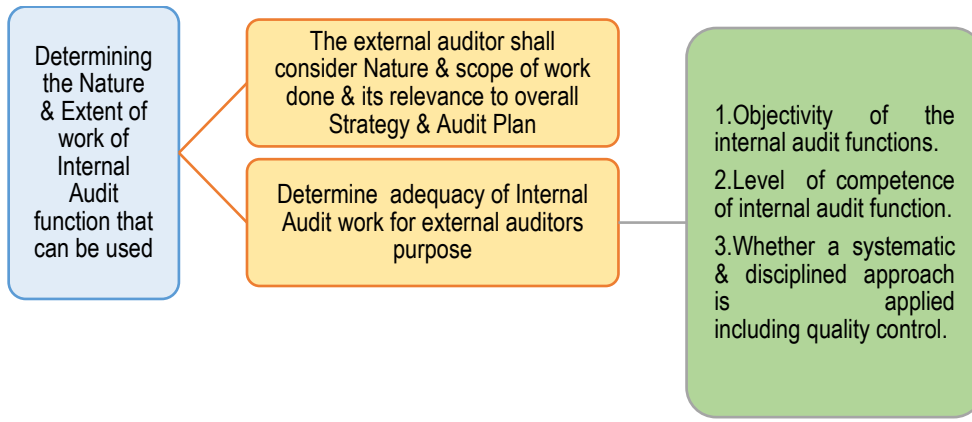
7.1 Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function:



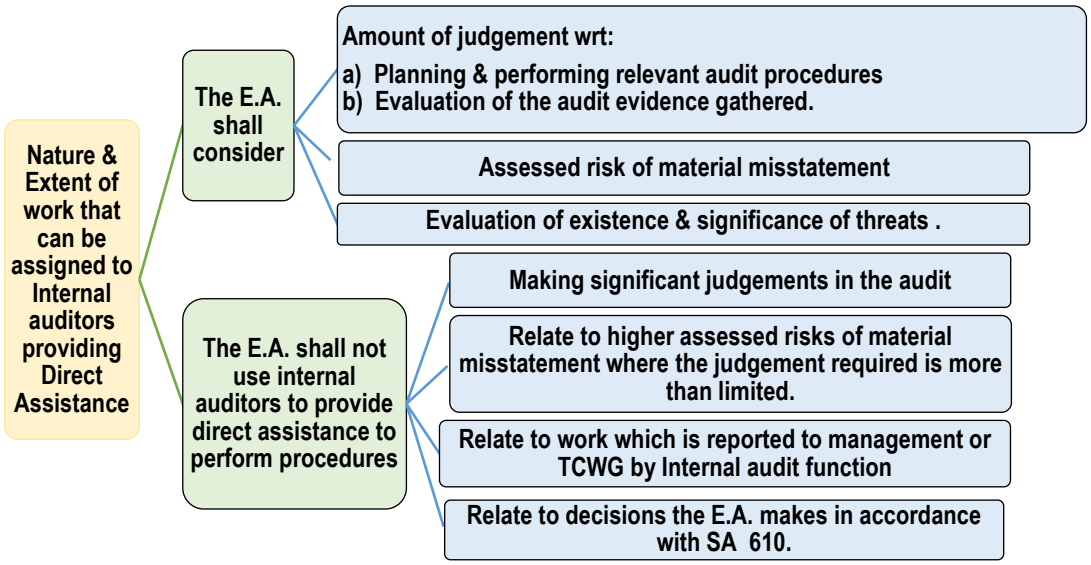
7.2 Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

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



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



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

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

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

(a) The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;

(b) The basis for the decision regarding the nature and extent of the work performed by the internal auditors;

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(c) Who reviewed the work performed and the date and extent of that review in accordance with SA 230 Audit Documentation;

(d) The written agreements obtained from an authorized representative of the entity and the internal auditors; and

(e) The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

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

[**Note: Student are advised to refer Chapter 3 and SA 610 Using the work of Internal Auditor for more details**.]

Illustration 2

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

Solution

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

(i) Job Stress & work life imbalance;

(ii) Wrong policies of the Management;

(iii) Unbearable behaviour of Senior Staff;

(iv) Safety factors;

(v) Limited opportunities for promotion;

(vi) Low monetary benefits;

(vii) Lack of labour welfare schemes;

(viii) Whether the organization has properly qualified and experienced personnel for the various levels of works?

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(ix) Is the number of people employed at various work centres excessive or inadequate?

(x) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

8. INTERNAL AUDIT AS A MANAGEMENT FUNCTION

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

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

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

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

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9. AUDIT TRAIL



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

Records maintained as audit trail may include the following information:

- when changes were made i.e., date and time (timestamp)
- who made the change i.e., User Id

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- what data was changed i.e., data/transaction reference; success/failure

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

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

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

TEST YOUR UNDERSTANDING 3

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

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

Key Takeaways

- Internal Audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organisational objectives.

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- It is mandatory for all listed companies, unlisted public companies/private companies fulfilling certain criteria to appoint internal auditor in accordance with provisions of Section 138 of the Companies Act, 2013 and relevant rules.
- The internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company in terms of section 138 of the Companies Act, 2013. He may or may not be employee of the company.
- In such companies specified in section 138 of the Companies Act, 2013, the Audit Committee or the Board, in conjunction with management and the Chief of Internal Audit, is expected to exercise the responsibility to formulate the objectives of internal audit.
- Basic principles governing an internal audit include independence, integrity and objectivity.
- Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted.
- The work done by the internal auditor has an important bearing on the work performed by the statutory auditor as evaluation done by the internal auditor in respect of internal controls, reliability of financial information, verification of assets, etc. is also required to be done by the external auditor.
- It is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. For the purpose, he should examine the Internal Audit Department of the organisation, the strength of the internal audit staff, their qualification and their powers.
- The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit.
- The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures.
- The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.
- Standards on Internal audit are recommendatory in nature.

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APPENDIX

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

Section I: Preface

Preface to the Standards on Internal Audit

Section II: Quality Standards on Internal Audit

QSIA 1: Internal Audit Quality Aspects

QSIA 2: Peer Review and Third-Party Assessment

Section III: Core Concepts and Principles (100 Series)

SIA 110: Basic Principles of Internal Audit

SIA 120: Terms of Internal Audit Engagement

SIA 130: Managing the Internal Audit Function

SIA 140: Internal Controls

SIA 150: Risk Management .

SIA 160: Compliance with Laws and Regulations

Section IV: Audit Execution (200 Series)

SIA 210: Knowledge of the Entity and its Environment

SIA 220: Internal Audit Planning

SIA 230: Internal Audit Evidence

SIA 240: Use of Tools

SIA 250: Internal Audit Documentation

SIA 260: Review and Supervision of Audit Assignments

SIA 270: Experts and Third-Party Engagement

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SIA 280: Irregularities and Fraud

SIA 290: Communication with Management and Those Charged with Governance

Section V: Internal Audit Reporting (300 Series)

SIA 310: Presentation and Communication of Internal Audit Report.

SIA 320: Issuing Assurance Reports

SIA 330: Special Purpose Reports

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 3: Advanced Auditing, Assurance and Professional Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at https://boslive.icai.org/AAAPE_SARANSH.pdf

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *Write a short note on the Internal Audit Report.*
2. *State the important aspects to be considered by the External auditor in the evaluation of the Internal Audit Function.*
3. *AB Pvt. Ltd. company has outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint an internal auditor. Please guide him for the applicability of the same and who can be appointed as an internal auditor and what work would be reviewed by him.*
4. *Moon Ltd., of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit.*
5. *Mr. A is appointed as a statutory auditor of XYZ Ltd. XYZ Ltd. is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. B as its internal auditor. The external auditor Mr. A asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.*

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(a) *Discuss whether Mr. A, statutory auditor, can ask direct assistance from Mr. B, internal auditor as stated above in view of auditing standards.*

(b) *Will your answer be different if Mr. A asks direct assistance from Mr. B, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?*

6. *The XYZ Ltd. has to appoint Mr. A as Chief Internal Auditor to lead the internal audit function for the Company. The Managing Director of the Company has asked the HR head to define the reporting structure of the Chief Internal Auditor, so that he can discharge his duties objectively? Suggest the ideal reporting structure of the Chief Internal Auditor that HR head may propose to the Managing Director?*

7. *Zero Ltd. has appointed Mr. Shubh to conduct their internal audit for the new financial year. The Audit committee requested Mr. Shubh to perform a detailed analysis of their expenses in the previous year and report on all risks and underlying gaps. Elucidate the steps Internal Auditor should take to identify such gaps?*

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

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

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

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

9. *Rishi is appointed as internal auditor for SPOM Limited, a medium-sized manufacturing company, while CA Nitin is the statutory auditor of SPOM Limited.*

(a) *During the review, Rishi notices several discrepancies in the disbursement records and suspects there might be weaknesses in the internal control system. Additionally, there have been recent changes in the company's business policies that he was not*

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informed about. Rishi is concerned about maintaining his independence and objectivity while ensuring that management is aware of these issues. What are the responsibilities of Rishi as an Internal Auditor with respect to the accounting function and financial records of the organisation?

(b) *CA Nitin asked Rishi to provide direct assistance to him regarding evaluating the appropriateness of management's use of the going concern assumption. In view of Standards on Auditing, whether Nitin can ask direct assistance from Rishi as stated above?*

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

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

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

11. *The management of High Limited is concerned with the reporting requirement cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 for the financial year 2025-26 with regard to the Audit Trail (edit log). Audit trails may be enabled at the accounting software level depending on the features available in such software or same may be captured directly in the database underlying such accounting software. Consequently, the management of the company approached CA J and asked him to suggest them list of internal controls which may be required to be implemented and operated to demonstrate that the Audit trail (or Edit Log) feature was functional, operated and was not disabled. Guide CA J.*

12. ***Jeneva Technologies Pvt. Ltd., a private limited company engaged in the manufacturing of automation equipment, having turnover of ₹ 210 crores during the financial year 2025-26. Additionally, the company had taken a loan of ₹ 95 crores from a consortium of banks during the same year, which remained outstanding as of the balance sheet date.***

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Meanwhile, Cross Buildcon Ltd., an unlisted public company involved in real estate development, had the following financial details for the year 2025-26:

Particulars	*Amount*
Paid-up share capital	*₹ 48 crores*
Turnover	*₹ 198 crores*
Outstanding borrowings from a bank	*₹ 110 crores*
Outstanding deposits	*₹ 30 crores*

The management of both companies has approached their respective consultants seeking clarity on whether they are required to appoint an internal auditor under the Companies Act, 2013.

As a professional consultant, you are required to advise:

(a) Whether Jeneva Technologies Pvt. Ltd. is required to appoint an internal auditor for the financial year 2025-26.

(b) Whether Cross Buildcon Ltd. is required to appoint an internal auditor for the financial year 2025-26.

(c) State who can be appointed as internal auditors under the Companies Act, 2013.

13. *LED Ltd., a manufacturing company, has recently implemented a new ERP system for processing all financial transactions. During the audit, the auditors notice that:*

- *Some User IDs are being shared among employees.*
- *It is not clear whether the audit trail feature has been consistently active and secure.*
- *Access logs for audit trails and configuration changes are not routinely reviewed.*

Explain the purpose and importance of an audit trail in a computerized accounting system. Also advise the key internal controls which may be required to be implemented and operated to verify the functionality of the audit trail by the auditor.

14. *UV Limited is a large multinational company with a global outreach. Due to the voluminous business, it has an in-house internal audit function to monitor the day-to-day operations of the company. LK and associates, Chartered Accountants have been engaged to conduct the statutory audit for the financial year 2025-26. Since the company has large scale operations and there is a limited time to perform statutory*

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audit, CA L, the engagement partner decides to take direct assistance from the internal auditors for certain areas of audit. CA L assigns the audit documentation part to one of his audit assistants and instructs him to do the requisite documentation of working papers. Further, he tells his audit assistant not to document the working papers prepared by the internal auditors who directly assisted them, as it does not form part of statutory audit.

Is CA L right in excluding the working papers prepared by internal auditor from the audit documentation? Guide him as to the matters to be included in the Audit Documentation in this scenario.

15. Rajveer & Associates have been the statutory auditors of Ish and Vish Ltd., a listed company. CA Vishav, the engagement partner, had designed certain substantive procedures on some selected assertions in response to the assessed risk of material misstatements for the year under audit. These assertions were not examined by him in previous years due to materiality or risk considerations.

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

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

16. Shine Appliances Ltd. uses a customised ERP system for recording all financial transactions. The management is concerned about compliance with Rule 11(g) of the Companies (Audit and Auditors) Rules, 2014, which mandates reporting on whether the company's accounting software had an Audit Trail (Edit Log) feature enabled, operative, and not tampered with during FY 2025-26.

Since the ERP allows both system-level and database-level logging, the management seeks guidance from CA M, the statutory auditor, on the internal controls that should be implemented to demonstrate that the Audit Trail feature was continuously enabled and not disabled at any point of time.

Advise CA M on the internal controls the company should establish and operate in this regard.

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Answers to Test Your Understanding

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

The Board can appoint any professional as may be decided by it. The applicant in question is a law post graduate and he has spent 25 years of his career in Indian Audit & Accounts Service. Therefore, he has got the necessary experience and skills required for the said vacancy. The Board would be in a position to appoint such a competent and experienced person in the field of auditing as its Chief Internal auditor.

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

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

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

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

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

Hints /Answers to Theoretical Questions

1. Refer para 6.

2. **Evaluation of Internal Audit Functions by External Auditor:** The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he

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can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

(a) **Organisational Status -** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, his reports to the highest level of management and are free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

(b) **Scope of Function -** The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

(c) **Technical Competence -** The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) **Due Professional Care -** The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

3. **Applicability of Internal Audit:** Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if it's outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

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

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

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

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

4. Refer Para 7.3.

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

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

Significant judgments include the following:

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

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

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

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

6. HR Head needs to evaluate multiple options and identify the most suitable option in light of the relevant provisions, guidance and overall governance of the organization. HR head also needs to evaluate different options for his administrative reporting and various options for

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functional reporting of Chief Internal Auditor. The possible options to be considered and evaluated include the Board of Directors, Audit Committee, Managing Director of the Company and Chief Executive Officer or Chief Financial Officer.

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

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

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

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

7. Refer para 5.0.

8. As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of the Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

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(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

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

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

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

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

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

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

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

(b) As per SA 610, "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.

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

Significant judgments include the following:

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

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

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

In the above case, engagement partner had designed certain substantive procedures on some selected assertions in response to assessed risk of material misstatements in year under audit. Such assertions were not tested by him in the previous years due to materiality or risk considerations. It is being done now for incorporating an element of unpredictability in audit procedures to be performed as individuals within the company who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting.

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

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

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

11. Refer para 9.0.

12. **Refer Applicability of Provisions of Internal Audit under Para 1.**

(a) In the case of Jeneva Technologies Pvt. Ltd., the company recorded a turnover of ₹ 210 crores during the financial year 2025-26 and had obtained a loan of

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₹ 95 crores from a consortium of banks during the same period. As the turnover exceeds the prescribed threshold of ₹ 200 crores, the company falls within the criteria specified under Rule 13 of the Companies (Accounts) Rules, 2014. Hence, it is mandatorily required to appoint an internal auditor for the financial year 2025-26.

(b) In the case of Cross Buildcon Ltd., the company has a paid-up share capital of ₹ 48 crores, a turnover of ₹ 198 crores, outstanding borrowings from a bank amounting to ₹ 110 crores, and outstanding deposits of ₹ 30 crores as per the financial year 2025-26. Although the paid-up capital and turnover are below the prescribed thresholds, the outstanding borrowings and deposits exceed the specified limits under Rule 13 of the Companies (Accounts) Rules, 2014. Therefore, Cross Buildcon Ltd. is mandatorily required to appoint an internal auditor for the financial year 2025-26.

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

- *The internal auditor may or may not be an employee of the company.*
- *To be effective, the internal auditor must be regarded as a part of the management and not merely as an assistant thereto.*

13. **Refer Para 9.**

As per facts of the case, in LED Ltd., the new ERP system shows weaknesses such as shared User IDs and lack of clarity over activation and review of audit trails. Since an audit trail records all data changes with user and time details, it ensures accountability and reliability of financial records. If not properly enabled and monitored, data integrity may be affected. Hence, the auditor should ensure the compliance of above.

14. *Refer Para 7.4*

In the given situation, CA L the engagement partner decided to take direct assistance from the internal auditor for certain areas of audit and he assigned his audit assistant to do the requisite documentation of working papers. However, he instructed them not to document the working papers prepared by the internal auditors who directly assisted them as those documents do not form part of statutory audit.

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In view of the above, the auditor is required to document the working papers prepared by the internal auditor in case of direct assistance, thus, contention of CA. L in excluding the working papers prepared by internal auditor from the audit documentation is not correct.

15. *As per SA 610, "Using the Work of Internal Auditors", prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:*

(i) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and

(ii) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor shall not use an internal auditor to provide direct assistance if: (a) There are significant threats to the objectivity of the internal auditor; or (b) The internal auditor lacks sufficient competence to perform the proposed work.

In the current scenario, Rajveer & Associates are the statutory auditors of Ish and Vish Ltd., a listed company. CA. Vishav, the engagement partner, designed certain substantive procedures on some selected assertions in response to the assessed risks of material misstatements for the year, which were not previously examined. Mr. Yug, head of the internal audit department, reports to the audit committee. A senior audit team member decides to involve Mr. Yug in performing these substantive procedures.

As a result, the Rajveer & Associates is required to obtain written agreements from both the entity and the internal auditors regarding their cooperation and confidentiality. Further, using an internal auditor to provide direct assistance could prove to be counter-productive and defeat the very purpose of designing such

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substantive procedures. Hence, the decision of senior engagement team members to use Mr. Yug to provide direct assistance on above said matters is not in order as it is not in accordance with SA 610.

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

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

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