

## Future of Internal Audit is Now – Provisions in Companies Act, 2013



*The Companies Act, 2013, has definitely shaped the way forward for internal audit function in India, and has provided a strong legal mandate for the crucial role of internal auditors in the corporate governance structure. The writing on the wall is clear – from the earlier requirement of CARO prescribed in the erstwhile Companies Act, 1956, requiring the statutory auditor to comment on internal audit system being commensurate with the size and nature of business for specified companies, the internal audit has successfully earned a mandatory requirement in the new Companies Act, 2013. While listed companies, as per requirement in Clause 41 of the Listing Agreement, already maintained internal audit departments, the Companies Act, 2013 has extended the coverage to unlisted public companies and private companies meeting specified criteria.*

Section 138 to The Companies Act, 2013, states as follows:

### **“Internal audit**

*138 (1) Such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as*



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may be decided by the Board to conduct internal audit of the functions and activities of the company.  
(2) The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.”

### Companies (Accounts) Rules, 2014

In this regard, the Companies (Accounts) Rules, 2014, which comes into effect from 1st April, 2014, lays down rules, as follows:

#### “13. Companies required to appoint internal auditor:-

- (1) The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:-
- (a) every listed company,
  - (b) every unlisted public company having –
    - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
    - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
    - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
    - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
  - (c) every private company having –
    - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
    - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Provided that an existing company covered under any of the above criteria shall comply with the requirements of Section 138 and this rule within six months of commencement of such section.

*Explanation – For the purposes of this rule –*

- (i) The internal auditor may or may not be an employee of the company;
  - (ii) The term “Chartered Accountant” shall mean a Chartered Accountant whether engaged in practice or not.
- (2) The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.”

While listed companies, as per the requirement

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in Clause 41 of the Listing Agreement, already maintained internal audit departments, the Companies Act, 2013 has extended the coverage to unlisted public companies and private companies meeting specified criteria. This requirement is intended to ensure that the specified companies have a mechanism in place to regularly review and assess their internal control system and, thereby, to identify any weaknesses and develop and implement appropriate measures. The internal audit function plays an important role in the corporate governance framework, and would thereby protect investors and public interest. Internal auditors should rise to the task and seize the opportunity of establishing high performing internal audit functions as per the new requirements. Further, the abovementioned Rule is applicable from 1st April, 2014, which means that by 30th September, 2014, companies which are required to appoint the internal auditor should comply with the provisions of Section 138 and the corresponding Rules, thereby allowing sufficient time for companies that have not yet done so. The Rules also provide leverage to the companies to keep an employee of the company as internal auditor.

In order to maximise independence and objectivity of the internal audit function, the Companies Act, 2013, also specifies that the primary reporting line of the internal audit function should be the Audit Committee. The new regulatory requirement very clearly requires that the Audit Committee of the company or the Board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It is very important for the internal audit function to have the full support of the Board and the Audit Committee, and



also equally important for it is to understand their expectations. This direct contact with the Audit Committee would surely help the internal audit to maximise its contribution to good governance and exhibit high quality of professionalism and quality in its work. The objective is to set up an effective internal audit function which would assist the audit committee in discharging its responsibilities in light of its limited time and oversight capacity.

Further, Section 144 of The Companies Act, 2013, which deals with “Auditor not to render certain services” *inter alia* specifically prohibits the external auditor to render services of the internal audit to the company, whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company. This prohibition justifies that external audit and internal audit should be two separate functions with a clear division of responsibility.

### Internal Control Systems and Compliances

In the new regulatory environment, responsibility and liability have been elevated to an unprecedented level and the demand for heightened accountability resonates especially clearly for the Directors. Section 134 of the Companies Act, 2013, has added the following two new requirements to be included in 'Directors' Responsibility Statement':

“134.....

**Section 134 of the Companies Act, 2013, has introduced the following new requirement to be included in the report by the Board of Directors in its report given in general meeting: “134 (3) (n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company,”**

(5) The Directors' Responsibility Statement referred to in Clause (c) of sub-Section (3) shall state that

..... (e) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

*Explanation* – For the purpose of this Clause, the term “internal financial controls” means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.”

An effective internal audit function can help the Directors' in fulfilling these newly introduced requirements by objectively validating the effectiveness of the internal control system and compliance function. The internal auditor can provide support by examining the continued effectiveness of the internal control system through evaluation and make recommendations, if any, for improving that effectiveness. As far as compliance is concerned, the internal audit can review the adequacy and effectiveness of the functioning of controls implemented by the management to ensure compliance with the applicable laws and regulations. In broader terms, it can assist the directors in auditing compliance and the compliance function by providing valuable inputs.

The new regulations also specifically require, as per Section 177, for the Audit Committee to evaluate internal financial controls and risk management systems. Section 177 (5) of the Act clearly states as follows:

“Section 177 (5) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.”

It may also be clarified that under the provisions of the Act, the Board of Directors and the Audit Committee is solely responsible for establishing an efficient system of internal control. Internal audit may serve in many capacities, including advisory, testing, training and development, so long as that should not cross the line into a decision-making role.

## Risk Management

Risk management is a central part of any organisation's strategic management. In fact, risk management and internal control are two sides of the same coin, as risk management focuses on the identification of threats and opportunities, and controls are designed to effectively counter threats and take advantage of opportunities. Successful organisations seek to integrate risk management and internal control into all activities, through a framework of risk identification, risk assessment and risk response. Section 134 of the Companies Act, 2013, has introduced the following new requirement to be included in the report by the Board of Directors in its report given in general meeting:

"134 (3)(n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company,"

As soon as the task of reviewing the company's risk management systems reaches even a reasonably low level of complexity, the board of directors will find the need to delegate this important work. Decisions should be made only with the explicit understanding of related risks and the potential consequences for achieving an organisation's objectives. Thus, the Board of Directors require relevant and reliable information on risk management for decision making and control processes. In other words, it requires a skilled team of internal auditors who can act independently and report back objectively to



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the board of directors. Internal audit function, thus, can provide an objective assurance to the board on the effectiveness of the company's risk management activities to help ensure key business risks are being managed appropriately.

Further, the more risk-mature the organisation is, the more internal audit can give the board a realistic picture of how well risks to their strategic objectives are being managed. The top risks where internal audit can play a vital role are:

- Data privacy and security
- Business continuity
- Fraud
- Reputation and Brand
- Regulatory compliance
- Outsourcing
- Ethics and culture
- Merger and acquisitions
- Product innovation
- Employee relations
- Access to Finance
- Economic uncertainty

## Conclusion

Change and innovation are the norms. Indian corporates are facing challenges in implementing the new requirements and the internal auditors can and should take a leading role. Internal auditors must be conscious that the current responsibilities come with new risks and new rewards. Continuous learning with an eye on the future and a timely application of relevant knowledge to create value will help to increase the internal audit's credibility and confidence in their enhanced roles. The ability to learn, and translate that learning into action rapidly, is the ultimate competitive advantage, and then only the corporates will be able to reap the benefits of sustainable compliance in this new regulatory era. ■