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General Guidelines on Internal Audit

The basic draft of this publication was
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General Guidelines on Internal Audit

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Foreword to the Second Edition

Internal audit is an important professional assignment, being undertaken both by practicing members of the Institute as well as those in industry. Internal audit is one of those streams of our profession which is extremely dynamic, extremely sensitive to the changes in the expectations and requirements of the management as well as all the stakeholders, and not just shareholders, of an entity. That these expectations and requirements are on a continuous rise is no exaggeration.

Remaining alive and responsive to these expectations and requirements and designing ways and means to fulfill them is extremely important not just for justifying the existence of the profession but also for its surge ahead on the road to growth and evolution. It is heartening to note that the Committee on Internal Audit has brought out the revised General Guidelines on Internal Audit amply reflecting the latest trends and thinking in the field.

I am also of the view that whereas on the one hand bringing out such publications by the Institute is necessary to keep the members upto date, it is equally essential for the members to be wary of complacence, be proactive and make liberal use of technology to harness the various sources of information and knowledge to remain abreast with the significant developments impacting their professional lives.

I congratulate CA. Amarjit Chopra, Chairman, Committee on Internal Audit and his Committee members for the excellent work done. Co-opted members deserve special mention for their invaluable support and contribution.

January 25, 2007	CA. T N Manoharan
New Delhi	*President*

Preface to the Second Edition

"*Nothing is permanent but change*", said Heraclitus, an about 530 BC Greek philosopher. How right he was then and how right he is even now. Change touches every facet of our life, professional or personal, every day, every hour, every minute. Ability to foresee the change and adapt accordingly is what helps one tide over the ups and downs that come attached with the change and make the most of the latent opportunities, so necessary for survival and growth.

The subject of internal audit has also been touched by change, from being a mirror image of audit of financial statements, internal audit has moved to being a lot more than that. Spreading beyond the accounts and financial information, internal audit today, in its *avatar* of management/ operational audit, is an indispensable tool in the hands of modern management to increase value for money. It is helping managements in optimum allocation and utilization of limited resources, plug losses and maximise returns to the shareholders. Internal audit today is also being employed by managements to obtain added assurance from the control environment established by it.

The Institute had in 1983 issued the General Guidelines on Internal Audit. The Guidelines have been thoroughly revised to reflect the significant changes that have taken place in the profession of internal audit, especially, those arising out of the significant developments in the last six to seven years in the regulatory environment, the origins of which can be loosely traced to some mega corporate collapses in the world's most developed economy.

My immense thanks are due to CA. Archana Bhutani, chartered accountant from Delhi, for sharing her experiences and knowledge with us and preparing the draft of the revised Guidelines and bringing them in line with the latest developments in the field. My thanks are also due to my colleagues at the Committee on Internal Audit who have provided their invaluable guidance for further improving upon the draft. I would be failing in my duty if I do not thank CA. T N Manoharan, President and also CA. Sunil H Talati for their unstinted support and direction to the Committee. I also wish to express my appreciation for Shri Vijay Kapur, Director, ICAI and CA. Puja Wadhera, Secretary, Committee on Internal Audit for their inputs in giving final form to the publication.

January 24, 2007 | CA. Amarjit Chopra
New Delhi | *Chairman, Committee on Internal Audit*

Foreword to the First Edition

Auditing is a unified and dynamic discipline with its own philosophy, standards and techniques which require constant review in the context of the ever-changing social, economic and legal environment. With increasing decentralization in economic enterprises, internal auditing has assumed considerable importance in the recent decades. I ma, therefore, glad that the Research Committee of the Institute is bringing out this publication, 'General Guidelines on Internal Auditing'.

The Guidelines emphasise that internal auditing is not merely an examination of financial records, but is really a management control, which measures and evaluates effectiveness of all other managerial controls. This involves a specialized application of the auditing techniques in accordance with the specific needs of an enterprise. The members of our profession, by virtue of their education, training and experience are already playing a vital role in this area. This involvement is bound to grow in the years to come.

I hope that the Guidelines will provide timely guidance to all members in industry and in practice in discharging their duties effectively.

New Delhi	Ashok Kumbhat
May 28, 1983	President

Preface to the First Edition

There has been a growing realisation of the significance of internal auditing in the efficient management of economic enterprises. The Research Committee of the Council of the Institute has therefore drawn up an ambitious programme of issuing guidelines on the subject. This publication discusses the nature and scope of internal auditing in general and as such provides the basic guidelines. Apart from this, a series of industry-wise guidelines will be brought out.

These guidelines emphasise that as an independent appraisal involving specialised application of techniques of auditing in accordance with the special needs of an enterprise, modern internal auditing need not be confined to financial transactions alone and may also review managerial effectiveness. As such it involves a review of all operations of the enterprise as also an evaluation of the effectiveness with which the resources are being utilised.

The guidelines are divided into thirteen sections. After an introduction on the concept of internal auditing, the inter-action between the management functions and scope of internal auditing have been discussed. The next seven sections discuss the various facets of the internal audit function, i.e., a review of internal control system and procedures, custodianship and safeguarding of assets, compliance, management information system, organisation structure, utilisation of resources and accomplishment of goals and objectives. Then the vexed issues of independence and qualifications of internal audit reports and their follow-up.

I am grateful to Shri N.H. Mirza, an eminent member of our profession, who prepared a basic draft for these guidelines. Another draft was prepared by the Technical Directorate of the Institute. It was decided that the two drafts be merged and a composite set of guidelines prepared. The composite draft as finalised by the Professional Development Committee was issued as an Exposure Draft in November 1982. We received a large number of comments on the Exposure Draft and on the basis of the comments, the present guidelines were finalised in April 1983. I express my sincere gratitude, on behalf of the Research Committee, to all those who contributed in the formulation of these guidelines at the various stages.

New Delhi	P A Nair
May 28, 1983	*Chairman, Research Committee*

General Guidelines on Internal Audit

Contents

1

Background

1.1 Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise, for a stated purpose. The auditor perceives and recognizes the propositions before him for examination, collects and evaluates evidence and formulates an opinion communicated through the audit report. This comprehensive definition covers all forms of audit including internal audit. Internal audit is an independent appraisal involving specialized application of techniques of auditing in accordance with the specific needs of an enterprise. The nature and scope of internal audit depends upon the requirements of an enterprise. It is a systematic evaluation of risk management, control and governance processes particularly with reference to:

- Safeguarding of assets
- Compliance with laws, regulations and contracts as well as policies laid down by the management
- Reliability and integrity of financial and operational information
- Effectiveness and efficiency of operations
- Accomplishment of objectives and goals of the organization through ethical and effective governance

1.2 The following definition of internal audit, as contained in the Preface to the Standards and Guidance Notes on Internal Audit, issued by the Institute of Chartered Accountants of India, amply reflects the current thinking as to what is an internal audit:

> "3.1 Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements

thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."

1.3 It is, however, pertinent to note that variations in propositions do not change the basic philosophy of collecting and evaluating evidence and formulating an opinion; what undergoes a change is the approach, the tools and the techniques used. Internal audit activities can be performed by suitably trained persons within or outside the organisation or by a combination of both.

1.4 Internal audit is, therefore, an important tool in the hands of the management to help improve its decision making process. The growing importance of internal audit to good governance can be appreciated from the spate of legal and regulatory requirements world over, directly or indirectly necessitating the need for internal help management to rope in the services of internal audit to help in improving the former's efficiency in running an enterprise. However, before discussing how internal audit can help management in that respect and the drivers of an efficient and effective internal audit, it is essential to understand the various stages of evolution of internal audit over time.

Evolution of Internal Audit

1.5 K H Spencer Pickett[1], a noted authority in the field of internal audit, has identified the following stages in the evolution of modern internal audit.

As a Sibling of External Audit

1.6 In the initial stages, internal audit began as an extended arm of an external/statutory audit of financial statements. The main, but rather restricted, function of the internal audit at this stage was verifying the reliability of the financial information included in the financial statements. The internal audit function in this stage of evolution could not understandably add much value to functioning of the entity.

[1] *The Essential Handbook of Internal Auditing*, 2005 Edition.

As a Cross Check

1.7 In this stage of its evolution, internal audit was also required to test non-financial information and transactions in terms of their correctness and compliance with the laid down policies and procedures.

As a Probity Police

1.8 At this stage of its evolution, the internal audit came to be more concerned about the probity aspects of the transactions especially those involving liquid and highly movable assets such as cash, stocks, etc.

As a Non Financial Systems Police

1.9 As the global economy surged forward full steam, the need for having a full fledged, strategically directed internal audit emerged as an inevitable service that could assist managements in decision making, moving away from being merely a police on financial transactions. Thus, emerged the modern internal audit where the latter was established as a separate function, in house or outsourced, with clearly laid down missions and objectives to be achieved. As of today, internal audit undeniably is the backbone of a sound corporate governance system.

Factors Contributing to the Evolution of Internal Audit

1.10 Whereas in the preceding paragraphs the various stages in the evolution of internal audit have been discussed, the following are some of the factors, which have immensely contributed to that evolution.

Increased size and complexity of businesses

1.11 Increased size and business spread dilutes direct management oversight on various functions, necessitating the need for a full time, independent and dedicated team to review and appraise operations.

Enhanced compliance requirements

1.12 Increase in the geographical spread of the businesses has also led to crossing of political frontiers by businesses in a bid to tap global capital. This has thrown up compliance with the laws of the home country as well as the laws of that land as a critical factor for existence of businesses abroad.

Focus on risk management and internal controls to manage them

1.13 Internal auditors can carry out their job in a more focused manner by directing their efforts in the areas where there is a greater risk, thereby enhancing the overall efficiency of the process and adding greater value with the same set of resources.

Unconventional business models

1.14 Businesses today use unconventional models and practices, for example, outsourcing of non-core areas, such as accounting.

Intensive use of Information Technology

1.15 Information technology (IT) is invariably embedded in all spheres of activities of a modern business enterprise today, from data processing to resource planning to online sales and e-commerce. Use of IT has, however, increased the threat of data thefts or losses on account of systems failure or hacking/ espionage, as well as the need to comply with the cyber laws, etc.

Stringent norms mandated by regulators to protect investors

1.16 The regulators are coming up in a big way to protect the interests of the investors. The focus of the latest regulations being ethical conduct of business, and enhanced corporate governance and financial reporting requirements, etc.

An increasingly competitive environment

1.17 Whereas deregulation and globalisation have melted the political as well as other barriers to entry in the markets for goods and services, free flow of capital, technology and know how among the countries as well as strong infrastructure has helped in bringing down the costs of production and better access to the existing and potential consumers. This in turn, has lured more and more players in the existing markets, thereby, stiffening the competition.

Need for internal audit to provide demonstrable value addition

1.18 Over the years, better corporate governance practices complemented by enhanced accounting and disclosure policies and practices codified in the form of Accounting Standards as well as immaculately designed advanced software packages for accounting and resource planning, have considerably brought down the need for the management to act as a police over the reliability and accuracy of the financial data. The internal audit has to, therefore focus, on areas other than financial data as well and help increase the stakeholders' value. One such focus area could be identifying areas of wastage of physical resources, deficiencies in internal controls, etc.

Scope of the Revised General Guidelines

1.19 Recognising the growing importance of internal audit in the efficient management of economic enterprises, the Institute of Chartered Accountants of India had published a set of guidelines, General Guidelines on Internal Audit in 1983. The publication discussed the general nature and scope of internal audit and suggested a broad framework for carrying out effective internal audit. The Guidelines dealt with significant practical aspects of internal audit such as the procedures to be followed by the internal auditor to review aspects such as internal control systems, custodianship and safeguarding of assets, compliance with policies, plans, laws and regulations, relevance and reliability of information, organisation structure, utilization of resources, accomplishment of goals and objectives; independence issues concerning internal audit, qualifications of an internal auditor, and the internal audit report. The revised General Guidelines, among other things, deal with areas crucial for an effective internal audit, *viz.,* internal audit skills, staffing issues, focus areas, internal audit reports, evaluation of the internal audit function. The revised General Guidelines also touch upon aspects essential for appropriately appreciating the internal audit aspect as it is perceived today. These areas include the impact of new corporate governance requirements on internal audit, positioning of the internal audit, etc.

2

Impact of New Corporate Governance Requirements on Internal Audit

Corporate Governance – An Overview

2.1 Corporate governance, in the simplest terms, refers to the system by which companies are directed and controlled[1]. Research has shown that companies having good corporate governance practices in place are remunerated in the form of better prices of their securities, easier access to capital, reduced cost of capital, better ability to attract and retain talent, better utilization of resources, etc. The importance of corporate governance, thus, cannot be over-emphasised. Corporate governance has also emerged a strong tool in the hands of the regulators for protecting the interests of the investors. Thus, over a period of time, the Governments and regulators, both at home and abroad, have issued comprehensive laws and regulations in respect of model corporate governance practices to be adopted by the companies.

Clause 49 of Listing Agreement

2.2 In India, introduction of clause 49 in the Listing Agreement issued by the Securities and Exchange Board of India (SEBI) has had a significant role to play in shaping the face of the corporate governance practices in listed companies in India. Some of the important requirements of clause 49 are as follows:

- Companies need to submit a quarterly report in respect of compliance with clause 49 of the Listing Agreement to the stock exchanges within

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[1] *The Cadbury Report on Financial Aspects of Corporate Governance, 1992, UK.*

the stipulated time from the close of quarter signed by the Compliance Officer or the Chief Executive Officer.

- The Audit Committees are required to review:
  - the adequacy of the internal audit function, if any, including the structure of internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit, including appointment, removal and terms of remuneration of the chief internal auditor.
  - internal audit reports relating to internal control weaknesses.
  - the findings of any internal investigations by the internal auditors into matters where there is a suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.
- The Audit Committee is also required to discuss with the internal auditors any significant findings and follow up thereon.
- The CEO and the CFO is required to certify to the Board of Directors:
  - that financial statements as well as the cash flow statement for the period:
    - do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading.
    - present a true and fair view.
    - are in compliance with the existing Accounting Standards, applicable laws and regulations.
    - no transactions were entered into by the company, which were fraudulent, illegal or violative of the company's code of conduct.
  - that they accept responsibility for effectiveness of internal controls and that they have disclosed to the auditors and the Audit Committee deficiencies in the design and operation of the internal controls and steps taken for rectification of the same.
  - that they have indicated to the Audit Committee and the internal as well as external auditors as to the following aspects:

- any significant changes in internal controls.
- any significant changes in the accounting policies and instances of significant fraud, if any, and that the same have been disclosed in the notes to the financial statements.
- instances of any significant fraud and involvement, if any, therein of the management or any employee having a significant role in the internal control systems of the company.

Thus, it is amply evident from the above that the management, especially the functional management as well as the Audit Committee needs extensive support from the internal audit function to give it the primary assurance about controls and compliances before giving the required reports/certificates or to appropriately review the necessary aspects and make informed decisions. The complete text of the clause 49 of the Listing Agreement is enclosed as APPENDIX I.

Section 292A of the Companies Act, 1956

2.3 In addition, section 292A of the Companies Act, 1956, requires public companies having paid up capital not less than Rs. Five crores to constitute a committee of the Board i.e., the Audit Committee. In terms of sub section (5) of the said section, the internal auditor is required to attend and participate at the meetings of such Audit Committees. Thus, by implication, section 292A also lays down the requirement for internal audit to the companies falling under the purview of section 292A of the said Act.

Companies (Auditor's Report) Order, 2003

2.4 The importance of internal audit to the corporate enterprises was recognised by the Government way back in 1975 under the Companies Act, 1956 itself. The Manufacturing and Other Companies (Auditor's Report) Order 1975 issued by the Central Government in terms of section 227(4A) of the Companies Act, 1956 required the statutory auditor to report whether, in relation to companies the paid-up capital of which at the commencement of the financial year concerned exceeded Rs.25 lakhs, the company had an internal audit system commensurate with its size and nature of its business. This implied requirement for internal audit was kept intact in the 1988 Order as well except that an additional condition of turnover of Rs. 2 crores for three consecutive years was introduced. The Central Government, in terms of the power vested under section 227(4A) of the Companies Act, 1956, in June 12, 2003, had notified the Companies (Auditor's Report) Order, 2003. Clause (vii) of the said 2003 Order requires the auditor to report as follows:

> *"whether in case of listed companies and/ or other companies having paid-up capital and reserves exceeding Rs. 50 lakhs at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business."*

Though the clause does not by itself mandate internal audit in the subjected companies, yet a company to which the same is applicable, would incur a negative remark from the auditor if it does not have an internal audit system.

2.5 In addition to the requirement to comply with the provisions of clause 49 of the Listing Agreement or the Companies Act, 1956, as mentioned above, companies going in for tapping the international capital market, especially, those seeking listing in US stock exchanges, NASDAQ, NYSE etc., also need a strong internal audit function to meet the stringent corporate governance and internal control requirements of those stock exchanges. In this context, the US companies, having US public as investor also need to comply with the requirements of section 302 and 404 of the Sarbanes Oxley Act of 2002.

Role of Internal Audit in Strengthening Corporate Governance

2.6 Implementation of corporate governance practices involves certain costs to be incurred by the company. The company needs to justify the cost of implementing good corporate governance principles *vis a vis* benefits derived therefrom. Internal audit can help maximizing the benefits from the corporate governance policies. A reference to the definition of "internal audit" as given in the Preface to the Standards and Guidance Notes on Internal Audit, issued by the Institute makes it clear that internal audit involves critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

2.7 Following are some of the measures by which internal audit contributes to sound corporate governance:

(i) Understanding and assessing the risks and evaluate the adequacies of the prevalent internal controls.

(ii) Identifying areas for systems improvement and strengthening controls.

(iii) Ensuring optimum utilisation of the resources of the entity, for example, human resources, physical resources, etc.

(iv) Ensuring proper and timely identification of liabilities, including contingent liabilities of the entity.

(v) Ensuring compliance with internal and external guidelines and policies of the entity as well as the applicable statutory and regulatory requirements.

(vi) Safeguarding the assets of the entity.

(vii) Reviewing and ensuring adequacy of information systems security and control.

(viii) Reviewing and ensuring adequacy, relevance, reliability and timeliness of management information system.

3

Basic Principles of Internal Audit

3.1 Like any other profession, the profession of internal audit also is based on a certain fundamental principles, which constitute the life and blood of this profession. These principles have been discussed in the following paragraphs:

Integrity, Objectivity and Independence

3.2 The internal auditor should be straight forward, honest and sincere in his approaching to the assignment, keeping free of any bias that may override/compromise his integrity and objectivity. The internal auditor should also be impartial and free of any interest that may be regarded as incompatible to integrity and objectivity and inform his supervisors of any personal or external factors that actually do or are likely to impede his independence and objectivity so that necessary remedial action may be taken.

Confidentiality

3.3 The internal auditor, in the course of his work, invariably comes across information that is confidential and/ or critical to the working of the entity. The internal auditor should respect the confidentiality of such information and should not disclose the same to a third party without the specific authority or unless there is a legal or professional duty to do so. The internal auditor should, therefore, ensure that there are adequate policies and mechanisms to protect the confidentiality of the information.

Due Professional Care, Skills and Competence

3.4 Performance of the audit and preparation of the report require due professional care by persons who have adequate training, experience and competence in auditing. Development of audit skills may be achieved through training courses. Much of staff development results from on the job training where experienced auditors assist in the training of new, less experienced internal staff. Each internal auditor is responsible for continuing his education in order to maintain his proficiency.

3.5 Internal auditors should also take reasonable professional care in specifying evidence required, in gathering and evaluating that evidence and in reporting the findings. They need to remain alert to the instances that could indicate errors, fraud, etc.

Planning

3.6 Adequate planning for every audit should cover all material areas. The audit working papers should incorporate documentary evidence of audit planning in the form of an audit plan, setting out the objectives and scope of an audit and the techniques and resources to be used by an internal auditor. Plans may be revised as required in the course of the audit.

Delegation and Supervision

3.7 Internal auditor would invariably require to delegate work to assistants. At times, services of an expert might also be sought. The internal auditor would, however, continue to be responsible for his opinion on the activities being subject to internal audit or his findings. The internal auditor should carefully direct, supervise and review the work delegated to assistants. The amount of supervision required depends on the skill and experience of the assistant on the job. The supervisory role of the internal auditor includes:

- Providing suitable instructions for the audit.
- Approving or recommending the approval of the audit plan.
- Ensuring that the audit program is completed.
- Ensuring that working papers adequately support the audit findings, conclusions and reports.
- Ensuring that the reports are unambiguous, accurate and concise.
- Ensuring that the audit objectives have been met.

Evaluation of Internal Control

3.8 Internal auditors should systematically evaluate the nature of operations and system of internal controls in the departments being audited to determine the nature, extent and timing of audit procedures. Internal controls of an organization comprise the plan of organization and methods adopted to safeguard assets, comply with laws, ensure the completeness and correctness of data, promote efficiency and encourage adherence to management policies. It is important that a review of an internal control system be directed primarily towards those controls that have an important bearing on the reliability of the system (i.e., key controls).

Evidence

3.9 The internal auditor should obtain all the evidence considered necessary for the expression of an informed opinion. Professional judgment is needed to determine the nature and amount of evidence required. In this regard, the internal auditor should consider:

- the item under consideration;
- materiality of possible errors;
- degree of risk of error; and
- probability of the error occurring.

Work Papers

3.10 The internal auditor should document matters that are important in providing evidence to his opinion or the findings. Advantages of having sufficient and properly maintained work papers include the following:

- Assistance in the performance of the audit.
- Providing record of work done.
- Forming basis of the auditor's observations/ findings in his report.
- Providing information for the report.
- Aiding the review and evaluation of the work done.

- Aiding cross referencing between audit evidence and decision taken by the internal auditor.
- Providing evidence that the internal audit was carried out in accordance with the requirements of the relevant pronouncements of the Institute of Chartered Accountants of India.

Quality Reviews

3.11 The review process should involve peer reviews. These aid in improving the standard of work performed and allow knowledge sharing.

Internal Audit Charter

3.12 Internal auditors need a mandate that provides the authority they need within the organisational structure that supports their independence and objectivity. This can be achieved through a written Internal Audit charter. An internal audit charter is an important document that codifies the position (organizational hierarchy) of the Internal Audit *vis a vis* the organisation. The charter outlines the objective, scope of internal audit as well as the duties, responsibilities and powers of the internal auditor(s). It also lays down measures to protect the independence of the internal auditors, the professional standards to be maintained by it as also the nature of the relationship of the internal audit with other functions. Some of the critical factors codified by the internal audit charter include:

- Roles and responsibilities of the internal audit function.
- Functional reporting relationship with the Audit Committee.
- Administrative reporting relationship.
- Access to employees, facilities and records.
- Restrictions on the scope/authority of internal audit, if any.
- Periodicity of reporting, time limit for follow up action, distinction between priority reports and routine reports.
- Active involvement of operational managers with internal audit and follow up action on internal audit findings.
- Internal audit standards to be followed.
- Relationship with external auditors.

- Distribution of reports and summaries.
- Follow up of previous recommendations.
- Mention of specific areas to be evaluated. (fraud controls, safety, IT, etc.)
- Conflict resolution mechanism.

Though the internal audit charter should be approved by the Board of Directors, as a measure of good corporate governance practice, the Audit Committee should also be involved in setting the internal audit charter. Further, any restrictions on the internal audit function by the management should be disclosed to and approved by the Audit Committee. A sample charter of the internal audit department is given in APPENDIX II.

3.13 To add value, it is necessary that the internal auditor is able to carry out his work in an environment where there are no threats to his independence and where there are no conflicts of interest. The management, on its part, should set the right tone at the top to ensure independent and effective internal audit. This primarily would include.

- ensuring independence of the internal audit by ensuring that the work of the internal auditor is not evaluated by those subjected to internal audit.
- ensuring support of the operational management for conducting audit, providing information and management response and action plan to operations management in a timely manner.
- refraining from using internal auditors for executive functions.

3.14 To enable internal audit to add value to the decision making process of the management, it is also necessary that the internal audit charter is reviewed and updated regularly.

Reporting Relationships

Audit Committee

3.15 The internal audit function is a major source of information and assurance to the Audit Committee on internal controls and other risk management activities. It is for this reason that the internal audit team should have functional reporting responsibilities to the Audit Committee as defined in the internal audit charter.

3.16 Both the internal audit and Audit Committee charters should clearly state that:

- The Chief Internal Auditor would have direct and unrestricted access to the Chairman of the Audit Committee.
- The Chief Internal Auditor would attend and participate in the meetings of the Audit Committee to present the internal audit plan for the period and to report the internal audit findings.
- The Audit Committee would review and approve the appointment/replacement of the chief internal auditor.
- The internal audit charter would be reviewed by the Audit Committee periodically.
- Internal auditor would provide the Audit Committee members and senior management with independent, objective views on risk and internal controls within the enterprise.
- Where internal audit function is outsourced, the outside agency should nominate its senior personnel who should report to the Audit Committee. Where more than one such agency is involved, each should nominate its senior personnel for this purpose. Where outside agency/ies are involved, a senior internal manager would be nominated to co-ordinate the internal audit function.

3.17 The Audit Committee should be responsible for confirming that internal audit has the competence, independence, resources and corporate support to do its job properly, and is demonstratively effective in getting results.

Board of Directors

3.18 The Chairman of the Audit Committee, when reporting to the Board, should include the recommendations of the Audit Committee as to the effectiveness, capabilities, findings and concerns of the internal auditor.

4

Internal Audit Skills

General Skills

4.1 The internal auditor personnel need certain general skills to be able to able to perform their duties effectively.

Technical Standards

4.2 The internal audit, at the foremost, should have adequate knowledge of the Standards applicable to them as also reasonable knowledge on how to apply them in practice.

Positive Attitude and Interpersonal Skills

4.3 The internal auditor should have a positive and objective attitude, free of any hind sight. He should also have good interpersonal and communication skills.

IT Skills

4.4 With the rapid increase in the use of information technology (IT) in the accounting and other operational aspects of an entity, it is essential for an internal auditor to be able to work in an IT driven environment. Thus, it is essential that the internal auditor should either have or acquire sufficient knowledge of how information technology has been integrated in the functioning of the organisaton as also skills that would enable him to effectively use IT in carrying out a purposeful internal audit.

Interviewing Skills

4.5 Interviewing is the process of ascertaining information through verbal interaction with auditees. It involves detailed questioning of auditees to ascertain the existing systems and controls. As a primary and significant source of information, interviews should be conducted by staff skilled in one to one interviews as well as in group discussions.

Audit Documentation Skills

4.6 Audit documentation is the process of compiling and filing test results. It involves collecting necessary papers for supporting audit findings, filing the analyses and supporting papers in a logical manner and assimilating information for presentation in a structured manner.

Reporting Skills

4.7 Reporting is the culmination of any audit assignment. It is, therefore, necessary that the audit report is written in such a manner that all issues are reported objectively and process gaps are addressed properly. It is also necessary that each observation is constructed in a manner that it represents the facts about the issue, its monetary or other impact, the cause of the issue and the suggestions for remedial actions and improvements.

Specific Skills

4.8 These skills would be required at senior levels and will assist the senior internal audit personnel in discharging the supervisory and management role efficiently and effectively.

Planning Audit Engagements

4.9 This involves the ability to plan audit engagements on the basis of a comprehensive risk assessment prior to commencement of audit. The individual has to be experienced in the conduct of a brainstorming discussion on risk assessment. He should also have the necessary experience and capability to be able to preempt significant issues that might come up during the audit, needing greater focus.

Team Building

4.10 This involves collecting people and facilitating coordination among them to ensure that they work as a unified team. It involves identification of team leaders, delegation of authority, motivating the team and communicating to them the results expected.

Managing Audit Engagements

4.11 This involves administration of the audit assignment. It involves the task of meeting auditees, understanding their expectations, communicating the engagement plan to them, selecting the right team, etc.

Making Professional Presentations

4.12 An experienced internal auditor should be able to make effective presentations to the Audit Committee. This would involve selecting and presenting the major issues that warrant senior management attention in a clear and unambiguous manner.

Knowledge Management Skills

4.13 An internal auditor either has or obtains sufficiently detailed knowledge of the operations of the entity as well as the constituents of the external environment in which the entity operates, for example, the industry, at large, the regulators, the customers, etc. Some of this knowledge might be confidential and critical to the working of the entity. The internal auditor needs to have skills to effectively manage the knowledge, for example, deciding on issues such as:

- collating the knowledge.
- how and where to apply the knowledge.
- assessing which team member needs what type and quantum of knowledge.
- assessing when the knowledge has become obsolete and needs updations.
- establishing the relationships between various pieces of knowledge and assessing how the same affects the internal audit.
- deciding on manner and channels of flow of information.

Benchmarking Skills

4.14 As in case of any other function, it is also essential that the performance and results of the internal audit function are adequately monitored and evaluated. For this purpose, it would be necessary to establish appropriate benchmarks to evaluate whether the internal audit has been able to successfully provide a direction for an effective decision making by the management.

5

Methodology and Approach

Planning

High Level Planning

5.1 Modern day businesses operate in fairly flexible legal and regulatory environment, the policy of the Government being intervention by exception. Government is increasingly simplifying the laws to provide flexibility being but is equally firm on ensuring ethical conduct of business. Consequently, some new regulations have been issued towards this purpose. In addition, the businesses are growing manifolds, not only in terms of production, consumers serviced, capital accessed domestically but also in the international markets. Further, to beat the cut-throat competition that comes along with a free market economy, businesses have also diversified into various areas significantly different from their main/ original line of business. Whereas this, on the one hand, has given rise to a number of opportunities to be reaped, it has exposed businesses to a wide array of risks as well. The present day Boards, therefore, have to devote considerable time on charting risk management strategy/ policy of the entity, *viz*., identification of risks, setting the risk appetite, managing the risk – accepting, rejecting, transferring risks, etc.

5.2 The internal audit function should carry out the task of assisting the Board of Directors in assessing the various risks. This assessment of risk is the starting point of the overall planning process. Risk analysis comprises the following activities:

- Determining objectives of the business.
- Identifying risks.
- Preparing a risk profile where risks are categorized in terms of impact and likelihood.

- Listing existing controls and assurances.
- Identifying control gaps.
- Assessing residual risks.

Long Range Planning

5.3 An internal audit plan may be drawn up for 3 to 5 years ensuring that every area gets covered at appropriate frequency, based on the risk perception of that particular area. A long range audit plan will assist in risk based allocation of internal audit resources and in strategic manpower planning. Such a plan should be reviewed periodically.

5.4 The Chief Internal Auditor (CIA) should prepare annual audit plan based on a comprehensive review and analysis of the organization's business activities and associated risks. Where an enterprise risk management process is already in place, this will provide a critical basis for developing an audit plan in alignment with the corporate priorities.

5.5 An ideal internal audit plan should, therefore, have at least the following features:

(i) Takes into consideration any planned new projects of IT upgrade/ implementation, new investment projects and advisory services.

(ii) Is founded on an appropriate and detailed costing so that budget constraints do not hamper the independence of the function.

(iii) Its adequacy has been reviewed by the Audit Committee.

(iv) Clearly brings out the risks not covered by the plan

(v) Includes an evaluation of risk of fraud.

It is essential that the internal audit plan is discussed and agreed upon with the management. As a measure of good practice, the external auditors may also be consulted while preparing the internal audit plan.

Determining the Scope of Work

5.6 This should include a detailed description of the controls and associated risks to be covered as well as the areas to be excluded by the internal audit during the year.

Scheduling Internal Audit Personnel

5.7 The extent of coverage of the internal audit depends on skill sets of the internal audit team. It is important to balance work areas between the team members, allowing them a combination of familiar and new areas.

Internal Audit Execution

Fieldwork

5.8 Fieldwork is the collection and analysis of information about the process under audit, which enables the formulation of audit conclusions. Fieldwork consists of describing the process flow, breaking down the processes into various sub processes, assigning risks – high, medium, low to these processes, evaluating internal controls and testing the key controls. Process flows that have been documented should clearly indicate:

- ♦ The transactions involved.
- ♦ Origin of these transactions.
- ♦ The manner in which these are recognized and recorded.
- ♦ The processing / accounting / reporting systems involved.

Evaluation of the key controls should result in a clear understanding of:

- ♦ Key controls
- ♦ Ineffective controls
- ♦ Missing controls
- ♦ Superfluous controls

5.9 The following table highlights the nature of tests for key controls:

Techniques	Details	Advantages	Disadvantages
Interviews	Enquire how the control operates, who are the personnel involved, what are the procedures established to ensure that the	Brings out the individual's understanding of the control technique and his diligence in resolving	Inadequate evidence, personnel may not cooperate

	control operates effectively	exceptions	
Observations	Observe the operations of a control, especially where written records are not available	Direct evidence of operation of control procedures	May not provide evidence that control procedures operate over the entire period
Re- performance	Tests involve re-performance of the actual control to independently evaluate actual results and management response	Precise	High level of effort. May not produce commensurate level of evidence
Verification	Match transactions to source documents to substantiate control operation	Focussed on potential problem areas	Time consuming
Analytical procedures	Establish the cause and effect relationship between the different variables under audit	Efficient as a large volume of transactions can be clubbed and tested	Time and effort intensive. Requires intelligent understanding of cause and effect relationships
CAAT	Processing test data through the computer and evaluating results against predetermined criteria	Efficient – allows testing of the entire population and stratification for sampling	May require assistance from IT professionals

Extent of Testing

5.10 An intelligent testing strategy should be used with due consideration to the following criteria:

- Scope of work to be performed
- Prior experience of the Internal Auditor regarding sufficiency of evidence required to substantiate a conclusion
- Nature and importance of control being tested
- Period of coverage

Sampling

5.11 The internal auditor should select the sample in such a way that it is representative of the population being tested. Three sampling methods are random selection, systematic selection and haphazard selection. Sample size depends on:

- Nature of control risk
- Tolerable sampling error
- Allowable risk of over reliance
- Size of population

Disposition of Exceptions Noted

5.12 All exceptions should be investigated to understand their root cause and overall impact. These should be documented and addressed. The following steps may be taken to deal with reportable issues:

- Discuss the exception with the process owner to understand the reason for such exception – this may cause the auditor to expand the scope of his work in the event of insufficient explanation
- Extend the sample size to determine the impact of the lapse – whether it was an odd instance or is a widespread problem
- Determine the presence and effectiveness of compensating controls
- Documenting and reporting to the appropriate level of management, all fundamental exceptions that do not have compensating controls in place.

Management Acknowledgement

5.13 A close out meeting with the management should not carry any surprises for either the management or the internal audit team. Thus, the internal auditors should regularly meet the management, apprise them of reportable issues as they arise and obtain management acknowledgment as to the existence of the problem and the steps to be taken by the management to rectify and prevent such problems.

Documentation and Work Papers

5.14 The internal auditor is required to obtain large amount of documentation and information, analyze the same and arrive at impartial conclusions. Work papers should substantiate the stated flow to allow an independent reviewer to understand the work done and the basis for conclusions. This also assures the reviewer that work has been completed satisfactorily.

Reporting and Follow up

5.15 The objective of preparing a formal internal audit report is to communicate the audit findings to the appropriate level of management. This is made at the end of the audit and should contain the internal auditor's opinion and information about the management's commitments to carry out corrective and preventive action. Further, the internal auditor should also document any draft reports submitted to the management and their comments thereon.

Computer Aided Audit Techniques

5.16 Computer Aided Audit Techniques (CAATs) are efficient and thorough methods of analyzing data to determine the effectiveness and compliance with internal controls. These can scan the entire population of transactions and can be done in a fairly short period of time. They can be effectively integrated into the normal audit process and can contribute to an effective and efficient method of collating audit evidence. These tools are of particular importance when testing transaction data.

6

Staffing the Internal Audit Function

6.1 It is critical that the internal audit team is technically competent to handle the audit. Hence, selection of the team should be such that it includes both specialists in respective fields like IT as well conventional internal auditors.

6.2 Internal audit may either be conducted with in house resources or may be outsourced to an external agency. An organization may also use an appropriate combination of external experts and the in-house staff. Some of the factors for consideration while deciding on the outsourcing of the internal audit include cost benefit analysis of in-house *vis a vis* outsourced internal audit, internal auditors' skills and their level, industry trends, etc.

6.3 Following factors also need consideration while deciding upon the in house *vis a vis* outsourcing of the internal audit function:

- Staffing of the internal audit function should be based on the number of skilled individuals required to cover the activities identified in the approved audit plan.
- The Chief Internal Auditor, in consultation with senior management and the Audit Committee should determine the most cost-effective mix of in-house and outsourced internal audit staffing.
- The size of the internal audit function should be benchmarked against similar organizations.
- The Audit Committee should review and assess the appropriateness and expertise of the resources as part of the annual audit plan.

- The Audit Committee should review and approve the appointment of outsourced audit firms and subsequently monitor the effectiveness of this arrangement.
- Based on the audit plan and its scope, complexity of business and scope of internal audit, qualifications of audit team should be defined to ensure it is competent while being cost effective.
- The Audit Committee should review the capabilities and qualification of internal audit department's manpower.
- Assessing the sufficiency of resources should generally include comparisons with similar organizations, the business risks and the degree of change within the organization.
- Assignments should not be accepted unless the Chief Internal Auditor has adequate manpower to staff the same since stretched resources mean poor quality of work and erosion in the reputation of the internal audit function.

The internal audit department should communicate its facts and findings, opinions and recommendations to the audit committee on a timely manner. The internal audit department should also report to the audit committee such recommendations of the department which have been approved by that committee but have not yet been implemented by the management.

7

Special Aspects in Internal Audit

Internal Control System

7.1 An internal control system is crucial to the successful functioning of any enterprise. It refers to the policies and procedures as well as the attitude of the management to assist in achieving the following overall objectives of the management:

- Orderly and efficient conduct of the business
- Adherence to management's policies and directives
- Safeguarding assets
- Prevention and detection of frauds and errors
- Accuracy and completeness of the accounting records
- Timely preparation of reliable financial information

The absence, inadequacy or malfunctioning of the internal control system could, therefore, have adverse results.

7.2 To be able to effectively help the management achieve its above mentioned objectives, it is essential that the internal control system[1] has the following elements:

- Integration with the risk management policy of the entity.
- Constant monitoring of various activities and functions.

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[1] Attention of the members in this regard is also invited to "*Enterprise Risk Management – Integrated Framework*" issued by the Committee of Sponsoring Organisations of the Treadway Commission, in September 2004.

- Identification and analysis of variances.
- Determination and implementation of corrective action.
- Revision of objectives and norms where needed and where supported.

In addition, the internal controls must also satisfy the three basic criteria[2]:

(i) they must be appropriate, i.e., the right control in the right place and commensurate to the risk involved;

(ii) they must function consistently as planned throughout the period, i.e., be complied with carefully by all employees involved and not by-passed when key personnel are away or the workload is heavy; and

(iii) they must be cost effective, i.e., the cost of implementing the control should not exceed the benefits derived.

The internal control system should focus on both accounting and non accounting operations and functions. Strong accounting controls result in correct, reliable, timely and relevant reporting of financial transactions that have already occurred while strong controls in operational areas improve the overall performance of the enterprise.

7.3 The internal auditor should review whether the internal controls are cost effective. Evaluation of cost effectiveness should take into consideration both direct and indirect costs. Review of internal controls may include interviews with personnel at various organizational levels, transaction walkthroughs, review and analysis of documented policies and procedures and mapping the process to determine and rectify existing control gaps and to suggest process improvement. The internal auditor should determine if the controls were in use throughout the period of intended reliance or have there any substantial alterations in the same during the stated period. Different techniques may be used to record information. Selection of a particular technique depends on the auditors' judgment

[2] "*Guidelines for Internal Control Standards*", issued by the International Organisation of Supreme Audit Institutions (INTOSAI), June 1992.

Safeguarding of Assets

7.4 Assets can be tangible or intangible. Their custody and administration has to be given to a number of personnel. The management needs to ensure that the assets are safe from unauthorized use or disposal and are properly accounted for. Following are some of the procedures that the internal auditor should adopt to review the custodianship of the assets and ensure that the assets are adequately safeguarded:

- Identifying weaknesses in controls that can lead to frauds. He cannot, however, be expected to carry out a continuous and roving search of frauds everywhere in the organization.
- Ensuring that assets are properly accounted for and that there is adequate segregation of duties in handling and accounting for assets.
- Examining whether the assets are adequately protected against loss (natural / deliberate).
- Reviewing control systems for intangible assets.
- Examining and testing the physical and systems controls on processing facilities and data storage.
- Verifying the physical existence of tangible assets.

In addition to the above, special attention should be given to technical know-how, special processes, formulas, etc. Often these are subject to industrial espionage. The internal auditor should also examine whether legal protection has been ensured through patents/copyrights, etc. Another area requiring special attention is the security and sanctity of customer, supplier and other data bases.

Compliance with Policies, Plans, Procedures, Laws and Regulations

7.5 The review of compliance by various sections/ departments of an enterprise, with its internal policies, procedures and practices as well as with the applicable external laws and regulations is an important task of the internal audit function. For this purpose, the internal auditor would, among other things:

- Examine whether the management has a system in place to communicate its policies, procedures and practices and external laws and regulations to the entire enterprise.
- Need to be aware of the laws and regulations and recent changes thereto, that have an impact on the enterprise and its operations, present and planned.
- Review whether the information provided about policies, procedures and practices and laws is commensurate with the authority and responsibility of each recipient and is in adequate detail so as to facilitate understanding and ensure compliance.
- Review the adequacy of the methods by which departments responsible for disseminating such information, keep themselves informed and updated.
- Review the system by which operating personnel are kept informed of changes in statutory requirements.
- Examine the system by which accounting policies are selected and implemented. The internal auditor should pay special attention to the manner and frequency of review of accounting policies to be followed. Special attention should also be paid to the timeliness and accuracy with which new policies or changes in existing policies are incorporated into the existing system.
- Carry out transaction checks to check if the policies and procedures are being complied with.
- Review the above stated systems and the results of the transaction checks to form an opinion on the effectiveness of the system in place, identify weaknesses and suggest remedial measures. The internal auditor should exercise his judgment when deciding the gravity of the system weakness / non compliance.

Relevance and Reliability of Information

7.6 Effective management depends largely on the timely availability of relevant and reliable information for planning, decision making and control. Management needs information from internal and external sources. Certain laws require that enterprise information be made available to external agencies or the public. For reviewing the relevance and reliability of the information, the internal auditor's procedures would include:

- Reviewing the information systems to evaluate the reliability and integrity of financial and operational information given to the management and external agencies.
- Reviewing the methods used to measure, classify and report pertinent information, as also the records from which the information is collected.
- Examining the accuracy and reliability of financial and operational records. The accuracy and reliability of reports prepared should be examined with reference to their conformity with the records and inclusion of all relevant information.
- Reviewing the frequency and timeliness of reports, keeping in view the time limits prescribed by law/government agencies.
- Examining the relevance of information conveyed to the user through these information systems/reports.
- Examining the cost effectiveness of reports.
- Examining whether a system of reporting exceptions is in place. Exceptions can be identified only where standards have been fixed for each function so that variations from these standards (classified into controllable, uncontrollable / normal / abnormal) can be reported.
- Checking the adequacy and effectiveness of controls over record keeping and reporting. There should be adequate and appropriate segregation of duties between the operational and accounting / recording functions.

Resource Use

7.7 The resources of an enterprise are under the control of various departments. Resources can be tangible (cash, fixed assets) or intangible (goodwill with customers/creditors). Another vital resource is trained manpower. Tangible resources are consumed / depleted over time. Intangible assets should be ideally be added to or maintained. The management needs information about the efficiency and effectiveness with which these resources are being used. Some of the procedures employed by internal auditor to review the resource use include:

- ♦ The internal auditor should check whether proper operating standards and norms have been established for measuring economical use of assets. The standards and norms are different for different functions and should be detailed yet easy to understand comprehensive enough so that they can be effectively implemented by the operational personnel for monitoring and evaluating their performance.
- ♦ The internal auditor needs to review the methods of establishing the operating standards and norms and the system of reviewing and updating established norms. The standards and norms should be based on operating plans. The relevance and reliability of these standards and the familiarity and understanding of the same by operating personnel should also be reviewed.
- ♦ Variations from standards should be examined to see if the standards are practical and achievable. The internal auditor should also see if timely and appropriate corrective action has been taken to minimise the recurrence of such deviations.
- ♦ The internal auditor should examine whether the analysis of variances are communicated to concerned personnel on a timely basis and in a manner that results in timely corrective action.
- ♦ The internal auditor should also identify under utilization of resources. He may identify over / under staffing in various areas that may result in sub optimal use of resources. He should pay special attention and comment on non-productive work being performed. This involves a detailed study of job descriptions along with observing the actual execution of work assigned.
- ♦ Instances of ineffective supervision should also be identified through observation, interviews with personnel, comparing performance of various teams, re-performance and reviewing records of work done.

8

Internal Audit Reports

8.1 The internal audit reports should aim at giving clearly the conclusions of the internal auditor and should be so designed that they motivate all to perform better. Normally, ABC principle, i.e., accuracy, brevity and clarity need to be followed while drafting the internal audit report. Following are some of the other characteristics of a comprehensive and useful internal audit report:

- The audit findings contained in the internal audit report should be supported by indisputable facts and reflect verifiable result.
- The report should also contain suggested corrective actions and timeplan thereof. The suggested corrective actions should be cost effective and amenable to implementation.
- Observations contained in the report should be classified according to their significance, so that management review can be held at appropriate levels, for instance, critical issues can be reviewed by top management while major/minor issues can be reviewed by respective departmental heads.
- Top management should be given summarized information of audit findings and action plan. An executive summary providing a crisp snapshot of the contents of the report, essentially, the findings and the recommendations is also quite helpful.
- Recommendations should be cost effective and possible to implement.
- Reports should be direct and straight forward written in a consistent style.
- Words should be chosen bearing in mind the sophistication of the addressee.

- Jargons and technical terms should be avoided.

8.2 In addition, following are the recommended elements of an internal audit report:

(i) Addressee

(ii) Scope of the internal audit, including the period covered

(iii) Internal audit methodology

(iv) Observations/ findings of the internal auditors and management's response thereto

(v) Impact of and risk associated with the observations/ findings

(vi) Recommendations/ opinion of the internal auditor

(vii) Non-rectification of previous observations

(viii) Date and place

(ix) Signature

9

Evaluating the Internal Audit Function

Objectives of Performance Evaluation

9.1 As in case of any other function, it is necessary to periodically subject the performance of internal audit also to an objective evaluation. Periodic quality assurance review of the internal audit function should be done with the following objectives:

- Identifying the degree of compliance with general and specific standards and other best practices on internal audit.
- Ensuring that audit operations are in compliance with organizational goals and departmental policies and procedures.
- Providing insights into the level of audit effectiveness and efficiency.
- Providing recommendations to improve the functioning of the internal audit.

Factors Affecting the Performance of Internal Audit

9.2 While carrying out a quality assurance review or performance evaluation of the internal audit, it must also be borne in mind that the performance of internal auditors, among other things, is also affected by factors which might be beyond their direct control. The following are some of such factors that affect the performance of internal audit:

- The extent to which internal audit is managed independently of other functions.
- Clarity of reporting line to the Board/Audit Committee.

- The extent to which the structure of the internal audit function encourages consistency in the quality of service to all the areas of organization.
- Appropriateness of the functional areas covered by the internal audit.
- The level of consensus between the management and the internal audit function as to what functional areas covered the latter needs to serve.
- The appropriateness of the services provided by internal audit.
- The quality of services provided by internal audit.
- The extent to which the funding structure of internal audit supports a risk-based allocation of resources, including the deployment of specialist resources where required.
- The extent to which the funding structure promotes the ability to raise issues to the appropriate level.
- The extent to which processes are in place to aid the internal audit function in managing its relationships with its key stakeholders.
- The level of relationship with statutory auditors.

Performance Parameters

9.3 The Chief Internal Auditor should develop performance parameters for the internal audit function and obtain consensus on them with the Audit Committee. The performance parameters should, at a minimum, include the following:

- Compliance with the audit plan for the year
- Staff utilization levels
- Actual time and cost vis-à-vis budgeted time and cost
- Cycle time for issuance and acceptance of reports
- Value addition to business
- Level of credibility and acceptance and implementation of recommendations

- Chargeable time vis-à-vis non-chargeable time
- Reasons for time overruns and delays in audit completion and issue of report
- Causal analysis of idle time
- Actual training time vis-à-vis planned training time

Satisfaction Survey

9.4 An important aspect of the quality assurance review of the internal audit function is that it can be used to address the operating management's perception of the internal audit function's performance. This can be done by surveying the auditees to find out their level of satisfaction with the services of the internal audit. Some areas that should be covered by the surveys are:

- Professional attributes of the internal auditors
- Level of communication
- Adequacy of the scope of work
- Execution of the work
- Adequacy of the report format
- Timeliness of the audit report
- Business perspective of internal auditors
- Knowledge application by internal auditors

Performance Management Process

9.5 As a part of a comprehensive and effective performance control for internal audit, it is essential that there is a formal process of performance management of each assignment. This should include the following key activities:

- Expectations / goals for each assignment
- Regular supervision of the audit assignment
- There should be a perpetual monitoring of performance against the standards by the Chief Audit Executive

Internal audit can use benchmarking against performance assessment methodology of other similarly placed organizations. Where practicable, internal audit might be subjected to an external quality review of the function every few years. The frequency of review depends on nature of the industry and degree of maturity of the internal audit function in the organization.

Clause 49 of the Listing Agreement

(Amended upto January 07, 2007)

49. Corporate Governance

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

(i) The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.

(ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.

(iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

   (a) apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

   (b) is not related to promoters or persons occupying management positions at the board level or at one level below the board;

   (c) has not been an executive of the company in the immediately preceding three financial years;

   (d) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:

(i) the statutory audit firm or the internal audit firm that is associated with the company, and

(ii) the legal firm(s) and consulting firm(s) that have a material association with the company.

(e) is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and

(f) is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

Explanation

For the purposes of the sub-clause (iii):

a. Associate shall mean a company which is an “associate” as defined in Accounting Standard (AS) 23, “Accounting for Investments in Associates in Consolidated Financial Statements”, issued by the Institute of Chartered Accountants of India.

b. “Senior management” shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

c. “Relative” shall mean “relative” as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

(iv.) Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Explanation:

“Institution’ for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a “corresponding new bank” as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts].”

(B) Non executive directors’ compensation and disclosures

All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders’ resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.

(C) Other provisions as to Board and Committees

(i) The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings. The minimum information to be made available to the board is given in Annexure– I A.

(ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.

2. For the purpose of reckoning the limit under this sub-clause, Chairmanship/membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.

3. The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

(D) Code of Conduct

(i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

(ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

II. Audit Committee

(A) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1: The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2: A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the Audit Committee shall be an independent director;

(iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

(B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:

a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956

b. Changes, if any, in accounting policies and practices and reasons for the same

c. Major accounting entries involving estimates based on the exercise of judgment by management

d. Significant adjustments made in the financial statements arising out of audit findings

e. Compliance with listing and other legal requirements relating to financial statements

f. Disclosure of any related party transactions

g. Qualifications in the draft audit report.

5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval

6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.

7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

8. Discussion with internal auditors any significant findings and follow up there on.

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.

10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.

12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.

13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Explanation (i): The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India.

Explanation (ii): If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions / features as is contained in this clause.

(E) Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;

2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;

3. Management letters / letters of internal control weaknesses issued by the statutory auditors;

4. Internal audit reports relating to internal control weaknesses; and

5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

III. Subsidiary Companies

i. At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.

ii. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

iii. The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Explanation 1: The term “material non-listed Indian subsidiary” shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

Explanation 2: The term “significant transaction or arrangement” shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

Explanation 3: Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

IV. Disclosures

(A) Basis of related party transactions

i. A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.

ii. Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.

iii. Details of material individual transactions with related parties or others, which are not on an arm’s length basis should be placed before the audit committee, together with Management’s justification for the same..

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management’s explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues etc.

When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

(E) Remuneration of Directors

i. All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.

ii. Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:

(a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.

(b) Details of fixed component and performance linked incentives, along with the performance criteria.

(c) Service contracts, notice period, severance fees.

(d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

iii. The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

iv. The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.

v. Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director

(F) Management

i. As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

1. Industry structure and developments.
2. Opportunities and Threats.
3. Segment–wise or product-wise performance.
4. Outlook
5. Risks and concerns.
6. Internal control systems and their adequacy.
7. Discussion on financial performance with respect to operational performance.
8. Material developments in Human Resources / Industrial Relations front, including number of people employed.

ii. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its. core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

(G) Shareholders

i. In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

a. A brief resume of the director;

b. Nature of his expertise in specific functional areas;

c. Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and

d. Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above

ii. Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

iii. A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/Investors Grievance Committee'.

iv. To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

V. CEO/CFO certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

   i. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

   ii. these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

   They have indicated to the auditors and the Audit committee

   - significant changes in internal control over financial reporting during the year;
   - significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
   - instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

VI. Report on Corporate Governance

i. There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Annexure- I C and list of non-mandatory requirements is given in Annexure – I D.

ii. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in Annexure I B. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company

VII. Compliance

1. The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

2. The non-mandatory requirements given in Annexure – I D may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annexure I A

Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial nonpayment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Annexure I B

Format of Quarterly Compliance Report on Corporate Governance

Name of the Company:

Quarter ending on:

Particulars	Clause of Listing agreement	Compliance Status Yes/No	Remarks
I. Board of Directors	491		
(A) Composition of Board	49 (IA)		
(B) Non-executive Directors' compensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct	49 (ID)		
II. Audit Committee	49 (II)		
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 (IIB)		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 II(D)		
(E) Review of Information by Audit Committee	49 (IIE)		
III. Subsidiary Companies	49 (III)		
IV. Disclosures	49 (IV)		
(A) Basis of related party transactions	49 (IV A)		
(B) Disclosure of Accounting Treatment	49 (IV B)		
(C) Board Disclosures	49 (IV C)		

Particulars	Clause of Listing agreement	Compliance Status Yes/No	Remarks
(D) Proceeds from public issues, rights issues, preferential issues etc.	49 (IV D)		
(E) Remuneration of Directors	49 (IV E)		
(F) Management	49 (IV F)		
(G) Shareholders	49 (IV G)		
V. CEO/CFO Certification	49 (V)		
VI. Report on Corporate Governance	49 (VI)		
VII. Compliance	49 (VII)		

Note:

(i) The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement.

(ii) In the column No.3, compliance or non-compliance may be indicated by Yes/No/N.A.. For example, if the Board has been composed in accordance with the Clause 49 I of the Listing Agreement, "Yes" may be indicated. Similarly, in case the company has no related party transactions, the words “N.A.” may be indicated against 49 (IV A)

(iii) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the "Remarks" column as – “will be complied with at the AGM”. Similarly, in respect of matters which can be complied with only where the situation arises, for example, "Report on Corporate Governance" is to be a part of Annual Report only, the words "will be complied in the next Annual Report" may be indicated.

Annexure I C

Suggested List of Items to Be Included In the Report on Corporate Governance in the Annual Report of Companies

1. A brief statement on company's philosophy on code of governance.
2. Board of Directors:
   a. Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
   b. Attendance of each director at the Board meetings and the last AGM.
   c. Number of other Boards or Board Committees in which he/she is a member or Chairperson.
   d. Number of Board meetings held, dates on which held.
3. Audit Committee:
   i. Brief description of terms of reference
   ii. Composition, name of members and Chairperson
   iii. Meetings and attendance during the year
4. Remuneration Committee:
   iv. Brief description of terms of reference
   v. Composition, name of members and Chairperson
   vi. Attendance during the year
   vii. Remuneration policy
   viii. Details of remuneration to all the directors, as per format in main report.
5. Shareholders Committee:
   ix. Name of non-executive director heading the committee
   x. Name and designation of compliance officer
   xi. Number of shareholders' complaints received so far
   xii. Number not solved to the satisfaction of shareholders

xiii. Number of pending complaints

6. General Body meetings:

xiv. Location and time, where last three AGMs held.

xv. Whether any special resolutions passed in the previous 3 AGMs

xvi. Whether any special resolution passed last year through postal ballot – details of voting pattern

xvii. Person who conducted the postal ballot exercise

xviii. Whether any special resolution is proposed to be conducted through postal ballot

xix. Procedure for postal ballot

7. Disclosures:

xx. Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.

xxi. Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

xxii. Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee.

xxiii. Details of compliance with mandatory requirements and adoption of the non-mandatory requirements of this clause

8. Means of communication.

xxiv. Quarterly results

xxv. Newspapers wherein results normally published

xxvi. Any website, where displayed

xxvii. Whether it also displays official news releases; and

xxviii. The presentations made to institutional investors or to the analysts.

9. General Shareholder information:

xxix. AGM : Date, time and venue

xxx. Financial year

xxxi. Date of Book closure

xxxii. Dividend Payment Date

xxxiii. Listing on Stock Exchanges

xxxiv. Stock Code

xxxv. Market Price Data : High., Low during each month in last financial year

xxxvi. Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.

xxxvii. Registrar and Transfer Agents

xxxviii. Share Transfer System

xxxix. Distribution of shareholding

xl. Dematerialization of shares and liquidity

xli. Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity

xlii. Plant Locations

xliii. Address for correspondence

Annexure I D

Non-Mandatory Requirements

1. The Board

A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties.

Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

2. Remuneration Committee

i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.

iii. All the members of the remuneration committee could be present at the meeting.

iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

3. Shareholder Rights

A half-yearly declaration of financial performance including summary of the significant events in last six-months, may be sent to each household of shareholders.

4. Audit qualifications

Company may move towards a regime of unqualified financial statements.

5. Training of Board Members

A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

6. Mechanism for evaluating non-executive Board Members

The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

7. Whistle Blower Policy

The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

Sample Internal Audit Charter of XYZ Company Limited

(Refer paragraph 3.12)

I. Management Responsibility

The management of the XYZ Company Limited is committed to increase the shareholders' value as also serve and protect the legitimate interests of the various stakeholders. To this end, the management has instituted internal controls to help management effectively and efficiently achieve its objectives of:

- Reliability and integrity of financial and operational information
- Effectiveness and efficiency of operations
- Safeguarding of assets
- Compliance with laws, regulations and contracts as well as policies laid down by the management
- Accomplishment of objectives and goals of the organization through ethical and effective governance

II. Nature and Objective of Internal Audit

Internal audit is an integral part of the internal controls. Internal audit is an independent management function and involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the company, including the company's strategic risk management and internal control system.

III. Scope and Responsibilities of Internal Audit

Internal audit is responsible for reviewing the adequacy of the risk management, control and corporate governance framework instituted by the management in ensuring that the management's objectives as listed in I. above are achieved. The internal audit would also be responsible for suggesting improvements to the existing risk management, control and corporate governance framework.

IV. Accountability and Reporting Responsibility

The internal audit department would be headed by the Chief Internal Auditor and would report functionally to the Audit Committee of the Board of Directors of XYZ Limited and administratively to the Chief Financial Officer/ Chief Executive Officer.

V. Independence of the Internal Audit Department

As a measure to protect the independence of the internal audit department, its staff is required to report to the Chief Internal Auditor, who, as mentioned in IV above, reports functionally to the Audit Committee and administratively to the Chief Financial Officer/ Chief Executive Officer.

Further, none of the staff of the internal audit department, including the Chief Internal Auditor, would perform any other duties either for the XYZ Ltd., or any of its group entities. As a corollary, none of the staff of the internal audit department would direct or supervise the activities of any employee of any other department of XYZ Ltd., except where such activities are a part of the internal audit undertaken.

The staff of the internal audit department shall also not initiate or approve financial transactions that originate from outside the internal audit department.

In case of any actual or perceived conflict of interest faced by the internal audit staff, the same must be immediately communicated to the chief internal auditor for necessary remedial action. In case the chief internal auditor faces any actual or perceived conflict of interest, he should immediately communicate the same to the Audit Committee.

VI. Authority

The Chief Internal Auditor as well as the other staff of the internal audit department have the authority in respect of:

(i) deciding as to the activities to be subjected to internal audit, approach and methodology, the resource allocation as well as the frequency

(ii) unrestricted access to all the departments, plant facilities etc., the records maintained and the personnel working thereat

(iii) obtaining necessary assistance from any employee(s) of any other department for the purposes of the internal audit

(iv) seeking assistance of experts/ professionals outside XYZ Ltd., for the purpose of the internal audit

(v) direct and unrestricted access to the Chairman of the Audit Committee

VII. Standards and Best Practices on Internal Audit

The internal audit staff including the chief internal auditor shall comply with the Standards on Internal Audit as well as other relevant technical literature issued by the Institute of Chartered Accountants of India. The internal audit would also keep itself abreast with the latest professional developments in the field of internal audit to be able to provide effective value addition to the management's decision-making process.

VIII. Relationship with the External Auditor

The internal audit department should, to the extent practicable, work in harmony with the external auditors. To that end, the internal audit department may also discuss their audit plan with the external auditors and also share with them their findings and opinions.

IX. Reporting

The internal audit department should communicate its facts and findings, opinions and recommendations to the audit committee on a timely manner. The internal audit department should also report to the audit committee such recommendations of the department which have been approved by that committee but have not yet been implemented by the management.