Ch 16
PARAM

16 Internal Audit

Part 1- Internal Audit

QBQ 2021/ 2022 PARAM | **Sec 138- Applicability/Average Turnover of Past 3 Years | Sec 2(45)- Definition of Small Company** | **Old Course – ONGC, SESLR, SAIL2, IRWA, NLCIL, NLMK, NLCIL, NLMK, NLCIL**

JKH Pvt Ltd, who is into the business of importing cooking to CA students did not appoint any internal auditor for the financial year 2021-22. The company's Profit & Loss Account showed a turnover of 9.50 lakhs and revenue of 9.10 crore. Its expense for that year amounting to crore added from the 2017 was 9.70 crore; 5 Lakh crores and 2 000 (Pence respectively. As an auditor of the company for the year ended 31st March 2022, how would you deal with the above?

OR

PQR Ltd., a listed company and having an average annual turnover of more than Rs 5 crores has no Internal Audit System. Give your views.

OR

ABC Pvt Ltd was involved in the business of manufacturing pipes and tubings. For financial year 2020-21, the company had a turnover of Rs 4 crore and a net profit of Rs 2 crore. The company's Profit and Loss Account showed Sales of Pipes Plus Manufacturing 100 Crore & Cost Holdings and Other Internal Expenses 20 Crore and Sales of Pipes Plus Manufacturing 60 Crore & Cost Holdings and Other Internal Expenses 10 Crore. Turnover and Profit of the company for the year 2021-22 is given hereunder: Segment Name Turnover Profit Steel 2 Iron Pipe Manufacturing 90 Crore 8 Crore Holdings and Old Internal Expenses 20 Crore Steel 2 Iron Pipe Manufacturing 70 Crore 6 Crore Holdings and Old Internal Expenses 10 Crore. Fully financed through its own capital during both years. Kindly assess whether the company was required to appoint internal auditor as per section 138 read with Rule 13 of the Companies (Accounts) Rules, 2014 for the year 2021-22.

Answer | **Section 138(1) Provided Inter Alia**
- As per section 138 of the Companies Act, 2013, read with Rule 13 of Companies (Audit and Auditors) Rules, 2014,

Section 138(1) Provided Inter Alia
- As per section 138 of the Companies Act, 2013, the following class of companies (prescribed in rule 13 of Companies (Audit and Auditors), 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:
  - **every listed company;**
  - **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
  - **Every private company having –**
    - (i) paid up share capital 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;

Section 138(1) Provided Inter Alia
- As per section 138 of the Companies Act, 2013, read with Rule 13 of Companies (Audit and Auditors) Rules, 2014,

Section 2(45) Provided Inter Alia
- Hence, the company has the statutory liability to appoint an internal Auditor and mandatorily conduct internal audit.

Section 2(45) Provided Inter Alia
- In the present case, PQR Ltd is a listed company and having an average annual turnover of more than 5 crores.
  - As the company is a listed company, the provisions related to internal audit shall be applicable to the company irrespective of its turnover and net worth.

Section 2(45) Provided Inter Alia
- Therefore, the auditor will have to maintain in his report the fact of not having such internal audit system in place.

Author's Note

Only turnover of last year is important. Turnover of previous years either than that is of no use. Earlier previous three turnover was important as average of last three year was calculated to be 5000 reporting on internal audit. Now there is no such requirement.

QBQ 2021/ 2022 PARAM | **Who can become Internal Auditor?** | **New Course – (DMCS)**

Who can become Internal Auditor?
- **Partner in Practice (Chartered Accountant) or Firm of Chartered Accountants**
- **Internal Employee (Chartered Accountant)**
- **Outsourcing Agency (Chartered Accountant)**

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Who can be appointed as Internal Auditor?
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QBQ 2021/ 2022 PARAM | **Applicability of Internal Audit & Scope of Internal Audit** | **New Course – (DMCS)**

Applicability of Internal Audit & Scope of Internal Audit
- **Section 138 of the Companies Act, 2013 states that every private limited company having outstanding loans or borrowings from banks exceeding one hundred crore rupees or more at any point of time during the preceding financial year, shall be required to appoint an internal auditor and what work would be entrusted to him.**

Applicability of Internal Audit & Scope of Internal Audit
- **Section 138 of the Companies Act, 2013 states that every private limited company having outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.**
- **In view of above provisions, JK Pvt. Ltd. is under compulsion to conduct internal audit as its loans or borrowings are falling under the prescribed limit.**

Who can be appointed as Internal Auditor? Internal auditor shall either be a chartered accountant or a

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

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

QBQ 2021/ 2022 PARAM | **Reporting Approach** | **New Course – (DMCS)**

Reporting Approach
- **The IAC ect is to appointed Bc. A to conduct their internal audit for one financial year. The audit committee requested Bc. A to present their internal audit plan for next financial year after approval.**

Answer The internal auditor should, in consultation with those charged with governance, including the audit committee, prepare a risk based plan to ensure that internal audit engagement to help best rendered for engagement in an efficient and timely manner.

Internal audit plan should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle. Also, ensuring that appropriate consideration is made and adequate balance is ensured to the following aspects:
- Risk profiling the business process
- Impact on the internal audit can provide to the organization
- Cost of internal audit function, which is a particular business process.
- Risk appetite of the organization
- Coverage of auditable area within the defined time range

QBQ 2021/ 2022 PARAM | **Reporting Structure for Internal Auditor** | **New Course – (DMCS)**

Reporting Structure for Internal Auditor
- **The IAC ect is to appoint Mr. A as Chief Internal Auditor to lead the internal audit function for the company. Mr. A is a senior manager in the company has asked the HR head to report directly to the Managing Director of the company. The Managing Director of the company has asked the HR head to report directly to the Chief Internal auditor and Chief Internal auditor must prepare to the Managing Director.**

Answer HR Head need to evaluate multiple options that identify most suitable option in light of the relevant factors and the organization's specific needs. The decision should prioritize the effectiveness of the internal audit function for the organization, ensuring that various factors, including reporting lines and internal auditor. The ultimate objective is to establish a structure that supports the overall goals of Structure, Audit Committee, Managing Director and Chief Internal Audit Officer or Chief Financial Officer.

As per Section 138 of the Companies Act 2013, the internal auditor shall either be a chartered accountant, or a firm of chartered accountants, or such other professional as may be decided by the board to conduct internal audit of the functions and activities of the company.

As per the revised definition of the term 'Internal Audit' as per para 2 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organizational objectives".

Advantage The Internal auditor can be two types of internal auditors. Internal Employee Internal Auditor and Outsourcing Internal Auditor. Internal Employee Internal Auditor Advantages Also, the internal auditor should be independent of the activities being audited and should have no operational responsibilities or interests in the organization. Also we expect the independence to be able to perform his duties and report to audit committee or Board of Director independently.

QBQ 2021/ 2022 PARAM | **Appraisal of Organizational Function** | **Old Course – (BCBM, NLMK)**

Appraisal of Organizational Function
- **Internal auditor makes an appraisal of organization structure to ensure that it is harmony with the objectives of the entity, handles checking of control information and operations and utilization of the entity. Elaborate.**

OR

ABC Ltd. is engaged in manufacturing of Fans and Heater. It sells its product in both domestic as well as in International Market. It has achieved turnover of 200 crores in the F.Y. 2016-17. Directors of the company are considering to appoint an internal auditor. Explain the scope of work and the objectives of Internal Auditor for appraisal of the organizational structure to ascertain whether it is in harmony with the objectives of ABC Pvt Ltd. Comment.

Answer
- **Scope of Internal Audit**
  - **Organizational Structure Harmony Structure & Objectives**
    - The internal auditor should conduct an appraisal of the organization structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the authority and responsibilities is in consonance therewith.
  - **What to evaluate**
    - For this purpose:
      - He should review the **manner in which the activities of the enterprise are carried out** and ascertain whether it is in harmony with the prescribed authority responsibility and authority as in harmony with the progress pattern.
      - The internal auditor should **examine the organization chart** to find out whether **the lines of authority are commercial and that no function enjoys an undue dominance over the others.**
      - He should particularly see that the **responsibilities of managerial staff at headquarters do not overlap with those of chief executives or operating units.**
      - He should examine whether there is a **satisfactory balance** between authority and responsibility at various levels of management.
      - The internal auditor should examine the **reasonableness of the span of control of each executive** (the number of sub-ordinates that an executive controls). He should also examine whether there is a unity of command i.e. whether each person reports only to one superior.
      - When **duel responsibilities cannot be avoided, the primary one should be clearly defined and the responsibility to each senior head** This must be made known to all concerned.
      - Finally, he should evaluate the **process of managerial development** in the enterprise. This is a vital aspect in a fast-growing enterprise.

QBQ 2021/ 2022 PARAM | **Evaluation of the Internal Audit Function.** | **New Course – (DMCS)**

Evaluation of the Internal Audit Function.
- **Discuss the important aspects to be considered by the External auditor in the evaluation of the Internal Audit function.**

Answer Evaluation of Internal Audit Functions by External Auditor: The external auditor evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The following are the aspects for evaluation and conclusion to the report. The important aspects to be considered in the context are:

1. **Organizational Status** – Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself. the internal auditor reports to the management. In an ideal situation, his reports to the highest level of management and are free of any other influence or interference. The internal auditor should be free to express his opinion and conclusions should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

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2. **Scope of Function** – The external auditor should ascertain the nature and depth of coverage of the internal audit function. The internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
3. **Technical Competence** – The external auditor should ascertain that internal audit function is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the internal auditors and their continuing education.
4. **Professional Care** – The external auditor should ascertain whether internal audit work appears to be properly supervised and documented, sufficient appropriate evidence is obtained, and that professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

QBQ 2021/ 2022 PARAM | **Internal Auditor Agreed to Ensure Compliance with Laws & Regulations** | **Old Course – (NLCIL)**

Internal Auditor Agreed to Ensure Compliance with Laws & Regulations
- **As they is internal auditor of a listed company. The company wants to make sure that it is complying with SEBI requirements of all laws and it is now on the wrong side of law. As the internal auditor to ensure that the company is complying with all laws and regulations. Internal auditor agreed to ensure that "entire set-up" of internal audit spread of their organization "compliance with laws and regulations."**

Can he perform such type of activities? Capacity of Internal Auditor of company?

Internal Auditor Agreed to Ensure Compliance with Laws & Regulations
- **