

# The new internal audit paradigm

The Companies Act 2013 (Act) has introduced far-reaching changes to enhance transparency in financial reporting. **Dr. Suresh Surana** provides a brief overview of certain mandatory provisions for internal audit, the penalties for non-compliance, the meaning of internal audit and its role in businesses, the role of information technology in internal audit and actions required to comply with the provisions and align internal audit with organisational objectives.

The Companies Act 2013 (Act) has introduced far-reaching changes that have come into effect from April 1, 2014. These changes are expected to enhance transparency in financial reporting which will result in greater and unprecedented accountability on the part of the board of directors (BOD), the audit committee (AC), independent auditors and senior management (SM) including chief executive officers (CEOs), chief financial officers (CFOs), chief commercial officers (CCOs) and company secretaries. The board of directors and senior management have the responsibilities of risk management, establishing and ensuring internal control system and compliance framework and more. The Act stipulates specific requirements for compliance by certain class of companies with respect to internal audit (IA).

## The new paradigm for internal audit

What has changed? Earlier, under the Companies Act, 1956, there were no specific provisions for the appointment of internal auditors. The only reference to internal audit was under the Companies (Auditor's Report) Order, 2003 (CARO) wherein the statutory auditor had to comment under clause (vii) of the annexure to the Auditor's Report that "In our opinion, the company has an internal audit system

commensurate with the size and nature of its business". In the event the comment of the auditor was in the negative, only the disclosure of the same in the CARO report as a qualification by the auditor was required. There were no specific penalties under the provisions of the Companies Act, 1956.

## Regulatory requirements for internal audit under the Companies Act 2013

Section 138 (1) of the Act, has given statutory recognition to the function of internal audit by defining mandatory internal audit for certain class of companies.

**Effective from September 30, 2014 onwards applicable to all listed companies**  
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- All unlisted public companies which have in the preceding financial year (FY) either paid up share capital of ₹50 crore or more; or turnover of ₹200 crore or more; or outstanding loans or borrowings from banks or public financial institutions of ₹100 crore or more at any point of time; or outstanding deposits of ₹25 crore or more at any point of time.
- All private companies which have in the preceding financial year, turnover of ₹200 crore or more; or outstanding loans or borrowings from banks or public financial institutions of ₹100 crore or more at any point of time.



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The internal auditor has to be either a chartered accountant or a cost accountant or such other professional as may be decided by the board of directors. Further, the Act also clarifies that the internal auditor may or may not be an employee of the company and the term "chartered accountant" shall mean a chartered accountant, whether engaged in practice or not. Rule 13 of Companies (Accounts) Rules, 2014 specifies that the companies fulfilling the above criteria have to appoint an internal auditor or firm of internal auditors. It has also been specified that the central government may by rules prescribe the manner and the intervals in which internal audit will be conducted and reported to the board of directors.

The Act also says that where the existing internal auditor is also performing the role of a statutory auditor of the subsidiary, or its holding or associate company or subsidiary of such holding or associate company, then such an internal auditor will be disqualified from taking up the statutory audit unless he relinquishes the position of internal auditor of the company.

Besides this, companies have the additional responsibility to ensure that appropriate internal financial control framework, enterprise risk management, fraud risk management and legal compliance framework are in place.

## Penalties for non-compliance

No specific penalty has been prescribed for violation of Section 138.

As such the penalties under Section 450 (punishment where no specific penalty or punishment is provided) will be applicable, wherein for every violation, the company and any officer of the company or any other person involved shall be:

- Punishable with fine which may extend to ₹10,000; and
- Where the contravention is a continuing one, with a further fine which may extend to ₹1000 for every day after the first during which the contravention continues.

Section 451 of the Act provides for "punishment in case of repeated default":

If a company or an officer of the company commits an offence punishable either with fine or imprisonment and where the same offence is committed for the second or subsequent occasions, within a period of three years, then, that company and every officer thereof who is in default shall be punishable with twice the amount of fine for such offence in addition to any imprisonment provided for that offence.

As such, it is imperative that the board of directors, audit committee and chief financial officer of every company are fully aware of the provisions of the Act and, considering their eligibility or otherwise, under these provisions, take appropriate actions to ensure compliance of the regulations.

## Internal audit: meaning and role in businesses

Internal audit is not defined in the Act; however, it is defined in the preface to the standards on internal audit issued by the Institute of Chartered Accountants of India (ICAI) thus:

"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 systems."

Internal audit as an independent function evaluates adequacy and effectiveness of governance, risk and compliance management and controls and provides feedback to the board of directors and senior management which helps them fulfil their duties to the organisation and its stakeholders. Internal auditors work with businesses to monitor and



## Changing role of internal auditor

## Role of IT in internal audit

Businesses today are driven by information technology (IT) systems in terms of enterprise

Transactions processed through technology systems need special attention from the perspective of internal audit. These include tests to ensure that the transactions are processed completely, that they follow the business rules and ensure that integrity of the data is maintained. There are also tests to check application controls covering inputs, output and data processing controls.

For complying with the requirements of the Act and Rules, the board of directors/audit committee should undertake the following:

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