Compendium of Standards on Internal Audit

(As on July 1, 2013)

The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

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FOREWORD

In today's challenging times, the role of internal audit in effective governance has become highly critical in the functioning of business. Internal auditors are delivering much more than providing assurances on financial integrity and regulatory compliances. At the same time Internal auditors need to be aware of the changes happening in the professional environment to continue to play a vital role in the core areas of not only risk management but also effective corporate governance.

The Institute is continuously working to provide updated guidance for helping internal auditors to stay at the cutting edge of best practices. Standards on Internal Audit issued by the Institute are aimed to increase the overall credibility, consistency, clarity and comparability of the work performed by the internal auditors. The members can easily achieve quality in internal audit by applying Standards on Internal Audit and thereby meet the expectations of relevant stakeholders. This updated edition of Compendium of Standards on Internal Audit includes all the Standards on Internal Audit issued by the Institute till date which provide guidance on all the processes and aspects related to internal audit.

At this juncture, I wish to place my appreciation to CA. Shiwaji B. Zaware, Chairman, Internal Audit Standards Board and other members of the Board for their untiring efforts in bringing out comprehensive literature on internal audit and thereby strengthening internal audit profession in the country.

I am extremely confident that this updated edition of Compendium would prove useful to the members in efficiently discharging their responsibilities as internal auditors.

June 3, 2013
New Delhi

CA. Subodh Kumar Agrawal
President, ICAI

PREFACE

In today's global economy with increasingly interconnected markets, the important role of reliable financial information and good governance in the development of strong and sustainable organizations has been increasingly recognised. Internal audit has always been a valued part of an organisation, and it has the opportunity to play a vital and critical role at the heart of not only internal control and risk management, but also for achieving effective corporate governance. Internal auditors should be proactive to the challenging environment and should strive to engage with the change, with a heightened focus on effective governance, risk management and control.

The Institute has always been extending a helping hand to the members to demonstrate competence as internal auditors and meet the expectations of all the relevant stakeholders. The Internal Audit Standards Board of the Institute has issued Standards on Internal Audit which provide guidance to the members on all important aspects related to internal audit, so that they adopt the best practices and processes in carrying out internal audit. The Standards assist in providing confidence in the quality and consistency of the internal audit work conducted, help to deliver internal audit services in an effective and efficient way, and establish requirements and benchmarks against which the performance of internal audit can be measured. Since the issuance of the last edition in 2010, the Board has issued Standard on Internal Audit (SIA) 18, *Related Parties* which has been included in the updated edition of the Compendium.

The Board also issues generic and industry-specific technical guides on internal audit for the guidance of the members. These Technical Guides comprehensively cover detailed procedures to be undertaken by the internal auditor in respect of industry specific and other contemporary areas. It is very much essential that the members are alive to the environment and remain updated with their knowledge and skill set, so that they can better contribute and add value.

I wish to express my deep gratitude to CA. Subodh Kumar Agaarwal, President and CA. K. Raghu, Vice President for their continuous support and encouragement to the initiatives of the Board. I must also thank my colleagues from the Council at the Internal Audit Standards Board, *viz.*, CA. Babu Abraham Kallivayalil, CA. Rajkumar S. Adukia, CA. Jay Ajit Chhaira, CA. Tarun Jamnadas Ghia, CA. Pankaj Inderchand Jain, CA. Nihar Niranjan Jambusaria, CA. Dhinal Ashvinbhai Shah, CA. S. Santhana Krishnan, CA. J. Venkateswarlu, CA. Abhijit Bandyopadhay, CA. Anuj Goyal, CA. Naveen N. D. Gupta, Shri Manoj Kumar and Shri Gautam Guha. I also wish to place on record my gratitude for the co-opted members on the Board, *viz.*, CA. Ashok Patil Pundlik, CA. Chandrakant Raghunath Karode, CA. Rakesh Dhody, CA. Saurabh Mukund Chitale and CA. Sanjeeb Kumar Agaarwal as also CA. Sanjay Arora, special invitee on the Board for their devotion in terms of time as well as views and opinions to the cause of the strengthening internal audit practice in the country. I also wish to place on record the efforts put in by CA. Jyoti Singh, Secretary, Internal Audit Standards Board and CA. Arti Bansal, Senior Executive Officer, for their untiring efforts in supporting the Board in it’s activities.

I am confident that like earlier editions, this edition of the Compendium would also be extremely useful to all concerned.

June 7, 2013 **CA. *Shiwaji* B. Zaware**
Pune *Chairman*
Internal Audit Standards Board

CONTENTS

TERMS OF REFERENCE

Mission To reinforce the primacy of the Institute of Chartered Accountants of India as a promoter, source and purveyor of knowledge relating to internal audit and other aspects related to it in the society so as to enable its members to provide more effective and efficient value added services related to this field to the Industry and others; and help the latter to systematise and strengthen their governance process by systematising and strengthening their control and risk management process.

Objectives

1.1 to review the existing internal audit practices in India.

1.2 to develop Standards on Internal Audit (SIAs) to be issued under the authority of the Council of the Institute.

1.3 to develop Guidance Notes on the issues relating to internal audit, including those arising from the SIAs, to be issued under the authority of the Council of the Institute.

1.4 to formulate and issue Technical Guides, Practice Manuals, Studies and other papers on the areas relating to internal audit., under it's own authority for guidance of the members, in the cases felt appropriate by the Board.

1.5 to issue Clarifications on the issues arising from the SIAs, to be issued under the authority of the Council of the Institute.

1.6 to develop studies, reports, etc., on the issues arising from the SIAs, to be issued under the authority of either the Council of the Institute or of the Board.

2.1 to undertake research in the field of internal audit.

2.2 to organise/ provide technical assistance in, conferences, workshops, etc., on the topics related to internal audit organised by the Institute.

2.3 to conduct training programmes on internal audit for the members and other stakeholders.

2.4 to conduct certificate course on topics related to internal audit, as approve by the council of the institute.

SECTION I

Preface

PREFACE TO THE STANDARDS ON INTERNAL AUDIT*

Contents

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* The original Preface to the Standards on Internal Audit was issued in November, 2004 and revised in July, 2007. The revised Preface has also been published in the August 2007 issue of *The Chartered Accountant.*

** Hitherto known as Committee on Internal Audit.

1. Formation of the Internal Audit Standards Board

1.1 The Institute of Chartered Accountants of India constituted the "Committee for Internal Audit (CIA)" on 5th February 2004. At its 245th meeting held on November 29, 30 and December 1, 2005, the Council of the Institute of Chartered Accountants of India changed the nomenclature of the "Committee *for* Internal Audit" to "Committee on Internal Audit".

Further, at its 282nd meeting held on November 5–7, 2008, the Council has renamed the "Committee on Internal Audit" to "Internal Audit Standards Board (IASB)".

2. Scope and Functions of the Internal Audit Standards Board

2.1 A large number of the members of the Institute are involved in carrying out internal audit engagements. The Institute has, from time to time, issued general and industry specific guidelines on internal audit practices for the guidance of the members. The main function of the Internal Audit Standards Board (hereinafter "Internal Audit Standards Board" has been referred to as "Board") is to review the existing internal audit practices in India and to develop Standards on Internal Audit (SIAs). The SIAs aim to codify the best practices in the area of internal audit and also serve to provide a benchmark of the performance of the internal audit services. The SIAs are issued under the authority of the Council of the Institute.

2.2 While formulating the SIAs, the Board will take into consideration the applicable laws, customs, usages and business environment and generally accepted auditing practices in India. The Board may also, where it considers appropriate, take into consideration the international practices in the area of internal audit, to the extent they are relevant to the conditions existing in India.

2.3 The Internal Audit Standards Board will also develop Guidance Notes on internal audit, including those on issues arising from the Standards on Internal Audit. These Guidance Notes will be issued under the authority of the Council of the Institute.

2.4 The Internal Audit Standards Board will also formulate Clarifications on issues arising from SIAs. These Clarifications will also be issued under the authority of the Council of the Institute.

3. Scope of the Standards on Internal Audit

3.1 The Standards on Internal Audit shall apply whenever an internal audit is carried out. 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. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance.

4. Procedure for Issuing the Standards on Internal Audit

Broadly, the following procedure will be adopted for issuing Standards on Internal Audit.

4.1 The Internal Audit Standards Board will identify the broad areas in which the SIAs need to be formulated and the priority in regard to selection thereof.

4.2 In the preparation of the SIAs, the Board will be assisted by Study Groups constituted to consider specific subjects. In the formation of the Study Groups, provision shall be made for participation of a cross section of members of the Institute. In situations considered necessary, the Board may also consider having an expert on such Study Groups, subject to such terms and conditions, as may be finalized by the Board. The expert need not necessarily be a member of the Institute of Chartered Accountants of India. The Study Group will be responsible for preparing the draft of the Standard.

4.3 The above mentioned draft Standard would be considered by the Board. On the basis of the deliberations of the Board on the draft Standard, an

Exposure Draft of the proposed Standard will be prepared by the Board and issued for comments by the members of the Institute. The Exposure Draft will also be open for comments by non-members, including the regulators and other such bodies as well as general public.

4.4 The above mentioned Exposure Draft will be published in the Journal of the Institute and will also be hosted on the website of the Institute under appropriate head.

4.5 The Exposure Draft will normally remain open for comments for a period of at least sixty days from the date of issuance.

4.6 The above mentioned Exposure Draft will be circulated to all the Council members, Past Presidents, Regional Councils, Branches and CPE Study Circles of the Institute for their comments. The Exposure Draft will also be circulated to the following bodies, as may be necessary on a case to case basis, for their comments:

i. The Ministry of Corporate Affairs

ii. The Reserve Bank of India

iii. The Securities and Exchange Board of India

iv. The Insurance Regulatory and Development Authority

v. The Comptroller and Auditor General of India

vi. The Central Board of Direct Taxes

vii. The Institute of Cost and Works Accountants of India

viii. The Institute of Company Secretaries of India

ix. The Associated Chambers of Commerce and Industry

x. The Federation of Indian Chambers of Commerce and Industry

xi. The Confederation of Indian Industry

xii. The Indian Banks' Association

xiii. The Foreign Exchange Dealers' Association of India

xiv. The Standing Conference of Public Enterprises

xv. All recognised Stock Exchanges in India

xvi. The Competition Commission of India

xvii. The National Bank for Agricultural and Rural Development

xviii. The Controller General of Accounts

xix. The Ministry of Finance – Insurance and Banking Divisions

xx. The Indian Institute of Management - Ahmedabad, Bangalore, Kolkata, Indore, Kochi and Lucknow

xxi. The Central Registrar of Cooperative Societies, Government of India

xxii. The Bombay Mercantile Association

The Board may, however, in addition to the bodies listed above, circulate the Exposure Draft for comments to such other bodies also, as considered appropriate by it.

4.7 After taking into consideration the comments received on the Exposure Draft, the draft of the proposed Standard will be finalised by the Board and submitted for the consideration of the Council of the Institute.

4.8 The Council of the Institute will consider the final draft of the proposed Standard on Internal Audit and if necessary, modify the same in consultation with the Internal Audit Standards Board. The SIA will then be issued under the authority of the Council of the Institute.

4.9 For a substantive revision of a Standard on Internal Audit, the procedure followed for formulation of a new Standard on Internal Audit, as detailed in paragraphs 4.1 through 4.8 will be followed.

4.10 Subsequent to the issuance of a Standard on Internal Audit, some aspect(s) may require revision which are not substantive in nature. For this purpose, the Institute of Chartered Accountants of India may make limited revision to a Standard on Internal Audit. The procedure followed for the limited revision will substantially be the same as that to be followed for formulation of a Standard on Internal Audit, ensuring that sufficient opportunity is given to various interest groups and general public to react to the proposal for limited revision.

5. Procedure for Issuing the Guidance Notes on Internal Audit

Broadly, the following procedure will be adopted for issuing Guidance Notes on internal audit.

5.1 The Board will identify the issues on which Guidance Notes need to be formulated and the priority in regard to selection thereof.

5.2 In the preparation of the Guidance Notes, the Board will be assisted by Study Groups constituted to consider specific subjects. In the formation of the Study Groups, provision will be made for participation of a cross section of members of the Institute. In situations considered necessary, the Board may also consider having an expert on such Study Groups, subject to such terms and conditions, as may be finalised by the Board. Such expert need not necessarily be a member of the Institute of Chartered Accountants of India. The Study Group will be responsible for preparing the draft of the Guidance Note.

5.3 The above mentioned draft Guidance Note would be considered by the Board. On the basis of the deliberations of the Board on the draft Guidance Note, the draft of the proposed Guidance Note will be finalised by the Board and submitted for the consideration of the Council of the Institute. Unlike Standards on Internal Audit, ordinarily, no proposed Guidance Note will be required to be exposed for comments of the members and others. However, in situations considered necessary by the Board, an Exposure Draft of a Guidance Note may as well be issued for comments. In case an Exposure Draft of a Guidance Note is issued, the same procedures as required for an Exposure Draft of an SIA (listed in paragraphs 4.3 through 4.8 above) will be required to be followed.

5.4 The Council of the Institute will consider the final draft of the proposed Guidance Note and, if necessary, modify the same in consultation with the Internal Audit Standards Board. The Guidance Note will then be issued under the authority of the Council.

6. Compliance with the Standards and Guidance Notes on Internal Audit

6.1 The SIA(s) will be mandatory from the respective date(s) mentioned in the SIA(s). However, any limitation in the applicability of a specific Standard shall be made clear in the Standard. The mandatory status of a Standard on Internal Audit implies that while carrying out an internal audit, it shall be the duty of the members of the Institute to ensure that the SIAs are followed. If, for any reason, a member has not been able to perform all or any of such activities, as mentioned before, in accordance with the SIAs, his report should draw attention to the material departures therefrom.

6.2 Guidance Notes on internal audit are primarily designed to provide guidance to the members on matters which may arise in the course of their internal audit work and on which they may desire assistance in resolving issues which may pose difficulty. The Guidance Notes on internal audit will be recommendatory in nature. A member should, ordinarily, follow recommendations in a Guidance Note on internal audit except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

6.3 If any Standard or Guidance Note on Internal Audit is in variance/conflicts with any circular/notification/any such direction issued by any regulatory authority, the latter shall prevail. The member should, however, describe this fact in their internal audit report.

6.4 Whenever any specific Standard on Internal Audit is issued by the ICAI for which any Guidance Note is already in existence, then the date on which the Standard comes into effect, the Guidance Note shall stand withdrawn. Guidance Note will be ceased to exist from the date when Standard on Internal Audit is made applicable.

7. Effective Date

7.1 Members will be expected to follow SIAs in the internal audits commencing on or after the date(s) specified in the Standard.

SECTION II

Framework

FRAMEWORK FOR STANDARDS ON INTERNAL AUDIT*

Contents

Paragraph(s)

* Published in the October 2008 issue of *The Chartered Accountant*.

Introduction and Scope

1. In February 2004, the Institute of Chartered Accountants of India, set-up the Internal Audit Standards Board[1]. The main function of the Internal Audit Standards Board, as set out in its Terms of Reference and the Preface to the Standards on Internal Audit, is to review the existing internal audit practices in India and to develop Standards on Internal Audit (SIAs).

2. Paragraph 3.1 of the *Preface to the Standards on Internal Audit*, issued by the Council of the Institute of Chartered Accountants of India in 2004, describes internal audit as follows:

   "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."

3. Every standard setting process requires a framework, hence the need for this Framework for Standards on Internal Audit. The overall objective of the Framework for Standards on Internal Audit is to promote professionalism in the internal audit activity.

4. Internal audit is conducted in variant economic, legal, cultural and business environments. The organisations in which internal audit is performed differ widely in size, structure, nature of business, scale, purpose, objectives and geographical spread. Further, the internal audit activity may be performed by an entity's employees or by some external agency. Thus, the Framework for Standards on Internal Audit applies to all the persons performing internal audit activity, irrespective of whether the function is performed in-house or by an external agency.

5. The Framework for Standards on Internal Audit would cover all aspects of an internal audit activity, including, planning, gathering evidence, documentation, using the work of other experts, evaluating controls and risk management systems and reporting.

[1] Hitherto known as Committee on Internal Audit.

Components of the Framework

6. The Framework for Standards on Internal Audit comprises four components *viz*, the Code of Conduct, the Competence Framework, the Body of Standards and the Technical Guidance. Each of these components has been discussed in the following paragraphs.

The Code of Conduct

7. The Code of Conduct establishes the essential principles of conduct and prescribes ethical behaviour for the professionals in internal audit activity. Every professional must make a commitment to ethical conduct, including integrity, confidentiality, etc.

8. A member of the Institute of Chartered Accountants of India, carrying out an internal audit activity, would additionally be governed by:

   (i) the requirements of the Chartered Accountants Act, 1949;

   (ii) the Code of Ethics issued by the Institute of Chartered Accountants of India; and

   (iii) other relevant pronouncements of the Institute of Chartered Accountants of India.

The Competence Framework

9. The Competence Framework addresses the key characteristics that are required of persons performing internal audit. This includes aspects, such as, objectivity, technical competence, interpersonal skills, operational efficiency and due professional care. The Competence Framework is a minimum expectation.

The Body of Standards

10. The Body of Standards ensures commitment to providing quality services and details the expectations required of the individuals engaged in internal audit in discharging their responsibilities. The Standards will specify basic principles and processes, such as defining the scope,

planning, communicating, etc. They will further establish the basis for quality and performance evaluation of internal audit. The Body of Standards are mandatory minimum requirements that all the internal auditors must meet.

The Technical Guidance

11. Technical Guidance can take two forms. It will include explanatory material on the Standards or it may detail the application of Standards in specific industries or situations in the form of Technical Guides. These Technical Guides would, therefore, provide guidance to internal auditors in resolving professional issues arising during the course of an internal audit while discharging their duties as internal auditors.

Authority

12. The first three components of the Framework for Standards on Internal Audit *viz.*, the Code of Conduct, the Competence Framework and the Body of Standards shall be mandatory. Compliance with the mandatory elements of the Framework for Standards on Internal Audit is necessary to meet the responsibilities placed upon the internal auditors in execution of their work since the internal audit activity is carried out at the behest of the governing body and/or the management of an entity and renders service by assessing and reporting upon the effectiveness of issues related to governance, risk and controls and making recommendations for improvements in these areas.

SECTION III

Standards on Internal Audit

The following is the text of the Standards on Internal Audit (SIAs) issued by the Council of the Institute of Chartered Accountants of India. These Standards should be read in conjunction with the *Preface to the Standards on Internal Audit*, issued by the Institute.

In terms of the decision of the Council of the Institute of Chartered Accountants of India taken at its 260th meeting held in June 2006, the following Standards on Internal Audit shall be recommendatory in nature in the initial period. The Standards shall become mandatory from such date as notified by the Council.

STANDARD ON INTERNAL AUDIT (SIA) 1

PLANNING AN INTERNAL AUDIT*

Contents

Paragraph(s)

* Published in the September 2006 issue of *The Chartered Accountant*.

Objectives of Planning

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance in respect of planning an internal audit. An internal audit plan is a document defining the scope, coverage and resources, including time, required for an internal audit over a defined period. **The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.** Adequate planning ensures that appropriate attention is devoted to significant areas of audit, potential problems are identified, and that the skills and time of the staff are appropriately utilised. Planning also ensures that the work is carried out in accordance with the applicable pronouncements of the Institute of Chartered Accountants of India.

2. The overall objectives of an internal audit, as defined in the Preface to the Standards on Internal Audit are:

   - to suggest improvements to the functioning of the entity; and

   - to strengthen the overall governance mechanism of the entity, including its strategic risk management as well as internal control system.

3. Internal audit, therefore, helps *inter alia* in:

   (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.

4. **The internal audit plan should be comprehensive enough to ensure that it helps in achieving of the above overall objectives of an internal audit. The internal audit plan should, generally, also be consistent with the goals and objectives of the internal audit function as listed out in the internal audit charter as well as the goals and objectives of the organisation.** An internal audit charter is an important document defining the position of the internal audit *vis a vis* the organisation. The internal audit charter also outlines the scope of internal audit as well as the duties, responsibilities and powers of the internal auditor(s). **In case the entire internal audit or the particular internal audit engagement has been outsourced, the internal auditor should also ensure that the plan is consistent with the terms of the engagement.**

5. Planning involves developing an overall plan for the expected scope and conduct of audit and developing an audit programme showing the nature, timing and extent of audit procedures. Planning is a continuous exercise. **A plan once prepared should be continuously reviewed by the internal auditor to identify any modifications required to bring the same in line with the changes, if any, in the audit environment. However, any major modification to the internal audit plan should be done in consultation with those charged with governance. Further, the internal auditor should also document the changes to the internal audit plan.**

6. The internal auditor may also discuss the significant elements of his overall plan, including important procedures, with those charged with

governance. This would help the internal auditor as well as the client to assess whether the internal audit is directed to achieve the objectives as set out in the terms of engagement. The discussion would also help the internal auditor to gauge whether the client's perception of the role and responsibilities of the internal auditor is appropriate. **The internal auditor should also assess the client expectations as to the assurance level on different aspect of entity's operations and controls.** For instance, the client may feel assured if inventories are verified once in a quarter, while for cash verification, monthly interval may be specified. This will enable the auditor to plan the frequency and extent of audit procedures to be adopted.

Factors Affecting the Planning Process

7. **The internal audit plan should be based on the knowledge of the entity's business. While developing the internal audit plan, the internal auditor should have regard to the objectives of the internal audit engagement as well as the time and resources required for conducting the engagement. In addition, the internal audit plan should also reflect the risk management strategy of the entity.** Planning an internal audit involves establishing the overall strategy for the engagement so as to keep the risks associated with the assignment at the acceptable level. Therefore, the planning process is also influenced by the internal auditor's understanding and assessment of:

    - The objectives of the activity being subjected to internal audit.
    - The significant risks associated with the above activity.
    - The risk management and internal control system instituted in the organisation to reduce the above risks to an acceptable level.
    - The possible areas in which the internal audit can suggest improvement to the risk management and/or internal control system associated with the concerned activity.

- The selection of engagement team (including, where necessary, the engagement team quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members.

- Business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.

- Industry developments such as changes in industry regulations and new reporting requirements.

- Changes in the financial reporting framework, such as changes in accounting standards.

- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Scope of Planning

8. Internal audit plan should cover areas such as:

- **Obtaining the knowledge of the legal and regulatory framework within which the entity operates.**

- **Obtaining the knowledge of the entity's accounting and internal control systems and policies.**

- **Determining the effectiveness of the internal control procedures adopted by the entity.**

- **Determining the nature, timing and extent of procedures to be performed.**

- **Identifying the activities warranting special focus based on the materiality and criticality of such activities, and their overall effect on operations of the entity.**

- **Identifying and allocating staff to the different activities to be undertaken.**

- **Setting the time budget for each of the activities.**
- **Identifying the reporting responsibilities.**

The internal audit plan should also identify the benchmarks against which the actual results of the activities, the actual time spent, the cost incurred would be measured.

9. The scope of an internal audit is normally affected by factors such as:

- Terms of the engagement.
- Nature of accounting system – manual or IT-based - and the degree of reliance placed by the auditor on the same.
- Accounting policies adopted by the entity.
- Nature of information technology system used by the client in the various business processes and the exception reports generated by the system.
- Authorization and delegation of authority in the systems environment and data entry checks and data security measures including generation of day end logs of security and authorisation violations.
- The nature of management information system in vogue and the extent to which the management information system reports are used by the client in establishing and reviewing internal controls.
- Expected audit coverage, including identification of areas of audit requiring special attention, number and locations to be included, nature of business segments to be audited and the need, if any, for specialized knowledge.
- Materiality thresholds established in respect of various areas of audit especially, those areas requiring special attention.
- Nature and extent of audit evidence to be obtained.

- Experience and skills of the staff and the need for supervising, directing, coordinating and reviewing their work.

- Requirements of the applicable pronouncements of the Institute of Chartered Accountants of India.

- Statutory or regulatory framework in which the entity operates.

Planning Process

Obtaining Knowledge of the Business

10. **The internal auditor should obtain a level of knowledge of the entity sufficient to enable him to identify events, transactions, policies and practices that may have a significant effect on the financial information.** Following are some of the sources wherefrom the internal auditor can obtain such knowledge:

    - Previous experience, if any, with the entity and the industry.

    - Legislation and regulations that significantly affect the entity.

    - Entity's policy and procedures manual.

    - Minutes of the meetings of the shareholders, board of directors, and important committees of the board such as the audit committee, remuneration committee, shareholders' grievances committee.

    - Management reports/ internal audit reports of prior periods.

    - Newspaper/ industry journals.

    - Discussion with client's management and staff.

    - Visits to entity's plant facilities etc., to obtain first hand information regarding the production processes of the entity.

    - Visits to the entity's department where the accounting and other documents are generated, maintained, and the administrative procedures followed.

- Other documents produced by the entity, for example, material sent to the shareholders and the regulatory authorities, management policy manuals, manuals relating to accounting and internal controls, organizational charts, job description charts, etc.

Knowledge of the entity's business, among other things, helps the internal auditor to identify areas requiring special focus, evaluate the appropriateness of the accounting policies and disclosures, accounting estimates and management representations. Knowledge of the business would also help the auditor to identify the priorities of the business, critical factors or constraints in the smooth running of the business as also understand the trends in respect of various financial and operating ratios, etc.

Establishing the Audit Universe

11. The next step in audit planning is establishment of the audit universe or the audit territory. Audit universe comprises the activities, operations, units etc., to be subjected to audit during the planning period. The audit universe is designed to reflect the overall business objectives and therefore includes components from the strategic plan of the entity. Thus, the audit universe is affected by the risk management process of the client. **The audit universe and the related audit plan should also reflect changes in the management's course of action, corporate objectives, etc.**

12. As discussed in paragraph 4, planning is a continuous exercise. **The internal auditor should periodically, say half yearly, review the audit universe to identify any changes therein and make necessary amendments, to make the audit plan responsive to those changes.**

Establishing the Objectives of the Engagement

13. The next stage in planning is establishing the specific objectives of the internal audit engagement. **The establishment of such objectives should be based on the auditor's knowledge of the client's business, especially a preliminary understanding and review of**

the risks and controls associated with the activities forming subject matter of the internal audit engagement. The preliminary understanding and review involves gathering necessary information by means of a combination of the following procedures:

- Observation of the activity being performed.
- Inquiry of the staff associated with performing the activity.
- Discussion with the client.
- Reading through the internal audit reports, management reports etc., of previous periods.
- Performing analytical procedures.
- Performing actual walk-through tests.

14. The internal auditor would use the information so gathered to determine the objective(s) of the engagement as also to decide the nature, timing and extent of his procedures. **The internal auditor should also document the results of his preliminary review so conducted.** The documented results would, normally, cover aspects such as:

- Preliminary assessment and understanding the risks and controls associated with the activity, *viz*., sufficiency and appropriateness of the controls, procedures for identification and management of risks associated with the activity.
- Significant issues thrown up by such a review, for example, significant errors, non-compliance with any significant law.
- Procedures proposed to be adopted by the internal auditor to resolve the above issues.
- Preliminary time budget for completing the engagement.

Establishing the Scope of the Engagement

15. The next stage in planning an internal audit is establishing the scope of the engagement. **The scope of the engagement should be sufficient in coverage so as to meet the objectives of the engagement. The internal auditor should consider the information gathered during the preliminary review stage to determine the scope of his audit procedures.** The nature and extent of the internal auditor's procedures would also be affected by the terms of the engagement. **In case the internal auditor is of the view that circumstances exist which would restrict the auditor from carrying out the procedures, including any alternative procedures, considered necessary by him, he should discuss the matter with the client to reach a conclusion whether or not to continue the engagement. The scope of his engagement should documented comprehensively to avoid misunderstanding on the areas covered for audit.** The internal auditors are often confronted with a situation where client denies access to certain information or has a negative list of areas where internal audit is not desired. There are also situations where while the client requires internal audit procedures to be carried but findings are not to form part of the report but to be reported separately.

16. Further, in case of information technology based environment, the scope of engagement would include the extent to which internal auditor are permitted to access the system and reports which can be viewed and those which can be exported. **Further, system based audit tools that an internal auditor can use to draw and analyze the data should be clearly understood in the scope of his engagement.**

Deciding the Resource Allocation

17. Once the scope of the internal audit procedures is established, the next phase is that of deciding upon the resource allocation. Efficient resource allocation is essential to achieve the desired objective, within the constraints of time and cost as well as optimum utilization of resources. **For this purpose, the internal auditor should prepare an audit work schedule, detailing aspects such as:**

    - **activities/ procedures to be performed;**

- **engagement team responsible for performing these activities/ procedures; and**

- **time allocated to each of these activities/ procedures.**

18. While preparing the work schedule, the internal auditor should have regard to aspects such as:

- **any significant changes to the entity's missions and objectives, business processes, and management's strategies to counter these changes, for example, changes in the entity's controls structure or changes in the risk assessment and management structures.**

- **any changes or proposed changes to the governance structure of the entity.**

- **composition of the engagement team in terms of skills and experience and any changes thereto.**

The engagement work schedule should, however, be flexible enough to accommodate any unanticipated changes as well as professional judgment of the engagement team in the components of the audit universe as discussed above. The work schedule should also reflect the internal auditor's assessment of risks associated with various areas covered by the particular internal audit engagement and the priority attached thereto.

Preparation of Audit Programme

19. **The internal auditor should also prepare a formal internal audit programme listing the procedures essential for meeting the objective of the internal audit plan. Though the form and content of the audit programme and the extent of its details would vary with the circumstances of each case, yet the internal audit programme should be so designed as to achieve the objectives of the engagement and also provide assurance that the internal audit is carried out in accordance with the Standards on Internal Audit.** As a corollary, the audit plan developed by the internal auditor

would need to be a risk-based plans, appropriately reflecting and addressing the priorities of the internal audit activity, consistent with the organisation's goals. **The internal audit programme should also be finalised in consultation with the appropriate authority before the commencement of the work.** The internal audit programme identifies, in appropriate details, the objectives of the internal audit in respect of each area, the procedures to be performed to achieve those objectives, the staff responsible for carrying out the particular activity, the time allocated to each activity as also the sufficiently detailed, instructions to the staff as to how to carry out those procedures. The internal audit programme may also have provision for information such as the procedures actually performed, reasons for not performing the originally identified procedures, actual time consumed in carrying out the relevant procedure, reasons for deviations from budgeted time etc. A well prepared, comprehensive audit programme helps proper execution of the work as well as of the proper supervision, direction and control of the performance of the engagement team.

Effective Date

20. This Standard on Internal Audit is applicable to all internal audits commencing on or after ……………………… Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 2

BASIC PRINCIPLES GOVERNING INTERNAL AUDIT*

Contents

Paragraph(s)

* Published in the August 2007 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards and provide guidance on the general principles governing internal audit.

2. Paragraph 3.1 of the Preface to the Standards on Internal Audit, issued by the Institute of Chartered Accountants of India defines internal audit as follows:

   "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 risk management and internal control system."

3. The other Standards on Internal Audit to be issued by the Institute of Chartered Accountants of India will elaborate the principles set out herein to give guidance on internal auditing procedures and reporting practices. Compliance with the basic principles requires the application of internal auditing procedures and reporting practices appropriate to the particular circumstances.

Integrity, Objectivity and Independence

4. **The internal auditor should be straightforward, honest and sincere in his approach to his professional work.** He must be fair and must not allow prejudice or bias to override his objectivity. **He should maintain an impartial attitude. He should not only be independent in fact but also appear to be independent. The internal auditor should not, therefore, to the extent possible, undertake activities, which are or might appear to be incompatible with his independence and objectivity.** For example, to avoid any conflict of interest, the internal auditor should not review an activity for which he was previously responsible. It is also expected from the management to take steps necessary for providing an environment conducive to enable the internal auditor to discharge his responsibilities independently and also report his findings without any management interference. For example, in case of a listed company, the internal auditor may be required to report directly to those charged with governance, such as the Audit Committee instead of the Chief Executive

Officer or the Chief Financial Officer. **The internal auditor should immediately bring any actual or apparent conflict of interest to the attention of the appropriate level of management so that necessary corrective action may be taken.**

Confidentiality

5. **The internal auditor should maintain the confidentiality of the information acquired in the course of his work and should not disclose any such information to a third party, including the employees of the entity, without the specific authority of the management/ client or unless there is a legal or a professional responsibility to do so.** The internal auditor, therefore, needs to ensure that there are well laid out policies and controls to protect confidentiality of the information.

Due Professional Care, Skills and Competence

6. **The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit.** Due professional care signifies that the internal auditor exercises reasonable care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit, assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement.

7. The internal auditor should either have or obtain such skills and competence, acquired through general education, technical knowledge obtained through study and formal courses, as are necessary for the purpose of discharging his responsibilities.

8. The internal auditor also has a continuing responsibility to maintain professional knowledge and skills at a level required to ensure that the client or the employer receives the advantage of competent professional service based on the latest developments in the profession, the economy, the relevant industry and legislation.

Work Performed by Others

9. The internal auditor would often need to delegate work to assistants. **The internal auditor should carefully direct, supervise and review the work delegated to assistants.** Similarly, the internal auditor may also need to use the work performed by other auditors or experts. Though the internal auditor will be entitled to rely on the work performed by other auditors and experts, he should exercise adequate skill and care in ascertaining their competence and skills and also in evaluating, analysing and using the results of the work performed by the experts. He must also look into the assumptions, if any, made by such other experts and obtain reasonable assurance that the work performed by other auditors and experts is adequate for his purposes. **He should be satisfied that he has no reasons to believe that he should not have relied on the work of the expert.** The reliance placed on the work done by the assistants and/ or other auditors and experts notwithstanding, the internal auditor will continue to be responsible for forming his opinion on the areas/ processes being subject to internal audit or his findings.

Documentation

10. **The internal auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the Standards on Internal Audit and support his findings or the report submitted by him.** In addition, the working papers also help in planning and performing the internal audit, review and supervise the work and most importantly, provide evidence of the work performed to support his findings or the report(s).

Planning

11. **The internal auditor should plan his work to enable him to conduct an effective internal audit in a timely and efficient manner, ensuring that appropriate attention is devoted to significant areas of audit, identification of potential problems and appropriate utilisation of skills and time of the staff.**

12. **The internal audit plan should be based on the knowledge of the business of the entity.** The internal audit plan would normally cover aspects such as:

    (i) obtaining the knowledge of the legal and regulatory framework within which the entity operates;

(ii) obtaining the knowledge of the entity's accounting and internal control systems and policies;

(iii) determining the effectiveness of the internal control procedures adopted by the entity;

(iv) identifying the activities warranting special focus based on the materiality and criticality of such activities, and its overall effect on presentation of the financial statements of the entity;

(v) identifying and allocating staff to each of the above activities;

(vi) determining the nature, timing and extent of procedures to be performed;

(vii) setting the time budget for each of the above activities;

(viii) identifying the reporting responsibilities; and

(ix) benchmark against which the actual results of the activities, the actual time spent, the cost incurred would be measured.

13. **A plan once prepared should be continuously reviewed by the internal auditor to identify any modifications to the plan required to bring the same in line with the changes, if any, to the audit universe.** Audit universe comprises the activities, operations, units, etc., to be subjected to audit during the planning period.

Evidence

14. **The internal auditor should, based on his professional judgment, obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings.** Factors affecting the professional judgment include the activity under audit, possible errors and their materiality and the risk of occurrence of such errors.

Internal Control and Risk Management Systems

15. While the management is responsible for establishment and maintenance of appropriate internal control and risk management systems, the role of

the internal auditor is to suggest improvements to those systems. **For this purpose, the internal auditor should:**

(i) **Obtain an understanding of the risk management and internal control framework established and implemented by the management.**

(ii) **Perform steps for assessing the adequacy of the framework developed in relation to the organisational set up and structure.**

(iii) **Review the adequacy of the framework.**

(iv) **Perform risk-based audits on the basis of risk assessment process.**

Internal auditor may, however, also undertake work involving identification of risks as well as recommend design of controls or gaps in existing controls to address those risks.

Reporting

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

Effective Date

17. This Standard on Internal Audit is effective for all internal audits beginning on or after…………………… Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 3
DOCUMENTATION*

Contents

Paragraph(s)

* Published in the August 2007 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish Standards and provide guidance on the documentation requirements in an internal audit.

2. Paragraph 10 of the Standard on Internal Audit (SIA) 2, *Basic Principles Governing Internal Audit,* states as follows:

   "10. The internal auditor should document matters, which are important in providing evidence that the audit was carried out in accordance with the Standards on Internal Audit and support his findings or the report submitted by him. *In addition, the working papers also help in planning and performing the internal audit, review and supervise the work and most importantly, provide evidence of the work performed to support his findings or report(s)."*

Definitions

3. (a) "*Internal audit documentation*" means the record of audit procedures performed, including audit planning as discussed in the Standard on Internal Audit (SIA) 1, *Planning an Internal Audit,* relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used). Thus, documentation refers to the working papers prepared or obtained by the internal auditor and retained by him in connection with the performance of his internal audit.

   (b) "*Experienced internal auditor*" or "*a reviewer*" means an individual (whether internal or external to the entity) who has:

   (i) reasonable knowledge and experience of internal audit processes;

   (ii) reasonable knowledge of SIAs, other relevant pronouncements of the Institute and applicable legal and regulatory requirements;

(iii) reasonable understanding of the business environment in which the entity operates; and

(iv) reasonable understanding of internal audit issues relevant to the entity's industry.

4. Internal audit documentation:

- Aid in planning and performing the internal audit.
- Aid in supervision and review of the internal audit work.
- Provide evidence of the internal audit work performed to support the internal auditor's findings and opinion.
- Aid in third party reviews, where so done.
- Provide evidence of the fact that the internal audit was performed in accordance with the scope of work as mentioned in the engagement letter, SIAs and other relevant pronouncements issued by the Institute of Chartered Accountants of India.

Form and Content

5. Internal audit documentation may be recorded on paper or on electronic or other media. It includes, for example, audit programmes, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence (including e-mail) concerning significant matters. Abstracts or copies of the entity's records, for example, significant and specific contracts and agreements, may be included as part of internal audit documentation, if considered appropriate. Internal audit documentation, however, is not a substitute for the entity's accounting records. The internal audit documentation for a specific internal audit engagement is assembled in an audit file.

6. Internal audit documentation should record the internal audit charter, the internal audit plan, the nature, timing and extent of audit procedures performed, and the conclusions drawn from the

evidence obtained. In case the internal audit is outsourced, the documentation should include a copy of the internal audit engagement letter, containing the terms and conditions of the appointment.

7. **Internal audit documentation should be designed and properly organised to meet the requirements and circumstances of each audit and the internal auditor's needs in respect thereof. The internal auditor should formulate policies that help in standardization of the internal audit documentation.** The standardization may be in the form of checklists, specimen letters, questionnaires, etc.

8. **Internal audit documentation should be sufficiently complete and detailed for an internal auditor to obtain an overall understanding of the audit.** The extent of documentation is a matter of professional judgment since it is neither practical nor possible to document every observation, finding or conclusion in the internal audit documentation. **All the significant matters which require exercise of judgment, together with the internal auditor's conclusion thereon should be included in the internal audit documentation. However, the documentation prepared by the internal auditor should be such that enables an experienced internal auditor (or a reviewer), having no previous connection with the internal audit to understand:**

   (a) the nature, timing and extent of the audit procedures performed to comply with SIAs and applicable legal and regulatory requirements;

   (b) the results of the audit procedures and the audit evidence obtained;

   (c) significant matters arising during the audit and the conclusions reached thereon; and

   (d) terms and conditions of an internal audit engagement/ requirements of the internal audit charter, scope of work, reporting requirements, any other special conditions, affecting the internal audit.

9. The form, extent and contents of the documentation would also be affected by the nature and terms of the engagement, and any statutory or regulatory requirements in that regard. The form, content and extent of internal audit documentation depend on factors such as:

   - the nature and extent of the audit procedures to be performed;
   - the identified risks of material misstatement;
   - the extent of judgment required in performing the work and evaluating the results;
   - the significance of the audit evidence obtained;
   - the nature and extent of exceptions identified;
   - the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
   - the audit methodology and tools used.

   It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.

10. **The internal audit documentation should cover all the important aspects of an engagement *viz.*, engagement acceptance, engagement planning, risk assessment and assessment of internal controls, evidence obtained and examination/ evaluation carried out, review of the findings, communication and reporting and follow up.** The internal audit documentation would, therefore, generally, include:

    - Engagement letter or the internal audit charter, as the case may be.
    - Internal audit plan and programme.
    - Papers relating to the staff requirement and allocation.
    - Papers relating to requirements for technical experts, if any .

- Time and cost budgets.
- Copies of significant contracts and agreements or management representations on terms and conditions of those contracts.
- Internal review reports.
- Evaluation questionnaires, checklists, flowcharts, etc.
- Papers relating to discussions/ interviews with the various personnel including legal experts, etc.
- Chart of the organizational structure, job profile of the persons listed in the chart and rules of delegation of powers.
- Annual budget and development plan.
- Progress report, MIS report.
- Reconciliation statements.
- Communication with the client personnel and third parties, if any.
- Certification and representations obtained from management.
- Copies of relevant circulars, extracts of legal provisions.
- Results of risk and internal control assessments.
- Analytical procedures performed and results thereof.
- List of queries and resolution thereof.
- Copy of draft audit report, along with the comments of the auditee thereon and final report issued.
- Records as to the follow up on the recommendations/ findings contained in the report.

Identification of the Preparer and the Reviewer

11. It is also essential that the internal audit documentation identify the following:

    (i) who performed that task and the date such work was completed;

    (ii) who reviewed the task performed and the date and extent of such review;

    (iii) reasons for creating the particular internal audit documentation;

    (iv) source of the information contained in the internal audit documentation; and

    (v) any cross referencing to any other internal audit documentation.

    The preparers and reviewers of the internal audit documentation should also sign them.

12. **The internal audit file should be assembled within sixty days after the signing of the internal audit report.** Assembly of the internal audit documentation file is only an administrative process and does not involve performance of any new audit procedures or formulation of new conclusions. Changes may be made to the audit documentation file only if such changes are administrative in nature. For example:

    - deleting or discarding superseded documentation;
    - sorting, collating and cross referencing internal audit documentation;
    - signing off on completion checklists relating to file assembly process;
    - documenting audit evidence that the internal auditor has obtained, discussed and agreed with the relevant members of the internal audit team before the date of the internal auditor's report.

13. When exceptional circumstances arise after the date of the submission of the internal audit report that require the internal auditor to perform new or additional audit procedures or that lead the internal auditor to reach new conclusions, the internal auditor should document:

(i) the details of circumstances encountered along with the documentary evidence, if any, thereof;

(ii) the new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and

(iii) when and by whom the resulting changes to the audit documentation were made, and (where applicable) reviewed.

Document Retention and Access

14. **The internal auditor should formulate policies as to the custody and retention of the internal audit documentation within the framework of the overall policy of the entity in relation to the retention of documents.** The internal auditor retains the ownership of the internal audit documentation. While formulating the documentation retention policy, any legal or regulatory requirements in this regard also need to be taken into consideration. Management and other designated personnel may seek access to the internal audit documentation of the internal audit department subject to the approval of the internal auditor and client or such other third party may seek access if there is any legal or regulatory requirement or as may be permitted by the client.

15. After the assembly of the audit file, the internal auditor should not delete or discard internal audit documentation before the end of the retention period.

Effective Date

16. This Standard on Internal Audit will apply to all internal audits commencing on or after …………………. Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 4
REPORTING*

Contents

Paragraph(s)

* Published in the October 2008 issue of *The Chartered Accountant*.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on the form and content of the internal auditor's report issued as a result of an internal audit performed by an internal auditor of the systems, processes, controls including items of financial statements of an entity.

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

3. This review and assessment involves considering whether the systems, procedures and controls are in existence and are operating effectively.

4. The internal auditor's report should contain a clear written expression of significant observations, suggestions/ recommendations based on the policies, processes, risks, controls and transaction processing taken as a whole and managements' responses.

Basic Elements of the Internal Audit Report

5. The internal auditor's report includes the following basic elements, ordinarily, in the following layout:

   (a) Title;

   (b) Addressee;

   (c) Report Distribution List;

   (d) Period of coverage of the Report;

   (e) Opening or introductory paragraph:

      (i) identification of the processes/ functions and items of financial statements audited; and

(ii) a statement of the responsibility of the entity's management and the responsibility of the internal auditor;

(f) Objectives paragraph - statement of the objectives and scope of the internal audit engagement;

(g) Scope paragraph (describing the nature of an internal audit):

(i) a reference to the generally accepted audit procedures in India, as applicable;

(ii) a description of the engagement background and the methodology of the internal audit together with procedures performed by the internal auditor; and

(iii) a description of the population and the sampling technique used.

(h) Executive Summary, highlighting the key material issues, observations, control weaknesses and exceptions;

(i) Observations, findings and recommendations made by the internal auditor;

(j) Comments from the local management;

(k) Action Taken Report – Action taken/ not taken pursuant to the observations made in the previous internal audit reports;

(l) Date of the report;

(m) Place of signature; and

(n) Internal auditor's signature with Membership Number.

A measure of uniformity in the form and content of the internal auditor's report is desirable because it helps to promote the reader's understanding of the internal auditor's report and to identify unusual circumstances when they occur.

6. **The internal auditor should exercise due professional care to ensure that the internal audit report*, inter alia*, is:**

   (i) clear

   (ii) factual – presents all significant matters with disclosure of material facts

   (iii) specific

   (iv) concise

   (v) unambiguous

   (vi) timely

   (vii) complies with generally accepted audit procedures in India, as applicable.

Title

7. **The internal auditor's report should have an appropriate title expressing the nature of the Report.**

Addressee

8. **The internal auditor's report should be appropriately addressed as required by the circumstances of the engagement.** Ordinarily, the internal auditor's report is addressed to the appointing authority or such other person as directed.

Report Distribution List, Coverage and Opening or Introductory Paragraph

9. **There should be a mention of the recipients of the report in the section on Report Distribution List.**

10. **The internal auditor's report should identify the systems, processes, functional lines or other items of the entity that have been audited, including the date of and period covered.**

11. The report should include a statement that the operation of systems, procedures and controls are the responsibility of the entity's management and a statement that the responsibility of the internal auditor is to express an opinion on the weaknesses in internal controls, risk management and governance (entity level controls) framework, highlighting any exceptions and cases of non-compliance and suggest or recommend improvements in the design and operations of controls based on the internal audit.

Scope Paragraph

12. **The internal auditor's report should describe the scope of the internal audit by stating that the internal audit was conducted in accordance with generally accepted audit procedures as applicable.** The management needs this as an assurance that the audit has been carried out in accordance with established Standards.

13. "Scope" refers to the internal auditor's ability to perform internal audit procedures deemed necessary in the circumstances.

14. The report should include a statement that the internal audit was planned and performed to obtain reasonable assurance whether the systems, processes and controls operate efficiently and effectively and financial information is free of material misstatement.

15. The internal auditor's report, in line with the terms of the engagement, should describe the internal audit as including:

(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(b) assessing the strength, design and operating effectiveness of internal controls at process level and identifying areas of control weakness, business risks and vulnerability in the system and procedures adopted by the entity;

(c) assessing the accounting principles and estimates used in the preparation of the financial statements; and

(d) **evaluating the overall entity-wide risk management and governance framework.**

16. The Report should include a description of the engagement background, internal audit methodology used and procedures performed by the internal auditor mentioning further that the internal audit provides a reasonable basis for his comments.

Executive Summary Paragraph

17. The Executive Summary paragraph of the internal auditor's report should clearly indicate the highlights of the internal audit findings, key issues and observations of concern, significant controls lapses, failures or weaknesses in the systems or processes.

Observations (Main Report) Paragraph

18. The Observations paragraph should clearly mention the process name, significant observations, findings, analysis and comments of the internal auditor.

Comments from Local Management

19. The Comments from Local Management Paragraph should contain the observations and comments from the local management of the entity provided after giving due cognizance to the internal auditor's comments. This should also include local management's action plan for resolution of the issues and compliance to the internal auditor's recommendations and suggestions on the areas of process and control weakness/ deficiency. The management action plan, should contain, *inter alia*:

(a) the timeframe for taking appropriate corrective action;

(b) the person responsible; and

(c) resource requirements, if any, for ensuring such compliance.

20. Further comments from the internal auditor, in response to the auditee feedback, are to be clearly mentioned. **This paragraph should also**

contain the internal auditor's suggestions and recommendations to mitigate risks, strengthen controls and streamline processes with respect to each of the observations and comments made.

Action Taken Report Paragraph

21. The Action Taken Report paragraph should be appended after the observations and findings and should include:

(a) Status of compliance/ corrective action already taken/ being taken by the auditee with respect to previous internal audit observations;

(b) Status of compliance/ corrective action not taken by the auditee with respect to previous internal audit observations and the reasons for non-compliance thereof; and

(c) Revised timelines for compliance of all open items in (b) above and fixation of the responsibility of the concerned process owner.

Date

22. The date of an internal auditor's report is the date on which the internal auditor signs the report expressing his comments and observations.

Place of Signature

23. The report should name the specific location, which is ordinarily the city where the internal audit report is signed.

Internal Auditor's Signature

24. The report should be signed by the internal auditor in his personal name. The internal auditor should also mention the membership number assigned by the Institute of Chartered Accountants of India in the report so issued by him.

Communication to Management

25. The internal audit report contains the observations and comments of the internal auditor, presents the audit findings, and discusses recommendations for improvements. **To facilitate communication and ensure that the recommendations presented in the final report are practical from the point of view of implementation, the internal auditor should discuss the draft with the entity's management prior to issuing the final report. The different stages of communication and discussion should be as under:**

    (a) ***Discussion Draft*** **- At the conclusion of fieldwork, the internal auditor should draft the report after thoroughly reviewing the his working papers and the discussion draft before it is presented to the entity's management for auditee's comments. This discussion draft should be submitted to the entity management for their review before the exit meeting.**

    (b) ***Exit Meeting*** **- The internal auditor should discuss with the management of the entity regarding the findings, observations, recommendations, and text of the discussion draft. At this meeting, the entity's management should comment on the draft and the internal audit team should work to achieve consensus and reach an agreement on the internal audit findings.**

    (c) ***Formal Draft*** **- The internal auditor should then prepare a formal draft, taking into account any revision or modification resulting from the exit meeting and other discussions. When the changes have been reviewed by the internal auditor and the entity management, the final report should be issued.**

    (d) ***Final Report*** **- The internal auditor should submit the final report to the appointing authority or such members of management, as directed. The periodicity of the Report should be as agreed in the scope of the internal audit engagement. The internal auditor should mention in the Report, the dates of discussion draft, exit meeting, Formal Draft and Final Report.**

Limitation on Scope

26. When there is a limitation on the scope of the internal auditor's work, the internal auditor's report should describe the limitation.

Restriction on Usage and Report Circulation Otherwise Than to the List of Intended Recipients

27. The internal auditor should state in the Report that the same is to be used for the intended purpose only as agreed upon and the circulation of the Report should be limited to the recipients mentioned in the Report Distribution List.

Effective Date

28. This Standard on Internal Audit is applicable to all internal audits commencing on or after ……………. Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 5
SAMPLING*

Contents

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* Published in the October 2008 issue of *The Chartered Accountant*.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on the design and selection of an audit sample and provide guidance on the use of audit sampling in internal audit engagements. The SIA also deals with the evaluation of the sample results. This SIA applies equally to both statistical and non-statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence.

2. **When using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of the internal audit engagement unless otherwise specified by the client.**

Definitions

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the internal auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form a conclusion concerning the population. Certain testing procedures, however, do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying internal audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

4. "Error" means either control deviations when performing tests of controls, or misstatements, when performing tests of details.

5. "Population'' means the entire set of data from which the sample is selected and about which the internal auditor wishes to draw conclusions. A population may be divided into various strata, or sub-populations, with each stratum being examined separately.

6. "Sampling risk'" means the risk that from the possibility that the internal auditor's conclusions, based on examination of a sample may be different from the conclusion reached if the entire population was subjected to the same types of internal audit procedure. The two types of sampling risk are –

   (a) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are more effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement does not exist when in fact it does.

   (b) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are less effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement exists when in fact it does not.

   The mathematical complements of these risks are termed confidence levels.

7. "Sampling unit" means the individual items or units constituting a population, for example, credit entries in bank statements, sales invoices or debtors' balances.

8. "Statistical sampling" means any approach to sampling procedure which has the following characteristics –

   (a) Random selection of a sample; and

   (b) Use of theory of probability to evaluate sample results, including measurement of sampling risk.

9. "Tolerable error" means the maximum error in a population that the internal auditor is willing to accept.

Use of Sampling in Risk Assessment Procedures and Tests of Controls

10. The internal auditor performs risk assessment procedures to obtain an understanding of the entity, business and its environment, including the mechanism of its internal control. Ordinarily, risk assessment procedures do not involve the use of sampling. However, there are cases, where the internal auditor often plans and performs tests of controls concurrently with obtaining an understanding of the design of controls and examining whether they have been implemented.

11. Tests of controls are performed when the internal auditor's risk assessment includes an expectation of the operating effectiveness of controls. Sampling of tests of controls is appropriate when application of the control leaves audit evidence of performance (for example, initials of the credit manager on a sales invoice indicating formal credit approval).

12. Sampling risk can be reduced by increasing sample size for both tests of controls and tests of details. Non-sampling risk can be reduced by proper engagement planning, supervision, monitoring and review.

Design of the Sample

13. **When designing an audit sample, the internal auditor should consider the specific audit objectives, the population from which the internal auditor wishes to sample, and the sample size.**

Internal Audit Objectives

14. The internal auditor would first consider the specific audit objectives to be achieved and the internal audit procedures which are likely to best achieve those objectives. In addition, when internal audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that

audit evidence will assist the internal auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of controls over an entity's purchasing procedures, the internal auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the internal auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the periodic financial statements. When performing tests of controls, the internal auditor makes an assessment of the rate of error the internal auditor expects to find in the population to be tested. This assessment is on the basis of the internal auditor's understanding of the design of the relevant controls, and whether they have actually been implemented or the examination of a small number of items from the population.

Population

15. The population is the entire set of data from which the internal auditor wishes to sample in order to reach a conclusion. The internal auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. For example, if the internal auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

16. The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. For example, if the internal auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The internal auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

17. It is important for the internal auditor to ensure that the population is appropriate to the objective of the internal audit procedure, which will include consideration of the direction of testing. The population also needs to be complete, which means that if the internal auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

18. When performing the audit sampling, the internal auditor performs internal audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate.

Stratification

19. To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification, therefore, enables the internal auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, the internal auditor may direct attention to larger value items for accounts receivable to detect overstated material misstatements. In addition, stratification may result in a smaller sample size.

Sample Size

20. **When determining the sample size, the internal auditor should consider sampling risk, the tolerable error, and the expected error**. The lower the risk that the internal auditor is willing to accept, the greater the sample size needs to be. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2 to the Standard.

21. The sample size can be determined by the application of a statistically based formula or through exercise of professional judgment applied objectively to the circumstances of the particular internal audit engagement.

Statistical and Non-Statistical Approaches

22. The decision of using either statistical or non-statistical sampling approach is a matter for the internal auditor's professional judgment. In the case of tests of controls, the internal auditor's analysis of the nature and cause of errors will often be of more importance than the statistical analysis of the mere presence or absence of errors. In such case, non-statistical sampling approach may be preferred.

23. When applying statistical sampling, sample size may be ascertained using either probability theory or professional judgment. Sample size is a function of several factors. Appendices 1 and 2 discuss some of these factors.

Tolerable Error

24. Tolerable error is the maximum error in the population that the internal auditor would be willing to accept and still conclude that the result from the sample has achieved the objective(s) of the internal audit. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the internal auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

25. In tests of controls, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the internal auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the internal auditor would be willing to accept so that when the results of all audit procedures are considered, the internal auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

26. If the internal auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the internal auditor would consider such matters as error levels identified in previous internal audits, changes in the entity's procedures, and evidence available from other procedures.

Selection of the Sample

27. The internal auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

28. While there are a number of selection methods, three methods commonly used are:

- Random selection and use of CAATs
- Systematic selection
- Haphazard selection

Appendix 3 to the Standard discusses these methods.

Evaluation of Sample Results

29. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the internal auditor should:

(a) analyse the nature and cause of any errors detected in the sample;

(b) project the errors found in the sample to the population;

(c) reassess the sampling risk; and

(d) consider their possible effect on the particular internal audit objective and on other areas of the internal audit engagement.

30. The internal auditor should evaluate the sample results to determine whether the assessment of the relevant characteristics of the population is confirmed or whether it needs to be revised.

Analysis of Errors in the Sample

31. In analysing the errors detected in the sample, the internal auditor will first need to determine that an item in question is in fact an error. In designing the sample, the internal auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

32. When the expected audit evidence regarding a specific sample item cannot be obtained, the internal auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been requested and no reply was received, the internal auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the internal auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the internal auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

33. The internal auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

34. In analysing the errors discovered, the internal auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In such circumstances, the internal auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The internal auditor would then perform a separate analysis based on the items examined for each sub-population.

Projection of Errors

35. The internal auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the internal auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

36. For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

Reassessing Sampling Risk

37. The internal auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the internal auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the internal auditor reassesses

the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative internal audit procedures.

38. If the evaluation of sample results indicate that the assessment of the relevant characteristic of the population needs to be revised, the internal auditor, may:

    (a) Request management to investigate the identified errors and the potential for any further errors, and to make necessary adjustments, in cases where management prescribes the sample size; and / or

    (b) Modify the nature, timing and extent of internal audit procedures. In case of tests of controls, the internal auditor might extend the sample size, test an alternative control or modify related substantive procedures; and / or

    (c) Consider the effect on the Internal Audit Report.

Documentation

39. Documentation provides the essential support to the opinion and/ or findings of the internal auditor. In the context of sampling, the internal auditor's documentation may include aspects such as:

    i. Relationship between the design of the sample *vis a vis* specific audit objectives, population from which sample is drawn and the sample size.

    ii. Assessment of the expected rate of error in the population to be tested *vis a vis* auditor's understanding of the design of the relevant controls.

    iii. Assessment of the sampling risk and the tolerable error.

    iv. Assessment of the nature and cause of errors.

v. Rationale for using a particular sampling technique and results thereof.

vi. Analysis of the nature an cause of any errors detected in the sample.

vii. Projection of the errors found in the sample to the population.

viii. Reassessment of sampling risk, where appropriate.

ix. Effect of the sample results on the internal audit's objective(s).

x. Projection of sample results to the characteristics of the population.

Effective Date

40. This Standard on Internal Audit is applicable to all internal audits commencing on or after………….. Earlier application of the SIA is encouraged.

Appendix 1

Examples of Factors Influencing Sample Size for Tests of Controls

The following are some factors which the internal auditor considers when determining the sample size required for tests of controls (TOC). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOC or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor to be considered by Internal Auditor	***Effect on sample size***
An increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls	Increase
An increase in the rate of deviation from the prescribed control activity that the internal auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribed control activity that the internal auditor expects to find in the population	Increase
An increase in the internal auditor's required confidence level	Increase
An increase in the number of sampling units in the population	Negligible effect

Notes –

1. Other things being equal, the more the internal auditor relies on the operating effectiveness of controls in risk assessment, the greater is the extent of the internal auditor's tests of controls, and hence the sample size is increased.

2. The lower the rate of deviation that the internal auditor is willing to accept, the larger the sample size needs to be.

3. The higher the rate of deviation that the internal auditor expects, the larger the sample size needs to be so as to make a reasonable estimate of the actual rate of deviation.

4. The higher the degree of confidence that the internal auditor requires that the results of the sample are indicative of the actual incidence of errors in the population, the larger the sample size needs to be.

5. For large populations, the actual population size has little effect on sample size. For small populations, sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 2

Examples of Factors Influencing Sample Size for Tests of Details (TOD)

The following are some factors which the internal auditor considers when determining the sample size required for tests of details (TOD). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOD or otherwise modify the approach to substantive procedures in response to assessed risks.

Factor to be considered by Internal Auditor	***Effect on sample size***
An increase in the internal auditor's assessment of the risk of material misstatement	**Increase**
An increase in the use of other substantive procedures by the internal auditor, directed at the same assertion	**Decrease**
An increase in the total error that the internal auditor is willing to accept (Tolerable Error)	**Decrease**
Stratification of the population when appropriate	**Decrease**
An increase in the amount of error which the internal auditor expects to find in the population	**Increase**
An increase in the internal auditor's required confidence level	**Increase**
The number of sampling units in the population	**Negligible effect**

Appendix 3

Methods of Sample Selection

The principal methods of sample selection are as –

1. **Using a computerised random number generator** or through random number tables.

2. **Systematic selection –** In this method, the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 20, and having thus determined a starting point within the first 20, each 20th sampling unit thereafter is selected. Although the starting point may be haphazardly determined, the sample is likely to be truly random if the same is determined by using a computerised random number generator or random number tables. In this method, the internal auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with any particular pattern within the population.

3. **Haphazard selection** – In this method, the internal auditor selects the sample without following any structured technique. **The internal auditor should attempt to ensure that all items within the population have a chance of selection, without having any conscious bias or predictability**. This method is not appropriate when using statistical sampling technique.

4. **Block selection –** This method involves selection of a block(s) of adjacent or contiguous items from within the population. Block selection normally cannot be used in internal audit sampling because most populations are structured in such a manner that items forming a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. This method would not be an appropriate sample selection technique when the internal auditor intends to draw valid inferences about the entire population, based on the sample.

Appendix 4

Frequency of Control Activity and Sample Size

The following guidance related to the frequency of the performance of control may be considered when planning the extent of tests of operating effectiveness of manual controls for which control deviations are not expected to be found. The internal auditor may determine the appropriate number of control occurrences to test based on the following minimum sample size for the frequency of the control activity dependant on whether assessment has been made on a lower or higher risk of failure of the control.

Frequency of control activity	**Minimum sample size**	
	Risk of failure	
	Lower	Higher
Annual	1	1
Quarterly (including period- end, i.e., +1)	1+1	1+1
Monthly	2	3
Weekly	5	8
Daily	15	25
Recurring manual control (multiple times per day)	25	40

Note : Although +1 is used to indicate that the period–end control is tested, this does not mean that for more frequent control operations the year-end operation cannot be tested.

STANDARD ON INTERNAL AUDIT (SIA) 6
ANALYTICAL PROCEDURES*

Contents

Paragraph(s)

* Published in the October 2008 issue of *The Chartered Accountant*.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on the application of analytical procedures during an internal audit.

2. **The internal auditor should apply analytical procedures as the risk assessment procedures at the planning and overall review stages of the internal audit.** Risk assessment procedures refer to the internal audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, in the information subjected to internal audit. Analytical procedures may also be applied at other stages.

3. "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships in both financial and non-financial data that are inconsistent with other relevant information or which deviate significantly from predicted amounts. Analytical procedures provide the internal auditor with an efficient and effective means of making an assessment of information collected in an audit. The assessment results from comparing such information with expectations identified or developed by the internal auditor.

Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity's financial and non-financial information with, for example:

   - Comparable information for prior periods.
   - Anticipated results of the entity, such as budgets or forecasts or expectations of the internal auditor.
   - Predictive estimates prepared by the internal auditor, such as an estimation of depreciation charge for the year.

- Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with other entities of comparable size in the same industry.

5. Analytical procedures also include consideration of relationships:

   - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.

   - Between financial information and relevant non-financial information, such as payroll costs to number of employees or total production costs to quantity produced.

6. Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information and relevant non-financial information. The internal auditor's choice of procedures, methods and level of application is a matter of professional judgement. Specific analytical procedures include, but are not limited to ratio, trend, and regression analysis, reasonableness tests, period-to-period comparisons, comparisons with budgets, forecasts, and external economic information.

7. **In determining the extent to which the analytical procedures should be used, the internal auditor should consider the following factors, including:**

   - **The significance of the area being examined.**

   - **The adequacy of the system of internal control.**

   - **The availability and reliability of financial and non-financial information.**

   - **The precision with which the results of analytical procedures can be predicted.**

- **The availability and comparability of information regarding the industry in which the organization operates.**

- **The extent to which other auditing procedures provide support for audit results.**

After evaluating the aforementioned factors, the internal auditor should consider and use additional auditing procedures, as necessary, to achieve the audit objective.

8. Analytical procedures are used for the following purposes:

   - to assist the internal auditor as risk assessment procedures to obtain initial understanding of the entity and its environment and thereafter in planning the nature, timing and extent of other internal audit procedures;

   - as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions;

   - as an overall review of the systems and processes in the final review stage of the internal audit; and

   - to evaluate the efficiency of various business/ management systems.

9. Analytical procedures may identify, among other things, differences that are not expected or absence of differences when they are expected, which may have arisen on account of factors such as errors, frauds, unusual or non recurring transaction or events, etc.

Analytical Procedures as Risk Assessment Procedures and in Planning the Internal Audit

10. **The internal auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the business, the entity and its environment and in identifying areas of potential risk.** Application of analytical procedures may indicate

aspects of the business of which the internal auditor was unaware and will assist in determining the nature, timing and extent of other internal audit procedures.

11. Analytical procedures in planning the internal audit use both financial and non-financial information, for example, in retail business, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical Procedures as Substantive Procedures

12. The internal auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions and assertions relating to process, systems and controls may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular internal audit objective is based on the internal auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions or assertions relating to process, systems and controls.

13. The internal auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the internal auditor is satisfied that such data is properly prepared.

14. When intending to perform analytical procedures as substantive procedures, the internal auditor will need to consider a number of factors such as the:

    - Objectives of the analytical procedures and the extent to which their results can be relied upon.

    - Nature of the business, entity and the degree to which information can be disaggregated.

- Availability of information, both financial, such as budgets or forecasts, and non-financial, such as the number of units produced or sold.

- Reliability of the information available, for example, whether budgets is prepared with sufficient professional care.

- Relevance of the information available, for example, whether budgets have been established as results to be expected rather than as goals to be achieved.

- Source of the information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.

- Comparability of the information available, for example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products.

- Knowledge gained during previous internal audits, together with the internal auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

- Controls over the preparation of the information, for example, controls over the preparation, review and maintenance of MIS reports, budgets, etc.

Analytical Procedures in the Overall Review at the End of the Internal Audit

15. **The internal auditor should apply analytical procedures at or near the end of the internal audit when forming an overall conclusion as to whether the systems, processes and controls as a whole are robust, operating effectively and are consistent with the internal auditor's knowledge of the business.** The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the internal audit of individual components

or elements of the financial statements, e.g., purchases, and assist in arriving at the overall conclusion. However, in some cases, as a result of application of analytical procedures, the internal auditor may identify areas where further procedures need to be applied before the internal auditor can form an overall conclusion about the systems, processes and associated controls.

Extent of Reliance on Analytical Procedures

16. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides the internal auditor evidence as to the completeness, efficiency and effectiveness of systems, processes and controls. However, reliance on the results of analytical procedures will depend on the internal auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

17. The extent of reliance that the internal auditor places on the results of analytical procedures depends on the following factors:

    - materiality of the items involved, for example, when inventory balances are material, the internal auditor does not rely only on analytical procedures in forming conclusions. However, the internal auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

    - other internal audit procedures directed toward the same internal audit objectives, for example, other procedures performed by the internal auditor while reviewing the credit management process, in the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

- accuracy with which the expected results of analytical procedures can be predicted. For example, the internal auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

- assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

18. The internal auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the internal auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the internal auditor could tests the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Investigating Unusual Items or Trends

19. When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the internal auditor should investigate and obtain adequate explanations and appropriate corroborative evidence. The examination and evaluation should include inquiries of management and the application of other auditing procedures until the internal auditor is satisfied that the results or relationships are sufficiently explained. Unexplained results or relationships may be indicative of a significant condition such as a potential error, irregularity, or illegal act. Results or relationships that are not sufficiently

explained should be communicated to the appropriate levels of management. The internal auditor may recommend appropriate courses of action, depending on the circumstances.

20. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

- corroboration of management's responses, for example, by comparing them with the internal auditor's knowledge of the business and other evidence obtained during the course of the internal audit; and
- consideration of the need to apply other internal audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

Effective Date

21. This Standard on Internal Audit is applicable to all internal audits commencing on or after ………….. Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 7
QUALITY ASSURANCE IN INTERNAL AUDIT*

Contents

Paragraph(s)

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* Published in the October 2008 issue of *The Chartered Accountant*.

Introduction

1. Paragraph 3.1 of the *Preface to the Standards on Internal Audit*, describes the internal audit as follows:

   "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. Internal audit, therefore, provides assurance that there is transparency in reporting, as a part of good governance."

2. Paragraphs 7 and 8 of the Standard on Internal Audit (SIA) 2, *Basic Principles Governing Internal Audit*, state as follows:

   "7. ***The internal auditor should either have or obtain such skills and competence, acquired through general education, technical knowledge obtained through study and formal courses, as are necessary for the purpose of discharging his responsibilities.***

   8. The internal auditor also has a continuing responsibility to maintain professional knowledge and skills at a level required to ensure that the client or the employer receives the advantage of competent professional service based on the latest developments in the profession, the economy, the relevant industry and legislation."

Scope

3. This Standard on Internal Audit shall apply whenever an internal audit is carried out, whether carried out by an in house internal audit department or by an external firm of professional accountants. For the purpose of this Standard, the term "firm" means a sole practitioner/ proprietor, partnership

or any such entity of professional accountants as may be permitted by law[1].

Objective

4. The purpose of this Standard on Internal Audit (SIA) is to establish standards and provide guidance regarding quality assurance in internal audit.

5. A system for assuring quality in internal audit should provide reasonable assurance that the internal auditors comply with professional Standards, regulatory and legal requirements, so that the reports issued by them are appropriate in the circumstances.

6. In order to ensure compliance with the professional Standards, regulatory and legal requirements, and to achieve the desired objective of the internal audit, a person within the organization should be entrusted with the responsibility for the quality in the internal audit, whether done in–house or by an external agency.

7. In the case of the in–house internal audit or a firm carrying out internal audit, the person entrusted with the responsibility for the quality in internal audit should ensure that the system of quality assurance include policies and procedures addressing each of the following elements:

a) *Leadership responsibilities for quality in internal audit* - The person entrusted with the responsibility for the quality in internal audit should take responsibility for the overall quality in internal audit.

b) *Ethical requirements* - The person entrusted with the responsibility for the quality in internal audit should establish policies and procedures designed to provide it with reasonable assurance that the personnel comply with relevant ethical requirements. If matters come to his attention

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[1] The Standard on Quality Control (SQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* issued by the Council of the Institute of Chartered Accountants of India applies to the firms carrying out internal audit to the extent such internal audit activities fall under the scope of audits and reviews of the historical financial information and other assurance and other related services.

that indicate that the members of the internal audit engagement team have not complied with relevant ethical requirements, he should, in consultation with the appropriate authority in the entity, determine the appropriate course of action.

c) *Acceptance and continuance of client relationship and specific engagement, as may be applicable* - The person entrusted with the responsibility for the quality in internal audit should establish policies and procedures for the acceptances and continuance of client relationships and specific engagements, designed to provide reasonable assurance that it will undertake or continue relationships and engagements.

d) *Human resources* - The person entrusted with the responsibility for the quality in internal audit should establish policies and procedures regarding assessment of the staff's capabilities and competence designed to provide it with reasonable assurance that there are sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to:

- Perform engagements in accordance with professional standards and regulatory and legal requirements; and
- Enable the firm or engagement partner to issue reports that are appropriate in the circumstances.

e) *Engagement performance* - The person entrusted with the responsibility for the quality in internal audit should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with the applicable professional Standards and regulatory and legal requirements and that the reports issued by the internal auditors are appropriate in the circumstances.

f) *Monitoring* - The person entrusted with the responsibility for the quality in internal audit should establish policies and

procedures designed to provide reasonable assurance that the policies and procedures relating to the system of quality assurance are relevant, adequate, operating effectively and complied with in practice.

8. In order to improve the functionalities of the organisation, transparency in reporting and good governance, the person entrusted with responsibility for the quality in internal audit, while establishing the quality assurance framework, should consider the following parameters of the internal audit activity:

- **Terms of engagement and their adequacy.**
- **Professional standards and compliance therewith.**
- **Internal audit goals and the extent to which they are being achieved.**
- **Recommendations for improving the quality of internal audit and the extent to which they are being implemented and their effectiveness.**
- **Skills and technology used in carrying out internal audit.**

9. The person entrusted with the responsibility for the quality in internal audit needs to ensure that the quality assurance framework is embedded in the internal audit. This can, for example, be achieved in the following manner:

- Developing an internal audit manual clearly defining the specific role and responsibilities, policies and procedures, documentation requirements, reporting lines and protocols, targets and training requirements for the staff, internal audit performance measures and the indicators.
- Ensuring that the internal audit staff at all levels is appropriately trained and adequately supervised and directed on all assignments.
- Identifying the customers of the internal audit activity.

- Establishing a formal process of feedback from the users of the internal audit services, such as the senior management executives, etc. Some of the attributes on which the feedback may be sought include quality, timeliness, value addition, efficiency, innovation, effective communication, audit team, time management. **The responses received from the users of the internal audit services should also be shared with the appropriate levels of management and those charged with governance.**

- **Establishing appropriate performance criteria for measuring the performance of the internal audit function. In case the internal audit activity is performed by an external agency, the contract of the engagement should contain a clause for establishment of performance measurement criteria and periodic performance review. These performance measurement criteria should be approved by the management**.

- Identify and benchmark with industry/ peer group performance.

10. **The quality assurance framework established by the person entrusted with the responsibility for the quality in internal audit should, therefore, cover all the elements of the internal audit activity.** For example,

    - Development and implementation of the internal audit policies and procedures.

    - Maintenance and monitoring of the budget for the internal audit activity.

    - Maintenance and updations of the overall internal audit plan.

    - Identification of the risk areas and the internal audit plan to address these risks.

    - Acquisition and deployment of audit tools and use of technology to enhance the efficiency and effectiveness of the internal audit activity.

- Co-ordination with the external auditors.
- Staffing related aspects of internal audit – recruitment, training, etc.
- Planning and implementation of the training and professional development of the internal audit staff.
- Implementation of the performance metrics for the internal audit activity and periodic monitoring of the same.
- Review of the follow up actions taken on the findings of the internal audit activity.

Internal Quality Reviews

11. The internal quality review framework should be designed with a view to provide reasonable assurance to that the internal audit is able to efficiently and effectively achieve its objectives of adding value and strengthening the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system.

Internal Quality Reviewer

12. The internal quality review should be done by the person entrusted with the responsibility for the quality in internal audit and/or other experienced member(s) of the internal audit function.

13. The internal quality reviews should be undertaken on an ongoing basis. The person entrusted with the responsibility for the quality in internal audit should ensure that recommendations resulting from the quality reviews for the improvements in the internal audit activity are promptly implemented.

Communicating the Results of the Internal Quality Review

14. The person entrusted with the responsibility for the quality in internal audit should also ensure that the results of the internal quality reviews are also communicated to the appropriate levels of management and those charged with governance on a timely basis

along with the proposed plan of action to address issues and concerns raised in the review report.

External Quality Review

15. External quality review is a critical factor in ensuring and enhancing the quality of internal audit. **The frequency of the external quality review should be based on a consideration of the factors such as the maturity level of the internal audit activity in the entity, results of the earlier internal audit quality reviews, feedbacks as to the usefulness of the internal audit activity from the customers of the internal audit, costs *vis a vis* perceived benefits of the frequent external reviews. The frequency should not in any case be less than once in three years.**

External Quality Reviewer

16. The external quality review should be done by a professionally qualified person having an in depth knowledge and experience of, inter alia, the professional Standards applicable to the internal auditors, the processes and procedures involved in the internal audit generally and those peculiar to the industry in which the entity is operating, etc. The external quality reviewer should be appointed in consultation with the person entrusted with the responsibility for the quality in internal audit, senior management and those charged with governance.

Communicating Results of the External Quality Review

17. The external quality reviewer should discuss his findings with the person entrusted with the responsibility for the quality in internal audit. His final report should contain his opinion on all the parameters of the internal audit activity, as discussed in paragraph 10, and should be submitted to the person entrusted with the responsibility for the quality in internal audit and copies thereof be also sent to those charged with governance. The person entrusted with the responsibility for the quality in internal audit should, also submit to those charged with governance, a plan of action to

address the issues and concerns raised by the external quality reviewers in his report.

Effective Date

18. This SIA is effective for all quality assessments/ reviews of internal audit undertaken on or after …………..… Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 8
TERMS OF INTERNAL AUDIT ENGAGEMENT*

Contents

Paragraph(s)

* Published in the December, 2008 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance in respect of terms of engagement of the internal audit activity whether carried out in house or by an external agency. A clarity on the terms of the internal audit engagement between the internal auditors and the users of their services (hitherto known as "*auditee*") is essential for inculcating professionalism and avoiding misunderstanding as to any aspect of the engagement.

2. **The internal auditor and the auditee should agree on the terms of the engagement before commencement.** The agreed terms would need to be recorded in an engagement letter. Normally, it is the responsibility of the internal auditor to prepare the engagement letter and it is to be signed both by the internal auditors as well as the auditee.

Terms of Engagement

3. The terms of engagement of the internal audit, *inter alia*, define the scope, authority, responsibilities, confidentiality, limitation and compensation of the internal auditors. **The terms of engagement should be approved by the Board of Directors[1] or a relevant Committee thereof such as the Audit Committee or such other person(s) as may be authorised by the Board in this regard. The terms should be reviewed by the internal auditor and the audit committee periodically and modified suitably, if required, to meet the changed circumstances.**

Elements of Terms of Engagement

4. The following are the key elements of the terms of the internal audit engagement:

   i. Scope

   ii. Responsibility

   iii. Authority

[1] Or an equivalent authority where the entity is not in a corporate form. For example, the Board of Trustees in a co-operative society.

iv. Confidentiality

v. Limitations

vi. Reporting

vii. Compensation

viii. Compliance with Standards

Each of these elements has been discussed in the following paragraphs.

Scope

5. Paragraph 3.1 of the Preface to the Standards on Internal Audit describes internal audit as *"an independent 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."*

6. The terms of the engagement should contain a statement in respect of the scope of the internal audit engagement. It should clearly delineate the broad areas of function of internal audit like evaluating internal controls, review of business process cycle controls, risk management and governance.

7. It should indicate areas where internal auditors are expected to make their recommendations and value added comments.

8. The terms of engagement should clearly mention that the internal auditor would not, ordinarily, be involved in the preparation of the financial statements of the auditee. It should also be made clear that the internal audit would not result in the expression, by the internal auditor, of an opinion, or any other form of assurance on the financial statements or any part thereof of the auditee.

9. The scope of the terms of the engagement, after delineating the broad areas of function of internal audit, should clarify that any additional services that are not encompassed by the engagement letter shall be performed only on mutual agreement and with separate engagement letter.

Responsibility

10. **The terms of the engagement should clearly mention the responsibility of the auditee *vis a vis* the internal auditor.** The auditee is responsible for establishing, maintaining and ensuring operating effectiveness of a system of internal control. The auditee would also be responsible for timely communication of material weaknesses or other significant issues relating to internal controls, misstatements in the financial information or similar matters to its external auditors, the Audit Committee, the Board of Directors, regulators and to those to whom the auditee is required to so communicate.

11. The management of the auditee is responsible for providing timely and accurate data, information, records, personnel etc., and for extending cooperation to the audit team.

12. **Similarly, where the internal auditor has a specific responsibility, say that arising out of a law or a regulation or a professional standard applicable to the internal auditor, to communicate directly, the above mentioned issues to an appropriate authority or someone within the entity or a regulator, the terms of the engagement should contain a clear mention of such responsibility.**

13. The internal auditor has the responsibility to inform the management before commencement of the assignment about the engagement team and the audit plan.

Authority

14. **The terms of engagement should provide the internal auditor with requisite authority, including unrestricted access to all departments, records, property and personnel and authority to call for information from concerned personnel in the organisation.**

15. **The internal auditor should have full authority on his technologies and other properties like hardware and audit tools he may use in course of performing internal audit.**

Confidentiality

Confidentiality of Working Papers

16. The terms of engagement should be clear that the ownership of the working papers rests with the internal auditor and not the auditee. It should also be made clear that the internal auditor may, upon a request received in this regard from the auditee, provide copies of non proprietary working papers to the auditee. The terms should lay down the policy and the procedures to be followed regarding requests received for internal auditor's working papers from third parties including external auditors.

17. The internal audit engagement may also be subject to a peer review by a regulator, requiring the internal auditor to disclose his working papers to the peer reviewer without the permission of the auditee. **The engagement letter should bring out this fact clearly.**

Confidentiality of the Report

18. The engagement letter should contain a condition that the report of the internal auditor should not be distributed or circulated by the auditee or the internal auditor to any party other than that mutually agreed between the internal auditor and the auditee unless there is a statutory or a regulatory requirement to do so.

Limitations

19. **The terms of engagement should specify clearly the limitations on scope, coverage and reporting requirement, if any.** It may also mention that the internal auditor or any of his employees shall not be liable to the auditee for any claims, damages, liabilities or expenses relating to the engagement exceeding the aggregate amount of compensation agreed upon by both the parties.

Reporting

20. The terms of the engagement should clearly lay down the requirements as to the manner frequency of reporting and the list of intended recipients of the internal audit report.

Compensation

21. **There should be a clear understanding among the internal auditor and the client as to the basis on which the internal auditor would be compensated, including any out of pocket expense, taxes etc., for the services performed by him.**

Compliance with Standards

22. **The terms of the internal audit engagement should contain a statement that the internal audit engagement would be carried out in accordance with the professional Standards applicable to such engagement as on the date of audit.**

Withdrawal from the Engagement

23. **In case the internal auditor is unable to agree to any change in the terms of the engagement and/ or is not permitted to continue as per the original terms, he should withdraw from the engagement and should consider whether there is an obligation, contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties.**

Effective Date

24. This Standard on Internal Audit is effective for all internal audits beginning on or after……………………………….. Earlier application of the Standard is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 9
COMMUNICATION WITH MANAGEMENT*

Contents

Paragraph(s)

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* Published in the January, 2009 issue of *The Chartered Accountant*.

Introduction

1. This Standard on Internal Audit provides a framework for the internal auditor's communication with management and identifies some specific matters to be communicated with the management as described in the terms of the engagement.

2. **The internal auditor while performing audit should :**

    a. **Communicate clearly the responsibilities of the internal auditor, and an overview of the planned scope and timing of the audit with the management;**

    b. **Obtain information relevant to the internal audit from the management;**

    c. **Provide timely observations arising from the internal audit that are significant and relevant to their responsibility as described in the scope of the engagement to the management; and**

    d. **Promote effective two-way communication between the internal auditor and the management.**

Matters to be Communicated

The Internal Auditor's Responsibilities in Relation to the Terms of Engagement

3. The internal auditor is responsible for performing the internal audit in accordance with the terms of engagement.

Planned Scope and Timing of the Internal Audit

4. Communication regarding the planned scope and timing of the internal audit may:

    a. Assist the management:

        - to understand better the objectives of the internal auditor's work;

        - to discuss issues of risk and materiality with the internal auditor; and

- to identify any areas in which they may request the internal auditor to undertake additional procedures;

b. Assist the internal auditor to understand better the entity and its environment.

5. When communicating to management about planned scope and timing of the internal audit, the internal auditor would need to ensure that such communication does not reduce the effectiveness of internal audit. For example, communicating the nature and timing of detailed audit procedures may make those procedures predictable.

6. Matters communicated may include:

   - How the internal auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.

   - The internal auditor's approach to internal control relevant to the internal audit.

   - The application of materiality in the context of an internal audit.

7. Communication with management may assist the internal auditor to plan the scope and timing of the internal audit. It does not, however, change the internal auditor's sole responsibility to establish the overall internal audit strategy and the internal audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings from the Internal Audit

8. Paragraph 25 of the Standard on Internal Audit (SIA) 4, *"Reporting*", states:

   "25. The internal audit report contains the observations and comments of the internal auditor, presents the audit findings, and discusses recommendations for improvements. To facilitate communication and ensure that the recommendations presented in the final report are practical from the point of view of implementation, the internal auditor

should discuss the draft with the entity's management prior to issuing the final report. ***The different stages of communication and discussion should be as under:***

Discussion Draft - At the conclusion of fieldwork, the internal auditor should draft the report after thoroughly reviewing his working papers and the discussion draft before it is presented to the entity's management for auditee's comments. This discussion draft should be submitted to the entity management for their review before the exit meeting.

Exit Meeting - The internal auditor should discuss with the management of the entity regarding the findings, observations, recommendations, and text of the discussion draft. At this meeting, the entity's management should comment on the draft and the internal audit team should work to achieve consensus and reach an agreement on the internal audit findings.

Formal Draft - The internal auditor should then prepare a formal draft, taking into account any revision or modification resulting from the exit meeting and other discussions. When the changes have been reviewed by the internal auditor and the entity management, the final report should be issued.

Final Report - The internal auditor should submit the final report to the appointing authority or such members of management, as directed. The periodicity of the Report should be as agreed in the scope of the internal audit engagement. The internal auditor should mention in the Report, the dates of discussion draft, exit meeting, Formal Draft and Final Report."

The Communication Process

Establishing the Communication Process

9. Clear communication of the internal auditor's responsibilities, the planned scope and timing of the internal audit, and the expected general content of communications helps establishing the basis for effective two-way communication.

10. Matters that contribute to effective two-way communication include:

    - Clarity in the purpose of communications which makes the internal auditor and the management better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.

    - Clarity in the form in which communications will be made.

    - Identifying the person(s) in the internal audit team and the management who will be responsible for communicating particular matters.

    - The internal auditor's expectation that communication will be two-way, and that the management will communicate with the internal auditor, matters they consider relevant to the internal audit, for example, strategic decisions that may significantly affect the nature, timing and extent of internal audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.

    - The process for taking action and reporting back on matters communicated by the internal auditor and the management.

Forms of Communication

11. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The internal auditor may communicate matters other than those described in the terms of engagement, either orally or in writing.

12. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

    a. Whether the matter has been satisfactorily resolved.

b. Whether management has previously communicated the matter.

c. The size, operating structure, control environment, and legal structure of the entity.

d. In the case of an internal audit of a specific aspect of an operation, whether the internal auditor also audits the entire operation or the entity.

e. The expectations of the management, including arrangements made for periodic meetings or communications with the auditor.

f. The amount of ongoing contact and dialogue the internal auditor has with the management.

g. Whether there have been significant changes in the membership of a governing body.

Timing of Communications

13. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by the management. For example:

- Communications regarding planning matters may often be made early in the audit engagement.

- It may be appropriate to communicate a significant difficulty encountered during the internal audit as soon as practicable.

- Similarly, it may be appropriate to communicate material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the internal auditor's attention as soon as practicable.

- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards.

- The exit meeting may also be an appropriate time to communicate findings from the internal audit.

Adequacy of the Communication Process

14. The internal auditor need not design specific procedures to support the evaluation of the two-way communication with the management, rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

    - The appropriateness and timeliness of actions taken by the management in response to matters raised by the internal auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the internal auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the internal auditor is satisfied that the matter has been adequately addressed or is no longer significant.

    - The apparent openness of the management in their communications with the internal auditor.

    - The apparent ability of the management to fully comprehend matters raised by the internal auditor, for example, the extent to which the management probes issues and questions recommendations made to them.

    - Difficulty in establishing the management, a mutual understanding of the form, timing and expected general content of communications.

    - Whether the two-way communication between the internal auditor and the management meets applicable legal and regulatory requirements.

15. Inadequate two-way communication may indicate an unsatisfactory control environment and influence the internal auditor's assessment of the risks of material misstatements. There is also a risk that the internal auditor may not have obtained sufficient appropriate internal audit evidence to support his findings or opinion.

Documentation

16. Where matters required by this SIA to be communicated are communicated orally, the internal auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the internal audit documentation.

Effective Date

17. This Standard on Internal Audit is effective for all internal audits beginning on or after ………………….... Earlier application of the Standard is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 10
INTERNAL AUDIT EVIDENCE*

Contents

* Published in the January, 2009 issue of *The Chartered Accountant.*

Introduction

1. Paragraph 14 of the SIA 2, *Basic Principles Governing Internal Audit*, states:

   "14. The internal auditor should, based on his professional judgment, obtain sufficient appropriate evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion or findings. *Factors affecting the professional judgment include the activity under audit, possible errors and their materiality and the risk of occurrence of such errors."*

   The purpose of this Standard on Internal Audit is to amplify the basic principle outlined above and to provide guidance in respect of applicability of this standard during an internal audit.

Objective

2. The scope of an internal audit is much broader in comparison to that of statutory audit. The depth of coverage of internal audit, being a management function, would also be much wider. An internal audit function normally is spread beyond checking of financial transactions and is expected to cover comments on internal control systems, risk management, propriety aspect of transactions. Accordingly, an internal auditor is required to collect appropriate evidence out of his audit process to substantiate his checking and findings. This Standard deals with the qualitative and quantitative aspects of evidence in internal audit.

3. Internal audit evidence is used by the internal auditor to support the facts and opinion contained in his report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the internal audit.

Sufficient Appropriate Internal Audit Evidence

4. Sufficiency and appropriateness are interrelated and apply to evidence obtained from audit procedures. Sufficiency refers to the quantum of internal audit evidence obtained; appropriateness relates to its relevance

and reliability. Normally, internal audit evidence is persuasive rather than conclusive in nature. The internal auditor may often seek evidence from different sources or of different nature to support the same finding.

5. **The internal auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The internal audit evidence should enable the internal auditor to form an opinion on the scope of the terms of the engagement.** In forming such an opinion, the internal auditor may obtain internal audit evidence on a selective basis by way of judgmental or statistical sampling procedures, in accordance with the principle laid on Standard on Internal Audit (SIA) 5, *Sampling,* issued by the Institute of Chartered Accountants of India.

6. The internal auditor's judgement as to what is sufficient and appropriate internal audit evidence is usually influenced by:

   - The materiality of the item.
   - The type of information available.
   - Degree of risk of misstatement which may be affected by factors such as :

     i. The nature of the item.

     ii. The nature or size of the business carried on by the entity.

     iii. Situation which may exert an unusual influence on management.

7. The reliability of the internal audit evidence depends on its source – internal or external and on its type. Four major categories of documentary evidence, which provide different degrees of reliability to the internal auditor, are:

   - Documentary evidence originating from and held by third parties;
   - Documentary evidence originating from third parties and held by the entity;

- Documentary evidence originating from the entity and held by third parties; and
- Documentary evidence originating from and held by entity.

Inconsistency in, or Doubts Over Reliability of, Internal Audit Evidence

8. When internal audit evidence obtained from one source is inconsistent with that obtained from another, or the internal auditor has doubts over the reliability of information to be used as internal audit evidence, the internal auditor shall determine what modifications to or additional audit procedures are necessary to resolve the matter.

Obtaining Internal Audit Evidence

9 The internal auditor obtains evidence by performing one or more of the following procedures:

- Inspection
- Observation
- Inquiry and confirmation
- Computation
- Analytical review

The timing of such procedures will be dependent, in part, upon the periods of time during which the internal audit evidence sought is available.

Inspection

10. Inspection consists of examining records, documents, or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability, depending on their nature and source and the effectiveness of internal controls over their processing.

Observation

11. Observation consists of witnessing a process or procedure being performed by others. For example, the internal auditor may observe the counting of inventories by client personnel.

Inquiry and Confirmation

12. Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the internal auditor with information which he did not previously possess or may provide him with corroborative evidence.

13. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the internal auditor requests confirmation of receivables by direct communication with debtors.

Computation

14. Computation consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

Analytical Review

15. Analytical review consists of studying significant ratios and trends and investigating unusual fluctuations and items.

Effective Date

16. This Standard on Internal Audit is effective for all internal audits beginning on or after ………………….. Earlier application of the Standard is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 11
CONSIDERATION OF FRAUD IN AN INTERNAL AUDIT*

Contents

Paragraph(s)

* Published in the January, 2009 issue of *The Chartered Accountant.*

Introduction

1. Fraud is defined as an intentional act by one or more individuals among management, those charged with governance, or third parties, involving the use of deception to obtain unjust or illegal advantage. A fraud could take form of misstatement of an information (financial or otherwise) or misappropriation of the assets of the entity.

2. The primary responsibility for prevention and detection of frauds rests with management and those charged with governance. They achieve this by designing, establishing and ensuring continuous operation of an effective system of internal controls.

3. Paragraph 6 of the Standard on Internal Audit (SIA) 2, *Basic Principles Governing Internal Audit*, states as follows:

   "The internal auditor should exercise due professional care, competence and diligence expected of him while carrying out the internal audit. *Due professional care signifies that the internal auditor exercises due professional care in carrying out the work entrusted to him in terms of deciding on aspects such as the extent of work required to achieve the objectives of the engagement, relative complexity and materiality of the matters subjected to internal audit, assessment of risk management, control and governance processes and cost benefit analysis. Due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement."*

   An internal auditor should, therefore, use his knowledge and skills to reasonably enable him to identify indicators of frauds. However, the internal auditor cannot be expected to possess the expertise of a person with specialized knowledge and skills in detecting and investigating frauds.

Common Fraud Situations

4. A fraud normally occurs in situations where there is an incentive or a pressure to commit fraud, an opportunity to commit fraud or a rationalisation for committing fraud. **Although, normally, an internal**

auditor is not expected to possess skills and knowledge of a person expert in detecting and investigating frauds, he should, however, have reasonable knowledge of factors that might increase the risk of opportunities for frauds in an entity and exercise reasonable care and professional skepticism while carrying out internal audit. In addition, the understanding of the design and implementation of the internal controls in an entity would also help the internal auditor to assess the risk of frauds.

Internal Control System

5. Internal control refers to the process designed, implemented and maintained by the management of the entity to ensure accomplishment of its following objectives:

   - Reliability of financial reporting;
   - Efficiency and effectiveness in operations;
   - Compliance with applicable laws and regulations; and
   - Safeguarding of assets.

   The design and the manner of implementation and maintenance of internal controls varies with the size and complexity of the entity.

6. Internal controls can, however, provide only reasonable assurance to the entity with regard to accomplishments of its objectives stated in paragraph 5 above since any system of internal control is subject to inherent limitations such as faulty human judgment, ineffective use of the information generated for the purpose of internal controls, collusion among two or more persons, management override of controls, faulty design of controls, management judgments as to nature and extent of risks it wants to assume, etc.

Elements of Internal Control System

7. A system of internal control comprise of following five elements:

   - the control environment;

- entity's risk assessment process;
- information system and communication;
- control activities; and
- monitoring of controls.

It is essential for the internal auditor to gain an understanding of the components of the system of internal control. These components have been discussed in the following paragraphs.

8. The *control environment* sets the tone at the top in an entity and greatly impacts the effectiveness of internal controls. It includes the following:

   - the policies and procedures established by the management to communicate and enforce the culture of integrity and ethical values in the entity.
   - management's commitment to competence.
   - management's philosophy and operating style.
   - organizational structure.
   - assignment of authority and responsibility.
   - human resources policies and practices.

9. The *entity's risk assessment process* includes the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities. In the context of prevention of frauds, the entity's risk assessment process would include the policies and procedures of the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

10. The *information system and communication* refers to the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity

to enable them to make timely and effective decisions and discharge their responsibilities efficiently. In the context of frauds, such policies and procedures could take form of whistleblower policies and mechanisms, ethics helplines and counseling, training of employees, etc.

11. The *control activities* refer to the policies and procedures established by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be. In the context of frauds, the control activities include actions taken by management to prevent or detect and correct the frauds or breach of internal controls.

12. *Monitoring* refers to continuous supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

Responsibilities of the Internal Auditor

13. As discussed in paragraph 2, the primary responsibility for prevention and detection of frauds is that of the management of the entity. **The internal auditor should, however, help the management fulfill its responsibilities relating to fraud prevention and detection.** The following paragraphs discuss the approach of the internal auditor regarding this.

Control Environment

14. The internal auditor should obtain an understanding of the various aspects of the control environment and evaluate the same as to the operating effectiveness.

Risk Assessment

15. The internal auditor should obtain an understanding of the policies and procedures adopted by the management to identify risks that can affect the achievement of the objectives of the entity and to distinguish risks from opportunities and evaluate the effectiveness of these policies and procedures. In the context of prevention of frauds, the internal auditor should specifically evaluate the policies

and procedures established by the management to identify and assess the risk of frauds, including the possibility of fraudulent financial reporting and misappropriation of assets.

Information System and Communication

16. The internal auditor should assess the operating effectiveness of the policies and procedures established by the management to identify, capture and communicate relevant information to the concerned persons in the entity to enable them to make timely and effective decisions and discharge their responsibilities efficiently.

Control Activities

17. The internal auditor should assess whether the controls implemented by the management to ensure that the risks identified are responded to as per the policy or the specific decision of the management, as the case may be, are in fact working effectively and whether they are effective in prevention or timely detection and correction of the frauds or breach of internal controls.

Monitoring

18. The internal auditor should evaluate the mechanism in place for supervision and assessment of the internal controls to identify instances of any actual or possible breaches therein and to take corrective action on a timely basis.

Communication of Fraud

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

Documentation

20. The internal auditor should document fraud risk factors identified as being present during the internal auditor's assessment process and document the internal auditor's response to any other factors. If during the performance of the internal audit fraud risk factors are identified that cause the internal auditor to believe that additional internal audit procedures are necessary, the internal auditor should document the same.

Effective Date

21. This Standard on Internal Audit is effective for all internal audits beginning on or after ………………….... Earlier application of the Standard is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 12
INTERNAL CONTROL EVALUATION*

Contents

Paragraph(s)

* Published in the February, 2009 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on the procedures to be followed by the internal auditor in evaluating the system of internal control in an entity and for communicating weaknesses therein to those charged with governance.

Nature, Purpose and Types of Internal Controls

2. Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated. Internal control system consists of interrelated components as follows:

    - Control (or Operating) environment.
    - Risk assessment.
    - Control objective setting.
    - Event identification..
    - Control activities.
    - Information and communication.
    - Monitoring.
    - Risk response.

3. The system of internal control must be under continuous supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in environment. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:

   a. "*control environment*" means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures and provides the background against which other controls are operated. Factors reflected in the control environment include:

      - The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).
      - The function of the board of directors and its committees, in the case of a company or the corresponding governing body in case of any other entity.
      - Management's philosophy and operating style.
      - Management's control system including the internal audit function, personnel policies and procedures.
      - Integrity and ethical values.
      - Commitment to competence.
      - Human resource policies and practices.

   b. "*control activities*" (or procedures) which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Control activities include approvals, authorizations, verifications, reconciliations, reviews of performance, security of assets, segregation of duties, and controls over information systems.

4. Internal controls may be either preventive or detective. Preventive controls attempt to deter or prevent undesirable acts from occurring. They are proactive controls that help to prevent a loss. Examples of preventive controls are separation of duties, proper authorization, adequate documentation, and physical control over assets. Detective controls attempt to detect undesirable acts. They provide evidence that a loss has occurred but do not prevent a loss from occurring. Examples of detective controls are reviews, analyses, variance analyses, reconciliations, physical inventories, and audits.

5. Internal controls are generally concerned with achieving the following objectives:

   - Transactions are executed in accordance with management's general or specific authorisation.

   - All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.

   - Assets and records are safeguarded from unauthorised access, use or disposition.

   - Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

   - Systems and procedures are effective in design and operation.

   - Risks are mitigated to a reasonable extent.

6. Internal control is a process. Internal control can be expected to provide only reasonable assurance, not absolute assurance. Internal control is geared to the achievement of objectives. Internal control is effected by people and not by policy manuals and forms alone.

Inherent Limitations of Internal Controls

7. Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

Role of the Internal Auditor in Evaluating Internal Controls

8. **The Internal auditor should examine the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness.** However, the internal auditor is not vested with management's primary responsibility for designing, implementing, maintaining and documenting internal control. Internal audit function adds value to an organisation's internal control system by bringing a systematic, disciplined approach to the evaluation of risk and by making recommendations to strengthen the effectiveness of risk management efforts. **The internal auditor should focus towards improving the internal control structure and promoting better corporate governance.** The role of the internal auditor encompasses:

- Evaluation of the efficiency and effectiveness of controls.

- Recommending new controls where needed – or discontinuing unnecessary controls.
- Using control frameworks.
- Developing control self-assessment.

9. The internal auditor's evaluation of internal control involves:

   - determining the significance and the sensitivity of the risk for which controls are being assessed;
   - assessing the susceptibility to misuse of resources, failure to attain objectives regarding ethics, economy, efficiency and effectiveness, or failure to fulfil accountability obligations, and non-compliance with laws and regulations;
   - identifying and understanding the design and operation of relevant controls;
   - determining the degree of control effectiveness through testing of controls;
   - assessing the adequacy of the control design; and
   - reporting on the internal control evaluation and discussing the necessary corrective actions.

10. The broad areas of review by the internal auditor in evaluating the internal control system, *inter alia*, are:

    - Mission, vision, ethical and organizational value-system of the entity.
    - Personnel allocation, appraisal system, and development policies.
    - Accounting and financial reporting policies and compliance with applicable legal and regulatory standards.
    - Objective of measurement and key performance indicators.

- Documentation standards.
- Risk management structure.
- Operational framework.
- Processes and procedures followed.
- Degree of management supervision.
- Information systems, communication channels.
- Business Continuity and Disaster Recovery Procedures.

11. **The internal auditor should obtain an understanding of the significant processes and internal control systems sufficient to plan the internal audit engagement and develop an effective audit approach. The internal auditor should use professional judgment to assess and evaluate the maturity of the entity's internal control. The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.** Such an understanding would also help the internal auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of internal audit procedures. The internal auditor assesses the *'as–is'* internal control system within the organization.

12. **The internal auditor should obtain an understanding of the internal control procedures sufficient to develop the audit plan.** In obtaining this understanding, the internal auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment, business processes and accounting system in determining whether any additional understanding of control procedures is necessary. **The internal auditor should understand and document the design and operations of internal controls to evaluate the effectiveness of the control environment.**

The important procedures to be adopted by the internal auditor for this purpose include:

- Narratives
- Flowcharts
- Questionnaires

13. When obtaining an understanding of the business processes, accounting and internal control systems to plan the audit, the internal auditor obtains a knowledge of the design of the internal control systems and their operation. For example, an internal auditor may perform a "*walk-through*" test that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control.

14. The internal auditor should consider the following aspects in the evaluation of internal control system in an entity:

- **Ascertaining whether the entity has a mission statement and written goals and objectives.**
- **Assessing risks at the entity level.**
- **Assessing risks at the activity (or process) level.**
- **Completing a Business Controls worksheet for each significant activity (or process) in each function or department with documentation of the associated controls and their degree of effectiveness (partial or full); prioritizing those activities (or processes) which are most critical to the success of the function or department.**
- **Ensuring that all risks identified at the entity and function or department level are addressed in the Business Controls worksheet along with the consolidated documentation of the operating controls.**

- **Ascertaining from the Business Controls worksheet, those risks for which no controls exist or existing controls are inadequate. This process is the stage of 'controls gap' analysis.**

Segregation of Duties

15. Segregation of duties is critical to effective internal control; it reduces the risk of both erroneous and inappropriate actions. **The internal auditor should ensure that in general, the approval function, the accounting/reconciling function, and the asset custody function is separated among employees of the entity**. **When these functions cannot be separated due to small department size, the internal auditor should ensure that a detailed supervisory review of related activities is in practice, as a compensating control activity**.

Control Activities for Information Technology

16. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The internal auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system. There are two broad categories of information systems controls - general controls and application controls. *General Controls* apply to all information systems-mainframe, minicomputer, network, and end-user environments. *Application Controls* are designed to cover the processing of data within the application software.

17. **While evaluating the information technology controls in a system-driven environment, the internal auditor should determine whether the entity, *inter alia*, uses:**

    - **encryption tools, protocols, or similar features of software applications that protect confidential or sensitive information from unauthorized individuals;**

- **back-up and restore features of software applications that reduce the risk of permanent loss of data;**

- **virus protection software; and**

- **passwords that restrict user access to networks, data and applications.**

18. The nature, timing and extent of the procedures performed by the internal auditor to obtain an understanding of the internal control systems will vary with, among other things:

- Size and complexity of the entity and of its information system.

- Materiality considerations.

- Type of internal controls involved.

- Nature of the entity's documentation of specific internal controls.

- Internal auditor's assessment of inherent risk.

19. Ordinarily, the internal auditor's understanding of the internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

a. inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;

b. inspection of documents and records produced by the accounting and internal control systems; and

c. observation of the entity's activities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.

Test of Controls

20. Tests of control are performed to obtain audit evidence about the effectiveness of the:

    a. design of the internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements;

    b. operation of the internal controls throughout the period; and

    c. cost of a control *vis-a-vis* the benefit obtained from the same.

21. Tests of control normally include:

    - Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.

    - Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.

    - Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

    - Testing of internal control operating on specific computerised applications or on the overall information technology function, for example, access or program change controls.

22. **Based on the results of the tests of control, the internal auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk.** The evaluation of deviations may result in the internal auditor concluding that the assessed level of control risk needs to be revised. In such cases, the internal auditor would modify the nature, timing and extent of planned substantive procedures.

23. **The internal auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period. The internal auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance.

Monitoring Internal Audit Findings

24. The internal auditor should identify internal control weaknesses that have not been corrected and make recommendations to correct those weaknesses. The internal auditor should document the rationale in deciding which audit recommendations should be followed up on and when, in contrast with recommendations where no follow-up is needed. The internal auditor should also inquire from the management and document that either audit recommendations have been effectively implemented or that senior management has accepted the risk of not implementing the recommendations.

Communication of Continuing Internal Control Weaknesses

25. When internal controls are found to contain continuing weaknesses, the internal auditor should consider whether:

- **Management has increased supervision and monitoring;**
- **Additional or compensating controls have been instituted; and/or**
- **Management accepts the risk inherent with the control weakness.**

26. **The internal auditor should evaluate identified control deficiencies and then determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The auditor should communicate significant deficiencies and material weaknesses to management and those charged with governance**. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

27. Some examples of common weaknesses in internal controls are:

    - Corporate philosophy is understood but not written exposing it to misinterpretation.
    - Organisational roles and responsibilities are not explicitly defined.
    - Lack of performance appetite and understanding of the entity's appetite for risk taking.
    - Management or board of directors do not receive the right information at the right time.
    - Disincentives exist which lead employees to behave in a dysfunctional manner.

28. As a result of obtaining an understanding of the internal control systems and tests of control, the internal auditor may become aware of weaknesses in the systems. **The internal auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the internal control systems, which have come to the internal auditor's attention**. The communication of material weaknesses to management would ordinarily be in writing, as part of the internal audit report. However, if the internal auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the internal auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

29. The internal auditor in his report to the management, should provide:

- **A description of the significant deficiency or material weakness in internal control.**
- **His opinion on the possible effect of such weakness on the entity's control environment.**

Effective Date

30. This Standard on Internal Audit is applicable to all internal audits commencing on or after …………. Earlier application of the SIA is encourage.

STANDARD ON INTERNAL AUDIT (SIA) 13
ENTERPRISE RISK MANAGEMENT*

Contents

Paragraph(s)

* Published in the February, 2009 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on review of an entity's risk management system during an internal audit or such other review exercise with the objective of providing an assurance thereon. This Standard applies where the internal auditor has been requested by the management to provide such an assurance on the effectiveness of its enterprise risk management system.

2. Enterprise risk management enables management to effectively deal with risk, associated uncertainty and enhancing the capacity to build value to the entity or enterprise and its stakeholders. Internal auditor may review each of these activities and focus on the processes used by management to report and monitor the risks identified.

Risk and Enterprise Risk Management

3. Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives. A business risk is the threat that an event or action will adversely affect an enterprise's ability to maximize stakeholder value and to achieve its business objectives. Risk can cause financial disadvantage, for example, additional costs or loss of funds or assets. It can result in damage, loss of value and /or loss of an opportunity to enhance the enterprise operations or activities. Risk is the product of probability of occurrence of an event and the financial impact of such occurrence to an enterprise.

4. Risk may be broadly classified into Strategic, Operational, Financial and Knowledge. *Strategic Risks* are associated with the primary long-term purpose, objectives and direction of the business. *Operational Risks* are associated with the on-going, day-to-day operations of the enterprise. *Financial Risks* are related specifically to the processes, techniques and instruments utilised to manage the finances of the enterprise, as well as those processes involved in sustaining effective financial relationships with customers and third parties. *Knowledge Risks* are associated with the management and protection of knowledge and information within the enterprise.

Process of Enterprise Risk Management and Internal audit

5. Enterprise Risk Management is a structured, consistent and continuous process of measuring or assessing risk and developing strategies to manage risk within the risk appetite. It involves identification, assessment, mitigation, planning and implementation of risk and developing an appropriate risk response policy. Management is responsible for establishing and operating the risk management framework.

6. The Enterprise Risk Management process consists of Risk identification, prioritization and reporting, Risk mitigation, Risk monitoring and assurance. Internal audit is a key part of the lifecycle of risk management. The corporate risk function establishes the policies and procedures, and the assurance phase is accomplished by internal audit.

Role of the Internal Auditor in Relation to Enterprise Risk Management

7. The role of the internal auditor in relation to Enterprise Risk Management is to provide assurance to management on the effectiveness of risk management. Due consideration should be given to ensure that the internal auditor protects his independence and objectivity of the assurance provided. The role of the internal auditor is to ascertain that risks are appropriately defined and managed.

8. The scope of the internal auditor's work in assessing the effectiveness of the enterprise risk management would, normally, include:

   (a) assessing the risk maturity level both at the entity level as well as the auditable unit level;

   (b) assessing the adequacy of and compliance with the risk management policy and framework; and

   (c) for the risks covered by the internal audit plan:

      (i) Assessing the efficiency and effectiveness of the risk response; and

(ii) Assessing whether the score of the residual risk is within the risk appetite.

9. The extent of internal auditor's role in enterprise risk management will depend on other resources, internal and external, available to the board and on the risk maturity of the organisation. **The nature of internal auditor's responsibilities should be adequately documented and approved by those charged with governance. The internal auditor should not manage any of the risks on behalf of the management or take risk management decisions. The internal auditor should not assume any accountability for risk management decisions taken by the management.** Internal auditor has a role only in commenting and advising on risk management and assisting in the effective mitigation of risk.

10. The internal auditor has to review the structure, effectiveness and maturity of an enterprise risk management system. In doing so, he should consider whether the enterprise has developed a risk management policy setting out roles and responsibilities and framing a risk management activity calendar. **The internal auditor should review the maturity of an enterprise risk management structure by considering whether the framework so developed, *inter alia*:**

    a) protects the enterprise against surprises;

    b) stabilizes overall performance with less volatile earnings;

    c) operates within established risk appetite;

    d) protects ability of the enterprise to attend to its core business; and

    e) creates a system to proactively manage risks.

11. **The internal auditor should review whether the enterprise risk management coordinators in the entity report on the results of the assessment of key risks at the appropriate levels, which are, *inter alia*:**

    - **Risk Management Committee.**

- **Enterprise Business and Unit Heads.**

- **Audit Committee.**

Internal Audit Plan and Risk Assessment

12. The internal auditor will normally perform an annual risk assessment of the enterprise, to develop a plan of audit engagements for the subsequent period. This plan will be reviewed at various frequencies in practice. This typically involves review of the various risk assessments performed by the enterprise (e.g., strategic plans, competitive benchmarking, etc.), consideration of prior audits, and interviews with a variety of senior management. It is designed for identifying internal audit key areas and, not for identifing, prioritizing, and managing risks directly for the enterprise. **The internal audit plan, which should be approved by the audit committee, should be based on risk assessment as well as on issues highlighted by the audit committee and senior management. The risk assessment process should be of a continuous nature so as to identify not only residual or existing risks, but also emerging risks. The risk assessment should be conducted formally at least annually, but more often in complex enterprises. To serve this objective, the internal auditor should design the audit work plan by aligning it with the objectives and risks of the enterprise and concentrate on those issues where assurance is sought by those charged with governance.**

13. The risk review process to be carried out by the internal auditor provides the assurance that there are appropriate controls in place for the risk management activities and that the procedures are understood and followed. Effective enterprise risk management requires a monitoring structure to ensure that the risks are effectively identified and assessed and that the appropriate mitigation plans are in place.

14. The review process conducted by internal auditors will help to determine, *inter alia:*

    a) whether the adopted measures result in what was intended;

b) whether the procedures adopted and information gathered for undertaking the assessment were appropriate; and

c) further, improved knowledge would help in reaching better decisions and identifying the lessons to improve future assessment and management of risks.

15. The internal auditor should submit his report to the Board or its relevant Committee, delineating the following information:

- **Assurance rating (segregated into High, Medium or Low) as a result of the review;**
- **Tests conducted;**
- **Samples covered; and**
- **Observations and recommendations.**

Effective Date

16. This Standard on Internal Audit is applicable to all internal audits commencing on or after …………… Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 14 INTERNAL AUDIT IN AN INFORMATION TECHNOLOGY ENVIRONMENT*

Contents

Paragraph(s)

* Published in the March, 2009 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on procedures to be followed when an internal audit is conducted in an information technology (IT) environment. An information technology environment exists when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data, and other types of information processing whether those computers are operated by the entity or by a third party. An IT system is a system that uses technology to capture, classify, summarize and report data in a meaningful manner to interested users, including an enterprise resource planning (ERP) system.

2. The overall objective and scope of an internal audit does not change in an IT environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and the interplay of processes, systems and control procedures. This may affect the internal control systems employed by the entity. Accordingly, an IT environment may affect:

   a) the procedures followed by the internal auditor in obtaining a sufficient understanding of the processes, systems and internal control system; and

   b) the auditor's review of the entity’s risk management and continuity systems.

IT Environment – Matters to Consider

3. **The internal auditor should consider the effect of an IT environment on the internal audit engagement, *inter alia*:**

   a. the extent to which the IT environment is used to record, compile, process and analyse information; and

   b. the system of internal control in existence in the entity with regard to:

      - **the flow of authorised, correct and complete data to the processing centre;**

- **the processing, analysis and reporting tasks undertaken in the installation; and**

- **the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.**

Skills and Competence

4. **The internal auditor should have sufficient knowledge of the information technology systems to plan, direct, supervise, control and review the work performed.** The sufficiency of knowledge would depend on the nature and extent of the IT environment. **The internal auditor should consider whether any specialised IT skills are needed in the conduct of the audit, for example, the operating knowledge of a specialised ERP system.** Specialised skills may be needed, for example, to:

   a) obtain sufficient understanding of the effect of the IT environment on systems, processes, internal control and risk management systems;

   b) design and perform appropriate tests of control and substantive procedures; and

   c) determine the effect of the IT environment on assessment of overall audit risk.

5. **If specialized skills are needed, the internal auditor should seek the assistance of a technical expert possessing such skills, who may either be the internal auditor's staff or an outside professional. If the use of such a professional is planned, the internal auditor should, in accordance with SIA16, "*Using the Work of an Expert*", obtain sufficient appropriate evidence that the work performed by the expert is adequate for the purposes of the internal audit**.

Planning

6. **The internal auditor should obtain an understanding of the systems, processes, control environment, risk-response activities and internal control systems sufficient to plan the internal audit and to determine the nature, timing and extent of the audit procedures, in accordance with SIA 1*, "Planning an Internal Audit".*** Such an understanding would help the internal auditor to develop an effective audit approach.

7. **In planning the portions of the internal audit which may be affected by the IT environment, the internal auditor should obtain an understanding of the significance and complexity of the IT activities and the availability of the data for use in the internal audit.** This understanding would include such matters as:

   i) the information technology infrastructure [hardware, operating system(s), etc., and application software(s)] used by the entity including changes, if any, therein since last audit.

   ii) the significance and complexity of computerised processing in each significant application. An application may be considered to be complex when, for example:

      a) the volume and materiality of transactions is such that users would find it difficult to identify and correct errors in processing.

      b) the computer automatically generates material transactions or entries directly to another application.

      c) the computer performs complicated computations of financial information and/or automatically generates material transactions or entries that cannot be (or are not) validated independently.

      d) transactions are exchanged electronically with other organisations [as in electronic data interchange (EDI) systems] without manual review for propriety or reasonableness.

iii) determination of the organisational structure of the client's IT activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.

iv) determination of the availability of data. Source documents, computer files, and other evidential matter that may be required by the internal auditor may exist for only a short period or only in machine-readable form. Information Technology systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer-assisted audit techniques may permit increased efficiency in the performance of internal audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of transactions.

8. **When the information technology systems are significant, the internal auditor should also obtain an understanding of the IT environment and whether it influences the assessment of inherent and control risks.** The nature of the risks and the internal control characteristics in IT environments include the following:

a. *Lack of transaction trails*: Some IT systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.

b. *Uniform processing of transactions*: Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.

c. *Lack of segregation of functions*: Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a IT environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.

d. *Potential for errors and irregularities*: The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in IT than in manual systems. In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

e. *Initiation or execution of transactions*: Information Technology systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the information technology systems and subsequent modification.

f. *Dependence of other controls over computer processing*: Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

g. *Potential for increased management supervision*: IT systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.

h. *Potential for the use of computer-assisted audit techniques*: The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Both the risks and the controls introduced as a result of these characteristics of information technology systems have a potential impact on the internal auditor's assessment of risk, and the nature, timing and extent of audit procedures.

9. **While evaluating the reliability of the internal control systems, the internal auditor should consider whether these systems, *inter alia*:**

   a. **ensure that authorised, correct and complete data is made available for processing;**

   b. **provide for timely detection and correction of errors;**

   c. **ensure that in case of interruption in the working of the IT environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;**

   d. **ensure the accuracy and completeness of output;**

   e. **provide adequate data security against fire and other calamities, wrong processing, frauds etc;**

   f. **prevent unauthorised amendments to the programs; and**

   g. **provide for safe custody of source code of application software and data files.**

Risk Assessment

10. **The internal auditor should make an assessment of inherent and control risks for material assertions related to significant processes and systems.** These assertions apply to significant processes and systems for example - sales, procurement, inventory management, production, marketing, human resources and logistics.

11. **The internal auditor should review whether the information technology system in the entity considers the confidentiality, effectiveness, integrity, availability, compliance and validity of data and information processed. The internal auditor should also review the effectiveness and safeguarding of IT resources, including – people, applications, facilities and data.**

12. The inherent risks and control risks in an IT environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements, as follows:

    a. The risks may result from deficiencies in pervasive IT activities such as program development and maintenance, system software support, operations, physical IT security and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the IT system.

    b. The risks may increase the potential for errors or fraudulent activities in specific applications, in specific databases or master files, or in specific processing activities. For example, errors are not uncommon in systems that perform complex logic or calculations, or that must deal with many different exception conditions. Systems that control cash disbursements or other liquid assets are susceptible to fraudulent actions by users or by IT personnel.

Audit Procedures

13. The internal auditor should consider the IT environment in designing audit procedures to review the systems, processes, controls and risk management framework of the entity.

Review of Information Technology Environment

14. The internal auditor should review the robustness of the IT environment and consider any weakness or deficiency in the design and operation of any IT control within the entity, by reviewing:

a) System Audit reports of the entity, conducted by independent Information System auditors;

b) Reports of system breaches, unsuccessful login attempts, passwords compromised and other exception reports;

c) Reports of network failures, virus attacks and threats to perimeter security, if any;

d) General controls like segregation of duties, physical access records, logical access controls;

e) Application controls like input, output, processing and run-to-run controls; and

f) Excerpts from the IT policy of the entity relating to business continuity planning, crisis management and disaster recovery procedures.

An illustrative checklist of IT controls to be reviewed by the internal auditor is given in the Appendix to this Standard.

15. If the internal auditor is not able to rely on the effectiveness of the IT environment as a result of the review, he may perform such substantive testing or test of IT controls, as deemed fit in the circumstances. **The internal auditor should apply his professional judgment and skill in reviewing the IT environment and assessing the interfaces of such IT infrastructure with other business processes.**

Outsourced Information Processing

16. The internal auditor should assess and review the reliance which the management of the entity places on the outsourced agency, in case where such information processing has been outsourced to the outside party. The risks associated with such outsourced services should be considered by the internal auditor in light of the review of IT controls prevalent in such outside entity. The internal auditor should also review the extent to which the entity's controls provide reasonable assurance regarding the completeness, validity, reliability and availab ility of the data and information processed by such outsourced agency.

Documentation

17. **The internal auditor should document the internal audit plan, nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained.** In an internal audit in IT environment, some or all of the audit evidence may be in the electronic form. **The internal auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required**.

Effective Date

18. This Standard on Internal Audit is applicable to all internal audits commencing on or after ……….. Earlier application of the SIA is encouraged.

Appendix

Illustrative Information Technology Controls to be Reviewed During Internal Audit in An IT Environment

(Refer paragraph 14)

(The Appendix is only illustrative in nature and does not form part of the Standard)

Sr. No.	CONTROL PARAMETERS
	IT Access Control
1	There is a structured IT Policy and facility personnel are aware of the applicable policies.
	IT Back-up and Recovery
2	The network has adequately documented backup and recovery procedures/plans/schedules for critical sites.
3	LAN is supported by an uninterruptible power supply (UPS).
4	UPS tested in the last year (to test the batteries)?
5	For disaster-recovery purposes, LAN applications have been prioritized and scheduled for recovery based on importance to the operation.
	IT Environmental Controls
6	Smoke detection and automatic fire-extinguishing equipments installed for adequate functioning and protection against fire hazards.
	IT Inventory
7	There is a complete inventory of the following: Hardware: Computers, File Servers, Printers, Modems, Switches, Routers, Hubs, etc. Software: all software for each Computer is logged with licenses and serial numbers.
8	There are written procedures for keeping LAN inventory and they identify who (title) is responsible for maintaining the inventory report.

Sr. No.	CONTROL PARAMETERS
9	Unused equipment is properly and securely stored.
	IT Operations
10	LAN administrator has a backup person.
11	LAN administrator monitors the LAN response time, disk storage space, and LAN utilization.
12	LAN administrator is experienced and familiar with operation of the LAN facility.
	IT Physical Security
13	Alarms installed at all potential entry and exist points of sensitive areas.
	IT Service Agreements
14	Vendor reliability considered before purchasing LAN hardware and software.
15	Service log maintained to document vendor support servicing.
16	LAN hardware and software purchase contracts include statements regarding vendor support and licensing.
	IT Virus Protection Policy
17	The level of virus protection established on servers and workstations is determined and the monitoring of infection are being done by IT administration. Virus Application should be updated on a monthly basis. Laptops if issued should be ensured to have secured internet access.

STANDARD ON INTERNAL AUDIT (SIA) 15
KNOWLEDGE OF THE ENTITY AND ITS ENVIRONMENT*

Contents

Paragraph(s)

* Published in the March, 2009 issue of *The Chartered Accountant.*

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on what constitutes the knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and its environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process. This Standard also sets out the guidelines regarding the application, usage and documentation of such knowledge by the internal auditor.

2. **In performing an internal audit engagement, the internal auditor should obtain knowledge of the economy, the entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity-wide processes, systems, procedures and controls. The internal auditor should identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement.** Such knowledge is used by the internal auditor in reviewing the key operational, strategic and control risks and in determining the nature, timing and extent of internal audit procedures.

Acquiring Knowledge of the Entity's Operations and Environment

3. **Prior to accepting an engagement, the internal auditor should obtain a preliminary knowledge of the industry and of the nature of ownership, management, regulatory environment and operations of the entity subjected to internal audit, and should consider whether a level of knowledge of the entity's business adequate to perform the internal audit can be obtained.**

4. **Following the acceptance of the engagement, further and more detailed information should be obtained. To the extent practicable, the internal auditor should obtain the required knowledge at the commencement of the engagement. As the internal audit progresses, that information should be assessed, enhanced,**

updated, refined and validated as the internal auditor and the engagement team obtain more knowledge about the entity's business.

5. In case of continuing engagements, the internal auditor should update and re-evaluate information gathered previously, including information in the prior year's working papers. The internal auditor should also perform procedures designed to identify significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

6. The internal auditor should obtain sufficient, appropriate information about the entity, specifically the following aspects:

   (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment.

   (b) The nature of the entity to enable the internal auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

   (c) Business operations.

   (d) Investments and investment activities.

   (e) Financing and financing activities.

   (f) Financial reporting.

   (g) The entity's selection and application of accounting policies, including the reasons for changes thereto. The

internal auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(h) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

(i) Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- **The development of new products or services that may fail;**
- **A market which, even if successfully developed, is inadequate to support a product or service; or**
- **Flaws in a product or service that may result in liabilities and reputational risk.**

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement in the information subject to internal audit.

The Appendix to the Standard contains an illustrative list of sources from where the internal auditor may obtain information about the abovementioned aspects.

Sources of Information on Entity's Business

7. The internal auditor can obtain knowledge of the industry and the entity from a number of sources, *inter alia*:

   a) Previous engagement experience with the entity and its industry.

   b) The business plan of the entity.

   c) Incorporation documents like memorandum and articles of association in case of companies.

   d) The organisational structure and hierarchy of reporting system.

   e) Discussion with key management persons and operating personnel within the entity.

   f) Discussion with statutory audit personnel and review of statutory audit reports.

   g) Discussion with other auditors, legal and other advisors who have provided services to the entity or within the industry.

   h) Discussion with suppliers, customers and third party agencies.

   i) Discussion with knowledgeable experts outside the entity.

   j) Publications related to the industry, for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers.

   k) Legislations and regulations that significantly affect the entity and its business.

   l) Visits to the entity premises, plant facilities, depots, warehouses and other processing locations.

   m) Internal documentation produced by the entity, for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature.

   n) Prior years' annual and financial reports, budgets, internal management reports, interim financial reports.

o) Standard operating procedures (SOP), management policy manual, procedure manuals of accounting and internal control systems, chart of accounts, job descriptions, purchase policy, human resource policy, information technology manuals and procedures, credit policy, marketing and sales plans.

Using the Knowledge

8. Knowledge of the entity's business is a frame of reference within which the internal auditor exercises professional judgment in reviewing the processes, controls and risk management procedures of the entity. Understanding the business and using this information appropriately assists the internal auditor in:

   a) Assessing risks and identifying key focus areas.

   b) Planning and performing the internal audit effectively and efficiently.

   c) Evaluating audit evidence.

   d) Providing better quality of service to the client.

9. The internal auditor conducts review about several matters throughout the course of the internal audit engagement where knowledge of the business is important. For example:

   a) Assessing inherent risk and control risk.

   b) Considering business risks and management's response thereto.

   c) Developing the overall internal audit plan and programme.

   d) Determining materiality level and assessing whether the materiality level chosen remains appropriate.

   e) Assessing audit evidence to establish its appropriateness.

   f) Evaluating financial and non-financial estimates and management representations.

   g) Identifying areas where special audit consideration and skills may be necessary.

h) Identifying related parties and related party transactions.

i) Recognizing conflicting information, for example, contradictory representations.

j) Recognizing unusual circumstances, for example, fraud and non-compliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results.

10. The internal auditor should ensure that the internal audit engagement team assigned to an internal audit engagement obtains sufficient knowledge of the business to enable them to carry out the internal audit work delegated to them. The internal auditor should also ensure that the audit team appreciates and understands the need to be alert for additional information and the need to share that information with the internal auditor and other members of the internal audit team.

11. To make effective use of knowledge about the business, the internal auditor should consider how this knowledge acquired, affects his review of the internal controls and systems taken as a whole and whether his overall entity-wide assessment of systems, procedures, controls and risk management principles are consistent with his knowledge of the entity's business.

Documentation

12. The information and knowledge obtained by the internal auditor on the entity and its environment should be adequately documented in the engagement working papers.

Effective Date

13. This Standard on Internal Audit is applicable to all internal audits commencing on or after ……….. Earlier application of the SIA is encouraged.

Appendix

Examples of Matters that the Auditor May Consider in Obtaining Knowledge About the Entity

(Refer paragraph 6)

Industry Factors

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

Regulatory Factors

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

External Factors

- General economic conditions.
- Interest rates.
- Availability of financing.
- Inflation or currency revaluation.

Nature of the Entity

- Operations.
- Ownership and governance structures.
- Types of investments that the entity is making and plans to make.
- The way that the entity is structured and how it is financed.

Business Operations

- Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
- Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- Alliances, joint ventures, and outsourcing activities.
- Geographic dispersion and industry segmentation.
- Location of production facilities, warehouses, and offices, and location and quantities of inventories.
- Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).

- Research and development activities and expenditures.
- Transactions with related parties.

Investment and Investment Activities

- Planned or recently executed acquisitions or divestitures.
- Investments and dispositions of securities and loans.
- Capital investment activities.
- Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

Finance and Financing Activities

- Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

Financial Reporting

- Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
- Revenue recognition practices.
- Accounting for fair values.
- Foreign currency assets, liabilities and transactions.

- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

Selection and Application of Accounting Policies

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Entity's Objectives, Strategies and Related Business Risks

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).

- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

- The measurement and review of the entity's financial performance.

STANDARD ON INTERNAL AUDIT (SIA) 16
USING THE WORK OF AN EXPERT*

Contents

Paragraph(s)

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* Published in the March, 2009 issue of *The Chartered Accountant*.

Introduction

1. The purpose of this Standard on Internal Audit is to establish standard and provide guidance where the internal auditor uses the work performed by an expert.

2. **The internal auditor should obtain technical advice and assistance from competent experts if the internal audit team does not possess the necessary knowledge, skills, expertise or experience needed to perform all or part of the internal audit engagement.**

3. An expert for the purpose of this Standard is a person, firm or other association of persons possessing special skill, expertise, knowledge and experience in a particular field.

Independence of the Expert

4. **When the internal auditor uses the work of an expert, he should satisfy himself about the competence, objectivity and the independence of such expert and consider the impact of such assistance or advice on the overall result of the internal audit engagement, specially in cases where the outside expert is engaged by the senior management or those charged with governance.**

Determining the Need to Use the Work of an Expert

5. In course of the internal audit engagement, the internal auditor may seek to obtain assistance or advice in the form of reports, opinions, valuations and statements of an expert.

6. **When determining whether to use the work of an expert or not, the internal auditor should consider:**

   - **the materiality of the item being examined.**

   - **the nature and complexity of the item including the risk of error therein.**

   - **the other internal audit evidence available with respect to the item.**

Skills and Competence of the Expert

7. **When the internal auditor plans to use the expert's work, he should satisfy himself as to the expert's skills and competence by considering:**

- **the expert's professional qualifications or membership in an appropriate professional body.**
- **the reputation of the expert in the relevant discipline.**
- **the knowledge and specific experience of the expert in the industry to which the auditee entity operates.**

Objectivity of the Expert

8. **The internal auditor should consider the objectivity of the expert.** The risk that an expert's objectivity will be impaired increases when the expert is:

- employed by the auditee, or
- related in some other manner to the auditee.

Accordingly, in these circumstances, the internal auditor should consider performing more extensive procedures than would otherwise have been planned, or he might consider engaging another expert.

9. **The internal auditor should satisfy himself that the expert has no personal, financial or organizational interests that will prevent him from rendering unbiased and impartial judgments and opinion.**

Evaluating the Work of an Expert

10. **When the internal auditor intends to use the work of an expert, he should gain knowledge regarding the terms of the expert's engagement and such other matters as to:**

- **the objectives and scope of the work.**

- **a general outline as to the specific items in the expert's report.**
- **access to records, personnel and physical properties.**
- **the ownership and custody of engagement documentation and working papers, if applicable.**
- **the confidentiality of the expert's work, including the possibility of its communication to third parties.**
- **the expert's relationship with the auditee, if any.**
- **the confidentiality of the auditee's information used by the expert.**

11. The internal auditor should seek reasonable assurance that the expert's work constitutes appropriate evidence in support of the overall conclusions formed during the internal audit engagement, by considering:

- **the source data used.**
- **the assumptions and methods used and, if appropriate, their consistency with the prior period.**
- **the results of the expert's work in the light of the internal auditor's overall knowledge of the business and of the results of his audit procedures.**

12. **The internal auditor should consider whether the expert has used source data which are appropriate in the circumstances.** The procedures to be applied by the internal auditor include:

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable.

- conducting independent review procedures on the data provided by the auditee to the expert to obtain reasonable assurance that the data are appropriate.

13. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The internal auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. **The internal auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable and consistent based on the internal auditor's knowledge of the auditee's business and on the results of his review procedures.**

14. **In exceptional cases where the work of an expert does not support the related representations in the overall systems, procedures and controls of the entity, the internal auditor should attempt to resolve the inconsistency by discussions with the auditee and the expert.** Applying additional procedures, including engaging another expert, may also assist the internal auditor in resolving the inconsistency.

Reference to an Expert in the Internal Audit Report

15. **The internal auditor should not, normally, refer to the work of an expert in the internal audit report.** Such a reference may, however, be considered useful, in case of reporting in respect of cases such as material weaknesses or deficiencies in the internal control system or in such other cases where the internal auditor feels that such a reference would benefit the readers of the report. **While referring to such work of the expert, the internal auditor should outline the assumptions, broad methodology and conclusions of the expert. Where, in doing so, the internal auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.**

Effective Date

16. This Standard on Internal Audit is applicable to all internal audits commencing on or after ……….. Earlier application of the SIA is encouraged.

Standard on Internal Audit (SIA) 17 Consideration of Laws and Regulations in an Internal Audit*

Contents

Paragraph(s)

* Published in the February, 2010 issue of *The Chartered Accountant*.

Scope

1. This Standard on Internal Audit (SIA) deals with the internal auditor's responsibility to consider laws and regulations when performing an internal audit. This SIA also applies to other engagements in which the internal auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Definition

2. For the purposes of this SIA, the following term has the meaning attributed below:

   Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Effect of Laws and Regulations

3. The effect on the functioning of an entity of laws and regulations varies considerably. Those laws and regulations to which an entity is subject to constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated sectors (such as banking, non-banking finance, insurance, telecom, etc.). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to environment, occupational safety and health).

4. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on not

only the reporting framework of the financial statements but also on the functioning of the entity and which in extreme cases may impair their ability to continue as a going concern itself.

Responsibility of Management for Compliance with Laws and Regulations

5. It is the primary responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

6. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

   - Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
   - Instituting and operating appropriate systems of internal control.
   - Developing, publicising and following a code of conduct. Ensuring employees are properly trained and understand the code of conduct. Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
   - Targeting information for compliance to those employees or departments who are in the best position to verify possibilities of non-compliance.
   - Engaging legal advisors to assist in monitoring legal requirements.
   - Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

These policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- A compliance function.
- An audit committee.

Objectives

7. The objectives of the internal auditor are:

   (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

   (b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a significant impact on the functioning of the entity; and

   (c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the internal audit.

Responsibility of the Internal Auditor

8. Paragraph 3.1 of the "*Preface to the Standards on Internal Audit*", issued by the Council of the Institute of Chartered Accountants of India in 2007, describes internal audit as follows:

   "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."

9. Compliance with laws and regulations is an inherent part of the functioning of an entity. Since the role of an internal auditor is to carry out a continuous and critical appraisal of the functioning of an entity and

suggest improvements thereto, the identification of non-compliance with laws and regulations is also an inherent part of his responsibilities. It will be pertinent to add here that the scope of an internal audit as described in paragraph 9 of the Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*", is also affected by the statutory or regulatory framework in which the entity operates.

10. Unlike the statutory audit function, in which the auditor is responsible for identification of non-compliance with the laws and regulations with a view to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatements, whether caused by fraud or error, the responsibilities of an internal auditor are much wider. As discussed in Para 3 (v) of the Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*", internal audit helps, *inter alia*, amongst other things, in ensuring compliance with the applicable statutory and regulatory requirements.

11. The scope of internal audit is determined by the terms of engagement of the internal audit activity whether carried out in house or by an external agency. Hence, in the case of an internal audit, the terms of engagement are variable and have an impact on the responsibility of the management *vis a vis* the internal auditor. The terms of engagement amongst other things, generally, require the internal auditor to examine the status of compliance with various statutes governing the entity. Even in the absence of an explicit mention in the terms of the engagement, the internal auditor has to verify compliance with laws and regulations within the overall objectives of an internal audit, as discussed in paragraph 2 of the Standard on Internal Audit (SIA) 1, "*Planning an Internal Audit*" which are as follows:

- to suggest improvements to the functioning of the entity; and
- to strengthen the overall governance mechanism of the entity, including its strategic risk management as well as internal control system.

12. Paragraph 8 of the Standard on Internal Audit (SIA) 12, "*Internal Control Evaluation*", describes that the internal audit function adds value to an organisation's internal control system by bringing a systematic, disciplined

approach to the evaluation of risks and by making recommendations to strengthen the effectiveness of risk management efforts. Further, as discussed in paragraph 10 of the Standard on Internal Audit (SIA) 12, one of the broad areas of review by the internal auditor in evaluating the internal control system, *inter alia*, includes accounting and financial reporting policies and compliance with applicable legal and regulatory standards.

13. At the same time, as discussed in paragraphs 8 and 9 of the Standard on Internal Audit (SIA) 12, it may be noted that though the internal auditor's evaluation of internal control involves assessing non-compliance with laws and regulations, the internal auditor is not vested with the management's primary responsibility for designing, implementing, maintaining and documenting internal control.

14. Paragraph 9 of the Standard on Internal Audit (SIA) 13, "*Enterprise Risk Management*", describes that "***the internal auditor should not manage any of the risks on behalf of the management or take risk management decisions. The internal auditor should not assume any accountability for risk management decisions taken by the management.*** *Internal auditor has a role only in advising on risk management and assisting in the effective mitigation of risk."*

15. The internal auditor is expected to exercise due professional care while carrying out the internal audit in detecting non-compliance with laws and regulations. As discussed in paragraph 6 of the Standard on Internal Audit (SIA) 2, "*Basic Principles Governing Internal Audit*", due professional care, however, neither implies nor guarantees infallibility, nor does it require the internal auditor to travel beyond the scope of his engagement.

16. The requirements in this SIA are designed to assist the internal auditor in identifying the significant impact of non-compliance with laws and regulations on the functioning of the entity. However, in view of the inherent limitations on the role of the internal auditor as discussed above, the internal auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

17. In conducting an internal audit of an entity, the internal auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an internal audit, there is an unavoidable risk that some non-compliances with laws and regulations and consequential material misstatements in the financial statements may not be detected, even though the internal audit is properly planned and performed in accordance with the SIAs. In the context of laws and regulations, the potential effects of inherent limitations on the internal auditor's ability to detect non-compliance are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the internal auditor.

- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions captured or reflected in the entity's information systems relevant to financial reporting, the less likely the internal auditor is to become aware of it or to recognise the non-compliance.

18. This SIA distinguishes the internal auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and laws regulating the reporting framework; and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, or may even have a significant impact on the operations of the entity, but are not considered to have a direct effect on the financial statements, as described in paragraph 18(a). Non-compliance with laws and regulations that have a significant impact on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting. An example here could be an airline failing to meet the safety norms prescribed by the government leading to an uncertainty over continuance of its license to operate. Non-compliance with such laws and regulations may, therefore, have a significant impact on the functioning of an entity.

19. In this SIA, differing requirements are specified for each of the above categories of laws and regulations :

- For the category referred to in paragraph 18(a), the internal auditor's responsibility is to obtain sufficient appropriate audit evidence, in accordance with the Standard on Internal Audit (SIA) 10, "*Internal Audit Evidence*", about compliance with the provisions of those laws and regulations.

- For the category referred to in paragraph 18(b), the internal auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a significant impact on the functioning of the entity.

20. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements and in some cases, may impact significantly the functioning of the entity itself. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the internal auditor's professional competence to determine. Paragraph 2 of Standard on Internal Audit (SIA) 16, "*Using the Work of an Expert*" states as follows:

"***The internal auditor should obtain technical advice and assistance from competent experts if the internal audit team does not possess the necessary knowledge, skills, expertise or experience needed to perform all or part of the internal audit engagement****.*"

Nevertheless, the internal auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the internal auditor's attention, may constitute non-compliance with laws and regulations.

21. The internal auditor may have a specific responsibility, one that may arise out of the terms of engagement or a law or a regulation or a standard applicable to the internal auditor, to communicate directly, the above mentioned issues to an appropriate authority within the entity or a regulator. **In these circumstances, Standards on Internal Audit, SIA 4, "*Reporting*" and SIA 8, "*Terms of Internal Audit Engagement*", deal with how these audit responsibilities should be addressed in the internal auditor's report.** Furthermore, where there are specific statutory reporting requirements, it may be necessary for the internal audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

The Internal Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework

22. As part of obtaining an understanding of the entity and its environment in

accordance with Standard on Internal Audit (SIA) 15, "*Knowledge of the Entity and its Environment*", the internal auditor shall obtain a general understanding of:

(a) The legal, regulatory and the financial reporting framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

To obtain a general understanding of such a legal and regulatory framework, and how the entity complies with that framework, the internal auditor may, for example:

- Use the internal auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a significant effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations as well as ethical issues within the entity; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements

23. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 18(a)). They could include those

that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

24. Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements).

25. The internal auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations

26. The internal auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a significant impact on the entity's functioning:

    (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

    (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

27. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the internal audit procedures required by paragraph 26 are directed to bringing to the internal auditor's attention instances of non-compliance with laws and regulations that may have a significant impact on the functioning of the entity.

Non-Compliance brought to the Internal Auditor's Attention through Other Audit Procedures

28. During the internal audit, the internal auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the internal auditor's attention. For example, such audit procedures may include:

    - Reading minutes;
    - Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
    - Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations

29. The internal auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations which impact the functioning of the entity, including the reporting framework, have been disclosed to the internal auditor.

30. Because the effect of non-compliance on the functioning of an entity can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a significant impact on the functioning of the entity. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the internal auditor.

Internal Audit Procedures When Non-Compliance is Not Identified or Suspected

31. In the absence of identified or suspected non-compliance, the internal auditor is not required to perform audit procedures regarding the

entity's compliance with laws and regulations, other than those set out in paragraphs 22-30.

Internal Audit Procedures when Non-Compliance is Identified or Suspected

32. If the internal auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the internal auditor shall obtain:

    (a) An understanding of the nature of the act and the circumstances in which it has occurred; and

    (b) Further information to evaluate the possible effect on the functioning of the entity.

Indications of Non-Compliance with Laws and Regulations

33. When the internal auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

    - Investigations by regulatory organisations and government departments or payment of fines or penalties.
    - Payments for unspecified services or loans to consultants, related parties, employees or government employees.
    - Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
    - Purchasing at prices significantly above or below market price.
    - Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
    - Unusual payments towards legal and retainership fees.

- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Internal Auditor's Evaluation

34. Matters relevant to the internal auditor's evaluation of the possible effect on the entity's functioning include:

    - The potential financial consequences of non-compliance with laws and regulations on the functioning of the entity including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations and litigation.
    - Whether the potential financial consequences need to be informed to the management for the limited objective of suitable disclosure.
    - Whether the potential financial consequences are so serious as to call into question the ability of the entity to continue as a going concern.

35. The internal auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the internal auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

36. If the internal auditor suspects there may be non-compliance, the internal auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information to the internal auditor that the entity is in fact in compliance with laws and regulations, the internal auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible impact on the functioning of the entity. When it is not considered appropriate to consult with the entity's legal counsel or when the internal auditor is not satisfied with the legal counsel's opinion, the internal auditor may consider it appropriate to consult the internal auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud in accordance with the Standard on Internal Audit (SIA) 11, "*Consideration of Fraud in an Internal Audit*", and what further action, if any, the internal auditor would take.

37. If sufficient information about suspected non-compliance cannot be obtained, the internal auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the internal auditor's observations and findings.

Evaluating the Implications of Non-Compliance

38. The internal auditor shall evaluate the implications of non-compliance in relation to other aspects of the internal audit, including the internal auditor's risk assessment and the reliability of written representations, and take appropriate action.

39. The implications of particular instances of non-compliance identified by the internal auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

40. In exceptional cases, the internal auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is

necessary when management or those charged with governance do not take the remedial action that the internal auditor considers appropriate in the circumstances. **When deciding whether withdrawal from the engagement is necessary, the internal auditor should consider whether there is an obligation, contractual or otherwise to report the circumstances necessitating the withdrawal to other parties.**

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Those Charged with Governance

41. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated in accordance with the Standard on Internal Audit (SIA) 9, "*Communication with Management*", by the internal auditor, the internal auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the internal auditor's attention during the course of the internal audit, other than when the matters are clearly inconsequential.

42. If, in the internal auditor's judgment, the non-compliance referred to in paragraph 41 is believed to be intentional and material, the internal auditor shall communicate the matter to those charged with governance as soon as practicable.

Reporting Non-Compliance in the Internal Auditor's Report

43. If the internal auditor concludes that the non-compliance has a significant impact on the functioning of an entity and has not been adequately dealt with by the management, the internal auditor shall report the same in accordance with SIA 4, "*Reporting*".

44. **If the internal auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be significant to the functioning of the entity has, or is likely to have, occurred, the internal auditor should report the same in accordance with SIA 4, "*Reporting*".**

45. If the internal auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the internal auditor shall evaluate the effect on the internal auditor's observations and findings in accordance with SIA 4, "*Reporting*".

Documentation

46. The internal auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity in accordance with the Standard on Internal Audit (SIA) 3, "*Documentation*".

47. The internal auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Effective Date

48. This Standard on Internal Audit (SIA) is applicable for all internal audits commencing on or after ………….. Earlier application of the SIA is encouraged.

STANDARD ON INTERNAL AUDIT (SIA) 18
RELATED PARTIES*

Contents

Paragraph(s)

The following is the text of the Standard on Internal Audit (SIA) 18, *Related Parties*, issued by the Institute of Chartered Accountants of India. The Standard should be read in the conjunction with the "*Preface to the Standards on Internal Audit*", issued by the Institute of Chartered Accountants of India.

In terms of the decision taken by the Council of the Institute at its 260th meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standard shall become mandatory from such date as may be notified by the Council in this regard.

* Published in the March 2013 issue of the Chartered Accountant.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standard and provide guidance on the procedures to be followed by the internal auditor in ensuring that related party activities of the entity are properly captured through internal controls; and that related party activities are consistent with the entity's code of conduct and conflict of interest policy, applicable laws and regulations and disclosure requirements.

2. Management is responsible for the identification and disclosure of related parties and accounting for the related party transactions. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified, recorded and disclosed in the financial statements. The internal auditor is the appropriate resource for assessing what management has implemented with regard to related party information by evaluating relevant internal controls, and informing the management about the deficiencies detected with suggestions for improvement.

Definitions

3. (i) *Related Party*

   Parties are considered to be related, if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making financial and/ or operating decisions.

   (ii) *Control*

   (a) Ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

   (b) Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) A substantial interest in voting power and the power to direct, by statute or agreement, the financial and/ or operating policies of the enterprise.

(iii) *Significant Influence*

Participation in the financial and/ or operating policy decisions of an enterprise, but not control of those policies.

(iv) *Relative*

In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/ her dealings with the reporting enterprise.

For the purpose of this Standard, all other terms used herein would have the same definition/ meaning as used in Accounting Standard (AS) 18, "*Related Party Disclosures*" issued by the Institute of Chartered Accountants of India.

4. An entity is considered to control the composition of:

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise, in case that enterprise is a company, the director is nominated by that company/ subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

Related Party Transactions

5. A related party transaction is a transfer of resources, services or obligations between an entity and a related party, regardless of whether or not a price is charged. Transactions that because of their nature may be indicative of the existence of related parties include:

(a) Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.

(b) Buying/ selling transactions at a price that differs significantly from its appraised value.

(c) Exchanging property for similar property in a non-monetary transaction.

(d) Making loans with no scheduled terms of repayment.

(e) Granting of a guarantee without adequate compensation.

6. Related party transactions may not be conducted under normal market terms and conditions at all times. There may be possibility

that transactions with related party may have been motivated solely, or in large measure, by conditions similar to the following:

(a) Lack of sufficient working capital or credit to continue the business;

(b) An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's share;

(c) An overly optimistic earnings forecast;

(d) Depending on a single or relatively few products, services, customers, suppliers or transactions for the continuing success of the venture;

(e) Excess capacity;

(f) Significant litigation, especially, litigation between stakeholders and management;

(g) A declining industry characterized by a large number of business failures;

(h) Significant technology obsolescence.

Internal Audit Procedures

7. The internal auditor shall perform the internal audit procedures and related activities to obtain information relevant to evaluating internal controls associated with related party relationships and transactions. The internal auditor shall gather the following information pertaining to related party relationships and transactions:

(a) The identity of the entity's related parties including changes from the prior period;

(b) The nature of the relationships between the entity and these related parties; and

(c) Whether the entity has entered into any transaction with these related parties during the period and, if so, the nature and extent, and the purpose of the transaction.

8. The following may be considered by the internal auditor while understanding the entity's related party relationships and transactions:

   (a) The nature and extent of the entity's relationships and transactions with related parties.

   (b) An emphasis on the importance of maintaining due professional care throughout the internal audit regarding the potential for material misstatement associated with related party relationships and transactions.

   (c) The circumstances or conditions of the entity that they indicate the existence of related party relationships or transactions that management has not identified or disclosed to the internal auditor (for example, a complex organizational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).

   (d) The records or documents that may indicate the existence of related party relationships or transactions.

   (e) The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions, and the related risk of management override of relevant controls.

9. The internal auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed:

   (a) Bank and legal confirmations obtained as part of the internal auditor's procedures;

   (b) Minutes of the meetings of the shareholders and of those charged with governance; and

   (c) Such other records or documents as the internal auditor considers necessary in the circumstances of the entity, for example:

      - Entity income tax returns.

- Information supplied by the entity to statutory and regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

If the internal auditor identifies significant transactions outside the entity's normal course of business then the internal auditor shall obtain information about the nature of these transactions and whether the related parties are involved.

10. In smaller entities, the identification of related party transactions can often be difficult. If the entity uses a standard software package to record transactions, consider obtaining an electronic copy of the transactions and importing them into an electronic spreadsheet. By using the sort feature and configuring the selection criteria, it may be possible to obtain information about customers/ suppliers with only a few, but large, transactions, or those with significant transactions of a size or nature that is unusual.

11. In responding to the identified risks of material misstatement associated with related party relationships and transactions, the internal auditor would consider the following:

    (a) Determine whether underlying circumstances confirm their existence;

    (b) Promptly communicate the information to the engagement team;

    (c) Request management to identify all the transactions with the related party;

    (d) If related party was not previously identified, consider:

    - failure of any related party identification controls, and
    - fraud (non- disclosure by management appears intentional);

    (e) Reconsider the risk that the other undisclosed related parties or significant related party transactions may exist, and perform additional internal audit procedures as necessary; and

    (f) Perform appropriate substantive internal audit procedures.

12. With regard to significant related party transactions outside normal course of business, the internal auditor should inspect underlying contracts or agreements, if any, and evaluate whether:

    (a) Rationale suggests possible fraudulent financial reporting or concealment of misappropriated assets;

    (b) Terms are consistent with management‘s explanations; and

    (c) Transactions are accounted for and disclosed in accordance with the generally accepted accounting principles;

    (d) Ensure transactions have been appropriately authorized and approved.

13. **The internal auditor should obtain sufficient appropriate audit evidence about management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.** Evaluating management's support for this assertion may involve one or more of the following:

    (a) Considering the appropriateness of management's process for supporting the assertion.

    (b) Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.

    (c) Evaluating the reasonableness of any significant assumptions on which the assertion is based.

14. **The internal auditor should consider the following matters:**

    (a) **Document the names of the identified related parties and the nature of the related party relationships; and**

    (b) **Communicate with those charged with governance, or relevant committee thereof, such as, audit committee, any significant matters arising during the internal audit in connection with related parties.**

15. **The internal auditor should consider the impact on the internal audit report if it is not possible to obtain sufficient appropriate audit evidence concerning related parties and transactions, and should suitably disclose it in the internal audit report, based on it's materiality.**

Effective Date

16. This Standard on Internal Audit will apply to all internal audits commencing on or after ______. Earlier application of the SIA is encouraged.