

Operational Audit and Internal Audit under Companies Act, 2013

15

This Module includes:

- 15.1 Introduction**
- 15.2 Preparation for an Audit**
- 15.3 Audit Engagement Letter**
- 15.4 Role of CMAs in Internal Audit and Operational Audit**
- 15.5 Internal Audit under Companies Act, 2013**
- 15.6 Internal Audit and Companies (Auditor's Report) Order**
- 15.7 Internal Audit in Companies under manufacturing sector**

Operational Audit and Internal Audit under Companies Act, 2013

SLOB Mapped against the Module

To obtain in-depth knowledge about the existing regulatory framework for internal and operational audit to conduct effective audit procedure in organisations. (CMLO 4a, b)

Module Learning Objectives:

Operational audits are audits that focus on the effectiveness, productivity and cost efficiency of the operations of the business. Internal audits focus on what has happened already. Businesses look at the mistakes that were made and the vulnerabilities in the system which allowed those mistakes to be made. After studying this module, the students will be able to –

- ✦ Appraise the company's objectives with regards to Operational and Internal Audit
- ✦ Evaluate company's policies, the structure of organisation and its Control Systems
- ✦ Conduct Appraisal of performance, which involves examination of work flow, determination of ideal work force, performance, productivity, profitability, performance, and appraisal of costs and looking for swags opportunity, if any.

As per section 138 of Indian Companies Act, 2013 read with Rule 13 of Companies (Accounts) Rules, 2014, certain class of companies are required to appoint Internal Auditors. An extract of Rule 13 of Companies (Accounts) Rules, 2014 is as follows-

Extract of Rule 13 of Companies (Accounts) Rules, 2014:

Companies required to appoint internal auditor.

The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely: -

- (a) every listed company; Always applicable
- (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(income) 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;
 - (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 – The internal auditor may or may not be an employee of the company. 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. However, the rule specifies that an internal auditor may or may not be an employee of the company. The Internal auditor may be a CA/CMA or any other professional. Also, neither the rules nor the Act, has specified the duties and responsibilities. So even if the rules and act made the appointment of Internal Auditor mandatory, the same rules and Act provides option

to companies to appoint any person as internal auditors. Anyone who has the knowledge can become an Internal Auditor, because the rules did not define the word “any other professional”.

Understanding of Operations of the entity is the pre-requisite for conducting Internal Audits (IA). The definition of Internal Audit (by The Institute of Internal Auditors) clearly indicates the IA’s role of value addition and improve an organisation’s operations. An unremitting commitment is elemental to accomplish success and ceaseless application of process specific operational audits is to be undertaken on a proactive basis.

Simple way of defining ‘operation audit’ is adopting the residuary approach that is **‘auditing which goes beyond financial transactions and accounting records and examines into the operating, managerial or administrative performance of the entity’**. In other words it is a future-oriented, systematic, and independent evaluation of the entire gamut of organisational activities, for example, how an organisation’s management and its operating procedures are functioning with respect to their efficiency in meeting stated objectives.

The objective of the operational audit process is to improve the way the business performs e.g. operational audit can help businesses lower costs, decrease the turnaround time for many processes, directly improving service delivery and customer satisfaction.

Discovering opportunities for improvement:

Operational audit programs are much more in-depth than normal internal audits. They do not look at how things are, they also look at how things could be. This means that in an operational audit, the auditors do not simply audit the performance of the organisation, they also look for better ways of accomplishing the same tasks effectively.

Preparation for an Audit

15.2

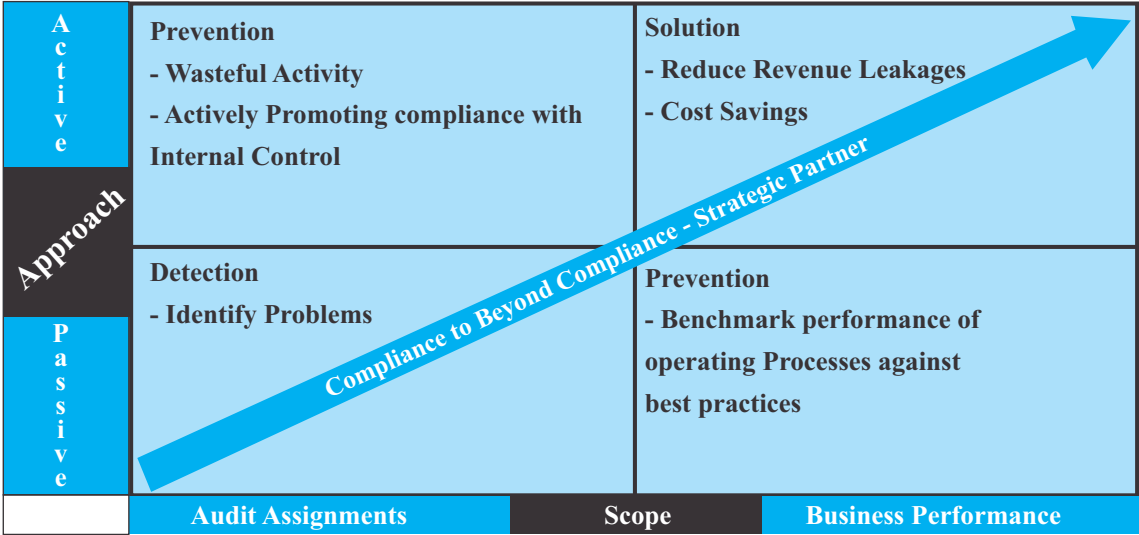


Figure 15.1: Preparation for Audit

The aforesaid diagram indicates ‘active’ and ‘passive’ approach in all types of ‘audit assignments’ and especially for ‘operational Audit’ for a paradigm shift to ‘beyond compliance’. As evident from above, the active zone of ‘operational audit’ is to prevent “wasteful activities” with a view ‘to reduce revenue leakages and cost’. This in turn having a positive impact on business performance.

The contemporary approaches of ‘Risk Based Audit’ are not in total sync with ‘Operational Audit’. Risk pertaining to “Operations” is prioritized for ‘Risk Based Audit’ and recommended mitigation, fails to provide a holistic coverage for the entire gamut of risk associated with the ‘Operation’ and improvement in ‘value chain’ through a set of corrective measures.

With the introduction of ‘Operation Audit’ the entire activities related to the operation reviewed for achieving the defined objective /s.

“Operational Audit” Objective:

‘Operational Audit’ objective has been coined here after the name of connoisseur of TQM (Total Quality Management), W.E. Deming. To define the objective the word ‘DEMING’ is used, where each of the word stands for a definitive objective accomplishment.

- D** – Detailed understanding for existing process to suggest improvement
- E** – Eliminate Waste, Duplication of work
- M** – Merge Operations/Processes to reduce Turn Around Time
- I** – Improve/Increase Quality, Volume, Revenue
- N** – New Methods, Techniques, Devices for better result/throughput
- G** – Govern Man, Machine, Methods and Money

To carry out the heightened expectations of ‘stakeholders’ on their shoulder, Auditors can no longer spend their time looking down at financial controls and compliances rather to spend much more time in operation Reviews.

Gone are days of ‘pushing the pencil’; ‘brain power’ is taking place of ‘brawn power’. To support the accomplishment of aforesaid objective, the audit process to lend appropriate support. Process provides a methodology for intelligently and efficiently integrating People, Tools, Procedures and Technology for the best results/ outcome.

Advantages and Disadvantages of ‘Operational Audit’

- ⊙ Going through the operational audit process provides a company with objective opinions. These opinions often generate quicker production by lowering TAT (Turn Around Time), pointing process inefficiencies, the location of areas of delay/lapses, cost rationalization/reduction.
- ⊙ Move towards operational excellence.

The mental fear of ‘resistance to change’ is the only disadvantage in organisational culture.

The following are the important steps:

- (i) Defining the scope of audit work.
- (ii) Obtaining knowledge of the business, processes and formulating the audit programme.
- (iii) Evaluation of the accounting and internal control system existing in the auditee enterprise.
- (iv) Determining the nature, timing and extent of audit procedures, keeping in mind the audit risk and materiality vs involvement.
- (v) Adequate documentation is also necessary, i.e. preparation of audit note book and working papers.
- (vi) Formulation of opinion.
- (vii) Issuance of audit report.

The auditor uses the following techniques to collect the necessary evidence:

- (i) Electronic data processing for understanding the gaps.
- (ii) Process Flow Charting
- (iii) Discussion for clarity

Audit Program:

An audit program is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item and the financial statements and the estimated time required. To be more comprehensive,

an audit program is written plan containing exact details with regard to the conduct of a particular audit. It is a description or memorandum of the work to be done during an audit. Audit program serves as a guide in arranging and distributing the audit work as well as checking against the possibility of the omissions.

An audit programme is a written plan containing exact details with regards to the conduct of a particular audit.

It is a description or memorandum of the work to be done during an audit.

Audit programme serves as a guide in arranging and distributing the audit work as well as checking against the possibility of omissions.

The below mentioned factors are considered at the time of chalking of Detailed Audit Programme

1. Major observations pointed out in previous internal audit report and action taken by the auditee on these observations.
2. Checklist of previous audit assignments is also referred to get insight about the areas to be focused in next assignments
3. Any new changes / amendments taken place in commercial laws.
4. Any special area / investigation as instructed by the top management

The Internal Audit Programme shall include the following

1. The objectives of the internal audit in respect of each of the area
2. The staff responsible for carrying out the particular activity
3. The time allocated to each activity
4. Detailed instructions to the staff as to how to carry out those procedures

Advantages of Audit Program:

The main advantages of an audit program are as follows:

- (i) It serves as a ready check list of audit procedures to be performed.
- (ii) The audit work can be properly allocated to the audit assistants or the article clerks.
- (iii) The auditor may easily know the extent of work done at any point of time. Thus, the progress of work done can be under the supervision and control of the auditor.
- (iv) Audit program would not only be useful for the audit assistants in carrying the audit work but for the principal too as he would be in a position to account for the individual responsibilities.
- (v) A uniformity of the work can be attained as the same program would be followed from time to time.
- (vi) It is a useful basis for planning the program for the following year.
- (vii) It may be used as evidence by the auditor in the event when any charge is brought against him. He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

Disadvantages of Audit Program:

The main disadvantages of an audit program are as follows:

- (i) The auditor's task becomes mechanical and the auditors may lose interest and initiative.
- (ii) Drawing up of an audit program may be unnecessary for a small concern.

- (iii) Though audit program helps in fixing responsibilities but inefficient staff may defend themselves by stating that the matter was not contained in the audit program.
- (iv) Rigid program cannot be laid down for each type of business.

Though an audit program may suffer from the above disadvantages, but these can be removed by taking some initiatives such as consulting the audit assistants, modifying the program on the basis of experience gained during audit, etc.

Continuous and Final Audit:

(a) Continuous Audit:

Continuous audit involves the detailed examination of all the transactions by the auditor continuously throughout the year or at regular intervals, say fortnightly or monthly. A continuous audit is one which is commenced and carried on before the close of the financial year to which it relates. It involves the constant engagement of auditor's staff at the client office throughout the period under review. Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year or there is great volume of transactions or the system of internal check is weak.

(b) Final Audit:

A final audit is also called as Completed Audit or Periodical Audit. Final audit is done after the close of the financial year, i.e., after the books of accounts have been closed and the final accounts are drawn up. In this type of audit, the client gives the possession of books of accounts to the auditor for audit and routine checking and other audit procedures begin only after that.

Audit Working Papers:

Meaning of Audit Working Papers

Audit Working Paper Files, often simply referred to as working papers, are formal documents and records that auditors prepare and maintain during the course of an audit.

These files serve as a comprehensive and organized documentation of the audit procedures performed, the evidence obtained, and the conclusions reached by the auditors.

The working papers provide a clear trail of the audit work and are critical for demonstrating the thoroughness and compliance with auditing standards.

Purpose

These are formal documents prepared by auditors to support and document the audit procedures performed, evident obtained, and conclusions reached during the audit.

Content

Contain more formal and organised documentation, such as trial balances, supporting schedules, testing documentation, analytical procedures, and any other relevant information that provides evidence of the audit work performed.

Confidentiality and Access

These are formal documents meant for retention in the audit file.

They are subject to review by external parties, such as regulatory authorities, external auditors, or internal auditors.

Structure and Format

Typically follow a standardised format and structure as prescribed by auditing standards.

They are organised to facilitate review and understanding by others, including auditors who were not directly involved in the audit field work.

Timeline

Prepared as the audit progresses and finalised at the conclusion of the audit fieldwork.

They provide a snapshot of the audit at specific point in time

Types of Working Paper Files:

In case of recurring audits, some working papers files may be classified into permanent audit files and current audit files. While the former is updated with the information of continuing importance, the latter contains information relating to audit of a single period. The contents of these files are given below:

Permanent Audit File	Current Audit File
(a) Legal and organisational structure of the entity, e.g., MOA and AOA in case of a company.	(a) Correspondence relating to acceptance of annual reappointment.
(b) Extracts or copies of legal documents, agreements and minutes relevant to the audit.	(b) Extracts of important matters in the minutes of Board Meetings and General Meetings relevant to the audit.
(c) A record if study and evaluation of internal controls.	(c) Copies of management letters
(d) Analysis of significant ratios & trends.	(d) Analysis of transactions and balances.
(e) Copies of the audited financial statements of previous year(s).	(e) Copies of communication with other auditors, experts and third parties.
(f) Notes regarding significant accounting policies.	(f) Audit program.
(g) Signification audit observations of the earlier years.	(g) Conclusions reached on significant aspects of audit.
(h) Copies of Cost Audit Reports and Secretarial Audit Reports of Previous Years.	(h) Cross references to source documents and other supporting materials.
	(i) Any adjustments proposed by the auditor.
	(j) Reconciliation between the client's records and auditor's findings.

Working papers are the property of the auditor, the portions or extracts of, which can be had at his discretion. These working papers should keep in safe custody and in confidential manner for such time as is sufficient to meet the requirements of his practice or to satisfy any related legal or professional requirement of record retention.

How long the Audit Working Paper Files should be preserved?

The retention period for Audit Working Paper Files is influence by the factors enumerated below :

1. Client Agreement

The terms of agreement with client may specify the duration for which audit documentation needs to be retained.

2. Firm Policies

Auditing firms typically establish their own policies regarding retention of audit documentation.

3. Nature of Engagement

The complexity and significance of the audit engagement may impact the retention period.

4. Legal Consideration

The retention period may be influenced by legal requirements

5. Litigation

Retaining working papers even beyond legal requirements may be necessary in view of ongoing litigation.

Advantages of Audit Working Paper Files

Here are some key advantages / benefits

1. Evidence of Due Diligence

Working papers provide evidence that the audit was conducted with due professional care and in accordance with auditing standards.

2. Reference for future audits

Documentation in working papers can be a valuable guide for future audits.

3. Legal Compliance

Working Papers help auditors demonstrate compliance with legal requirements

4. Training Tools for new auditors

They provide examples of how audit procedures are documented and help transfer knowledge and best practices within the audit team.

5. Facilitation of External Reviews

Well-prepared working papers contribute to a smoother and well efficient external review process

6. Record of Adjustments and Reconciliations

Working papers document any adjustments and reconciliations performed as may be proposed by the auditor which contributes to the reliability of financial statements

Audit Note Book

Meaning of Audit Note Book

It is a tool used by auditors to record and organise their thoughts, observations, and key information during the course of an audit.

It is usually a bound book in which a large variety of matters observed during the course of audit are recorded.

The audit note book is a permanent record of the auditor.

For each individual audit, the auditor usually maintains a separate audit note book.

The audit note book should be maintained clearly, completely and systematically.

Audit Note Book shall normally include the following :

1. Name of the organisation
2. Organisations structure
3. Important Provisions of MOA and AOA
4. Communication with previous auditors, if any
5. List of Books of Accounts maintained by the enterprise
6. Accounting Methods followed by the enterprise
7. Internal Controls followed by the enterprise
8. Key Managerial Personnel
9. Errors and fraud discovered
10. Matters requiring explanations or clarifications
11. Special points that need attention in audit report and for subsequent audits
12. Informal and preliminary notes, thoughts and reminders.
13. Brain storming, ideas and auditor's personal insights

How long Audit Note Book should be preserved?

The retention period for Audit Note Book is influence by the factors enumerated below :

1. Client Agreement
The terms of agreement with client may specify the duration for which audit documentation needs to be retained.
2. Firm Policies
Auditing firms typically establish their own policies regarding retention of audit documentation.
3. Nature of Engagement
The complexity and significance of the audit engagement may impact the retention period.
4. Legal Consideration
The retention period may be influence by legal requirements
5. Litigation
Retaining working papers even beyond legal requirements may be necessary in view of ongoing litigation.

Advantages of Audit Note Book :

Here are some advantages of creating Audit Note Book.

1. Personal Reference
Serves as a personal reference for the auditor throughout the audit engagement.
The note book allows auditor to keep track of their progress, priorities, and any other outstanding issues that may need attention.

2. Brain Storming and Idea Generation

Offers a space to auditor to engage in brain storming sessions and generate ideas related to audit procedures. It encourages creativity and critical thinking

3. Risk Identification

Helps auditor to identify and document potential risks and control weaknesses as they are discovered.

4. Preparation of Audit Working Capital Files

Information recorded in Audit Note Book can be used as a basis for creating more formalised Audit Working Paper Files

5. Training and Knowledge Transfer

If used as a part of training programme, the Audit Note Book can be a valuable resource for new auditors, allowing them to understand the thought process and methodology used by more experienced team members

Specimen of Audit Note Book

M/s. XYZ Private Limited Audit Notes for the Financial Year

Voucher/ Reference No.	Account Involved	Amount	Query/ Remarks	How disposed of
21	Machinery	2,000	Amount wrongly capitalized	Rectified after consulting with Mr. A, Chief Accountant
64	P.F.	1,750	Late deposited	Clarified with Mr. B from HR
80	Advertisement	5,000	MD sanction required	Sanction obtained
150	Colonel Securities	40,000	No TDS	TDS deducted and deposited with interest
167	Rent	2,000	Receipt required	Receipt obtained

Audit Engagement Letter

15.3

Auditors agree with the client's management, in writing, about the scope, terms and conditions of the audit engagement. This written communication is referred to as an engagement letter. The letter is usually addressed to chairman of the audit committee or, in the case of a corporation, the chair of the board of directors, with a copy being sent to the audit committee. The purpose of such a letter is to minimize any possible misunderstanding concerning the scope and terms of the audit engagement.

The letter is sent to all new audit clients and where there has been a change in the terms of the engagement or the auditor considers that management may not understand the existing terms of the engagement, the letter is also sent to continuing clients.

An audit engagement letter is a formal document that outlines the

- ⦿ Scope
- ⦿ Terms and
- ⦿ Conditions
- ⦿ Of the engagement between an auditing firm and its client.

The letter is a crucial component of the audit process as it helps establish clear expectations, responsibilities, and the scope of the audit.

Though the objective and the scope of audit is determined by the relevant statute and the pronouncement of the Institute, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstanding with respect to the engagement.

This will be in the interest of both the client and the auditor.

Audit Engagement Letter shall include the Following:

1. Introduction

Name and address of the client and the auditing firm

2. Objective of this Audit

The objective of this audit will be :

For example –

- Reliability and Integrity of Financial and Operational Information
- Compliance with Laws, Regulations and Contracts

- Inventory Management of Raw Materials, Stores and Finished Products
- Periodic Physical Verification of Inventory
- Safeguarding of Assets

To follow up on recommendations included in prior audit reports.

3. The proposed time table for this year's audit is as follows :

Qtr 1 – Bill Passing of Raw Materials, Natural Gas and Stores

Qtr 2 – Bill Passing of Project Bills

Qtr 3 – Central Accounts and Costing

Qtr 4 – Direct Taxation and Indirect Taxation

4. The audit team shall consist of following members

- Name Manager
- Name Staff Auditor
- Name Staff Auditor

5. At the beginning of our audit, we would like the opportunity to meet you and discuss with you the audit objectives and solicit your input.

Our goal is to perform an effective and efficient audit.

6. We will need your staff of respective departments as mentioned in 3) above to provide documents concerning them in related qtrs..

7. At the conclusion of our audit, 1st we shall circulate draft observations to all Functional HODs for their comments/proposed actions to remedy the situations.

8. Even these draft observations as mentioned in 7) above, if so desired, can also be discussed with either respective HOD or concerned executive of respective department.

9. For observations for which either satisfactory answers are received or action plan is received, those observations shall be dropped from the draft audit report.

10. So, only balance observations remaining if any, shall become part of Final Audit Report which shall be submitted to the management for its further discussion in Audit Committee.

11. Our mission is to achieve departments objectives by providing you information about the effectiveness of internal control and by recommending courses of action which improve performance.

12. If you have any questions about this year's audit, please feel free to contact us.

Terms of Audit Engagement:

- ⊙ Agreeing the terms of the engagement with the client; and
- ⊙ The auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

The auditor and the client should agree on the terms of the engagement. The agreement should be in writing.

Though the objective and scope of audit is determined by the relevant statute and the pronouncement of the Institute, the audit engagement letters will be informative to the clients.

The auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstanding with respect to the engagement. This will be in the interest of both the client and the auditor.

Specimen Internal Audit Engagement Letter

[DATE]

[NAME, TITLE] [DEPARTMENT] [ADDRESS]

[CITY, STATE PIN]

Dear [HEAD OF DEPARTMENT]

The Internal Audit Team is planning its audit for [DEPARTMENT NAME], The objectives of this audit will be: [LIST ACTUAL OBJECTIVES HERE]

For example:

- ⊙ Reliability and Integrity of Financial and Operational Information,
- ⊙ Compliance with Laws, Regulations, and Contracts,
- ⊙ Safeguarding of Assets, and
- ⊙ Effectiveness and Efficiency of Operations of the [AUDIT AREA], and
- ⊙ To follow-up on recommendations included in prior audit reports. The proposed timetable for this year's audit is as follows:
- ⊙ Start date in the field: [DATE]
- ⊙ Estimated weeks to complete: [NUMBER OF WEEKS] The audit team will include the following members:

[NAME], Manager [NAME], Staff Auditor [NAME], Staff Auditor

At the beginning of our audit, we would like the opportunity to meet with you to discuss our audit objectives and solicit your input. Our goal is to perform an effective and efficient audit. We will need your staff to provide us the following documents and schedules on:

1. [DOCUMENTS] and [DATE]
2. [DOCUMENTS] and [DATE]

At the conclusion of our audit, we will discuss audit results and potential recommendations with management of the audited area before scheduling an exit conference with you. Prior to the exit conference, you will receive a draft audit report. After the exit conference, a final audit report will be delivered to you with a request for formal management's responses to include in the audit report.

Our mission is to help you achieve [DEPARTMENTS] objectives by providing you information about the effectiveness of internal control and by recommending courses of actions which improve performance. If you have any questions about this year's audit, please do not Hesitate to call.

Yours truly,

[XYZ] [Designation]

Role of CMAs in Internal Audit and Operational Audit

15.4

Presently, the role of Internal Audit has become more critical. The backdrop and changing business scenario and the role metamorphosed as technology have erased global barriers. Customer expectations have increased and compliance demands are growing both in terms of quantity and complexity. The Enterprise Risk Management is emerging as the key element in Corporate Management.

The expectations of the Board from Internal Auditors are now to assist the Board in identification, monitoring and management of business risks and also to offer and provide insight, advice and assurance on enterprise risks. The Internal Auditors should also inform directors about the tone of the organisation-culture, ethics, performance and continuously evaluate the efficiency and effectiveness of operations. They should also check compliance with laws and regulations and authenticate the reliability of financial and management reporting. Internal Auditors has the added role of safeguarding the assets of the company. They should evaluate performance management and control systems and act as an advisor to the Management. The role of effective Cost Management involves in waste reduction and enhancing productivity and process improvement.

The Internal Audit must be synchronized to the expectations of the Board. It must develop an Internal audit strategy that is linked with the organisation's strategic plan with a focus on optimizing risks, costs, and value. It must develop dynamic risk based internal audit plans. The communication must be done frequently with key stakeholders on their needs, expectations, satisfaction with the internal audit. It should leverage technology to optimize audit operations and assist management in developing and maintaining a comprehensive performance management framework. It should support and facilitate business process improvement and re-engineering and provide active support in furthering good Corporate Governance. CMAs have a colossal role to play as they have a unique blend of core competencies in accounting, management and strategy. CMAs can apply their forward-looking insights across the organisation to manage risks, reduce costs and create new opportunities, preserve and enhance value.

CMAs possess the expertise to evaluate the operational efficiency, productivity and profitability, wastages, losses, inefficiency. They can apply their knowhow in judging efficiency of management of resources, capacity utilization, channeling resources into productive channels, standards of efficiency of performance, production processes and performance of respective units. Efficiency of business processes, Enterprise Performance Management, Business risks. Efficiency of Supply Chains, Efficiency of Utilities / Energy Consumption, Sustainability of Business are critical drivers to keep the business focused on priority areas.

The perspective of CMAs has changed in the present era of mergers & acquisitions, new product development and also to climate change and sustainability. The financial perspective, customer perspective, operational perspective and people perspective all can be aligned to meet the goal of the business.

Operational Audit:

The internal audit function in any organisation can be broadly categorized into three major functions namely (a) financial audit (b) compliance audit and (c) operational audits. However, an operational audit is sometimes defined as an extension of a financial audit. Regulatory agencies or other organizations concerned with compliance generally either send in their own auditors or hire an external audit firm. Therefore, Internal Audit mainly plays a supplementary role only in financial and compliance audits, but operational auditing is the primary, albeit not the exclusive, domain of the internal auditor.

An operational audit (or value-for-money audit) has been defined as an organized search for ways of improving efficiency and effectiveness. The objective of this audit is to assist the organization in performing functions more effectively and economically with focus on the efficiency and effectiveness of operations, it is also stated to be an early warning system for the detection of potentially destructive problems.

An operational audit can lead to better management of all aspects of business organisation whether it is production area or service area. Traditionally, operational audits have been conducted by means of a questionnaire interview of departmental employees. Virtually all large companies conduct operational audits in their major production and service departments. The financial audit tells where the entity was and where it is on the date of the balance-sheet.

However, an operational audit tends to answer the questions as to why the entity is where it is and how it got there. It means the evaluation of management’s performance and efficiency. Therefore, Operations Audit is a process to determine ways to improve production. It falls into the category of a management service by evaluating the four functions of management: (1) planning, (2) organizing, (3) directing, and (4) controlling. The operational audit can also be broken down further as a functional review; for example, Purchasing as a department versus the overall Procurement operation in coordination with production scheduling and market forecasting. The following table highlights the salient features of the traditional form of internal audit and operational audit:

INTERNAL AUDIT	OPERATIONAL AUDIT
1. Compliance objective	Risk identification, process improvement objective
2. Financial accounts focus	Business focus
3. Audit focus	Efficiency & improvement focus
4. Transaction-based	Process-based
5. Policies and procedures focus	Risk management focus
6. Cost Centre wise budget monitoring	Accountability for performance improvement results
7. Methodology: Focus on policies, transactions and compliance	Methodology: Focus on goals, strategies and risk management processes

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) had recently issued the “COSO report”, which was jointly sponsored by the Institute of Internal Auditors (IIA), the American Institute of CPAs, the Financial Executives Institute, the American Accounting Association, and the Institute of Management to provide a common, widely accepted definition of internal control and provide a framework of internal control which can be used as a benchmark for assessing its effectiveness. The COSO report defines internal control as follows:

...a process, effected by an entity’s board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objectives in one or more categories:

- ⦿ Effectiveness and efficiency of operations.
- ⦿ Reliability of financial information.
- ⦿ Compliance with applicable laws and regulations.

Operational audits concerned with the objectives of efficiency and effectiveness. There are many reasons for performing an operational audit: compliance with policies and procedures, excessive sales returns, proposed product mix, equipment down time or personnel turnover etc. Therefore, an auditor must establish the scope of an operational audit before formulating the approach to initiate an operational audit. This step will determine the extent of the scope of audit. The second step shall be to understand the auditee's operation, its purpose in the total environment of the entity, its history, its image, its staff, their skills and competence and its reporting path. The reporting path is of very critical importance because this path is the communication route along which, the audit results and conclusions will flow.

The prime records to be obtained in an operational audit are the organizational chart of the function/operation, applicable policies, guidelines and procedures etc. These will outline each employee's responsibility and authority. The function's/operation's performance reports for the reasonable period prior to the audit should be reviewed to do trend analyses or the critical analyses. These analyses or reports could indicate potential critical areas such as over- or under-staffing, noncompliance with corporate policies and procedures, weaknesses in internal controls, or inadequate job rotations etc. These indications could help the management auditor in determining scope of investigation and areas of potential improvement. Reports must be based on facts, informative, submitted in time and directed to the proper levels of management.

Internal Audit under Companies Act, 2013

15.5

Legislative Background:

The concept of Internal Audit was first introduced in the Companies Act, 1956 for every producer company vide section 581ZF.c

Internal Audit was first made mandatory for some companies vide the Manufacturing and Other Companies (Audit Report) Order, 1975.

Thereafter, MAOCARO 1988 replaced the MAOCARO 1975.

Companies (Auditor's Report) Order 2003 replaced MAOCARO, 1988.

Companies (Auditor's Report) Order 2016 replaced CARO, 2003.

Companies (Auditor's Report) Order 2016 is amended and issued as Companies (Auditor's Report) Order, 2020.

Section 138 enshrines this concept with the power being given to Central Government to prescribe the class of companies where the appointment of Internal Auditor is mandatory.

Compulsory requirement for appointment of internal auditor(s) in listed and specified companies

Section 138 read with rule 13 of the Companies (Accounts) Rules, 2014 provide that following class of companies shall be required to appoint an internal auditor or a firm of internal auditor; namely:

- (a) every listed company
- (b) every unlisted public company having:
 - (i) paid up share capital of 50 crore rupees or more during the preceding financial year; or
 - (ii) turnover (income) of 200 crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year; or
 - (iv) which has accepted deposits of 25 crore rupees or more at any point of time during the last financial year;
- (c) every private company having
 - (i) turnover of 200 crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding 100 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—

The internal auditor may or may not be an employee of the company; 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. However, the rule specifies that an internal auditor may or may not be an employee of the company. The Internal auditor may be CA/CMA or any other professional. And also neither the rules nor the Act, has specified the duties and responsibilities. So even if the rules and act made the appointment of Internal Auditor mandatory, the same rules and Act provides option to companies to appoint any person as internal auditors. And also anyone who has the knowledge can become an Internal Auditor, because the rules did not define the word “any other professional”

Eligibility for appointment as internal auditor

The following persons can be appointed as internal auditor

1. For Producer Company
 - Chartered Accountant as per Section 378ZF of Companies Act,2013
2. For Other Than Producer Company
 - (a) Chartered Accountant
 - (b) Cost Accountant
 - (c) Other Professionals as may be decided by the Board

Form MGT-14 to be Filed with ROC on appointment of Internal Auditor

Rule 8 of the Companies (Meeting of Board and its Powers) Rules,2014 provide that Internal Auditor can be appointed by passing resolution at the meeting of the Board.

So company is required to file Form MGT -14 with the Registrar within 30 days from the date of passing of the resolution by the Board.

Notification No GSR 464 (E) dated 05.06.2015 has dispensed with this requirement for private company.

Authority to appoint the Internal Auditors

Rule 8 (4) of Companies (Meetings of Board and its Power) Rules, 2014 that Internal Auditors shall be appointed by the Board of Directors only by means of resolution passed at the meeting of the Board

Statutory Auditors cannot be appointed as Internal Auditors

MCA Circular No. 29 of 1976, dated 27-8-1976 states that the internal auditor is appointed by the management and hence is in the position of an employee, whereas the statutory auditor is appointed by the company in accordance with the provisions of section 224 [section 139 of the Companies Act, 2013] and the auditor is required to perform the duties enjoined on him under section 227 [section 143 of the Companies Act, 2013] and the Rules/ Orders issued there under. As such, in the opinion of the Department (MCA), a statutory auditor of a company cannot also be its internal auditor.

Formation of policy and procedure for appointment of the internal auditor

The Companies (Accounts) Rules, 2014 provides 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.

Existing companies need to appoint the Internal Auditors within a period of six months, i.e. before 30th September, 2014

In case of an existing company, this needs to appoint internal auditors pursuant to the provisions of section 138 of the Companies Act, 2013 read with Rule 13 of the Companies (Accounts) Rules, 2014, shall appoint the internal auditor within a period of 6 months from the commencement of the section, i.e. needs to comply with the requirement before 30th September, 2014.

Scope of Internal Audit

Rule 13 (2) of the Companies (Accounts) Rules, 2014 does not provide for the scope of internal audit.

However, Rule 13 (2) of the companies (Accounts) Rules, 2014 provides 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.

Power and Duties of Internal Auditor

The Act or Rules do not lay down any powers or duties of Internal Auditor.

The same may be governed by the terms of reference of the appointment of internal auditor which may be decided mutually between the company and the internal auditor.

Punishment and Compoundability

As Section 138 does not provide for any penalty in case of non-compliance, Section 450 shall come into play.

Accordingly, for contravention, the company and every officer the company who is in default or such other person shall be liable to penalty of

1. ₹ 10,000
2. In case of continuing contravention, with a further penalty of 1 thousand for each day after the 1st during which the contravention continues
3. Subject to maximum of 2lakh of ruppees in case of a company and 50 thousands in case of an officer who is in default or any other person

Procedure to be followed by the company in the appointment of an internal auditor

1. Obtain a written consent of the auditor for being eligible for appointment as an internal auditor under the companies act,2013
2. Issuing a 7 days' notice for calling a board meeting for appointment of internal auditor
3. Hold a board meeting and appoint internal auditor
4. Inform the auditor about his appointment as an internal auditor of the company

5. Filing form MGT-14 for appointment of internal auditor within 30 days of passing the board resolution
6. Send intimation to appointed Internal Auditor

Notes:

1. Internal Auditor can not be appointed by the Board by passing a resolution by circulation
2. Statutory Auditor can not be appointed as internal auditor of the Company
3. A Cost Auditor of a company shall not be appointed as internal auditor of the company for the period for which he is conducting the cost audit

Internal Audit and Companies (Auditor's Report) Order

15.6

The Central Government in exercise of the powers conferred under sub-section (4A) of the section 227 of the Companies Act, 1956, has issued the I Companies (Auditor's Report) Order, 2003 ("the Order" or "the CARO") vide I Notification No. GSR 480(E), dated June 12, 2003. The Order contains certain I matters on which the auditors of the Companies (excepting those companies which are specifically exempted under it) have to make a statement in their audit report.

Section 227(4A) of the Companies Act, 1956 ceased to be operational from 1 April 2014 after notification of section 143 (11) under the Companies Act, 2013. Though section 143(11) of the 2013 Act provides requirements similar to section 227(4A) of the 1956 Act, the MCA had not prescribed CARO related requirements. Consequently, after consulting the Institute of Chartered Accountants of India (ICAI), the MCA on 10 April 2015 issued the Companies (Auditor's Report) Order, 2015 (CARO - 2015) prescribing certain reporting requirements for auditors of certain class of companies. CARO - 2015 amended again and recently CARO 2020 issued by MCA which is effective from the date of its publication in the Official Gazette, 25th February, 2020.

Clause (xiv) of CARO, 2020 spells out the requirements as to reporting by the statutory auditors on the internal control system and internal audit system respectively. Each of these clauses is discussed as below.

Clause (xiv) of CARO, 2020

- (a) Whether the company has an internal audit system commensurate with the size and nature of its business;
- (b) Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

(i) Internal Control System

As per SA 200, Internal Control System refers to all the policies and procedures adopted by the management of the entity to assist in achieving management's objective ensuring the orderly and efficient conducting the business, the accuracy and completeness of accounting records, the timely preparation of financial information, safeguarding of assets of enterprise and defection of fraud and error in a timely manner.

(ii) Extent of Reporting

It may be noted that obtaining an understanding of internal control system is a normal audit procedure. As per SA 315, 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 evaluated. While the requirement of the Order is confined only to the internal control system as regards purchases of inventory, and fixed assets and the sale of goods and services, it does not in any way reduces the responsibility of the auditor to examine other areas. It only signifies that while a special attention is required for the reporting on specified items of this clause, but to ensure a true and fair view of the financial statements, the examination of internal controls has to be extended to all the other areas.

(iii) Major Weakness

The Order does not define as to what constitutes ‘major weakness.’ Thus, it may be interpreted that major weakness depends upon the facts and circumstances of each case. For this, an auditor has to exercise his professional judgment. One view may be taken that any weakness in internal control which exposes the enterprise to a risk of significant loss is material weakness. Another view may be that a weakness in internal control exposing an organisation to the risk of material misstatement(s) in the financial statements is major weakness. It may be noted that while evaluating what is major weakness, the concept of audit materiality should always be given due consideration. It should also be noted that adequacy of internal controls and major weakness should be considered as distinct aspects of this clause, i.e. it does not mean that if there are no major weakness in internal control system, then the internal control system is adequate.

(iv) Adequacy of Internal Controls

As per SA 200 read with SA 315, the auditor should obtain an understanding of the accounting system sufficient to identify and understand major classes of transactions, manner of initiation of transactions, significant accounting records, supporting documents and specific accounts in the financial statements and the accounting and financial reporting process. Accounting control comprises the plan of an organisation and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial controls. Internal control so far as financial and accounting aspects are concerned, aims at the following:

- (i) Providing the flow of work through various stages.
- (ii) There should be proper segregation of personnel duties so that no single person can be in a position to handle whole of the work from its beginning to its end.
- (iii) Adequate documentation should be made at each stage of work.
- (iv) The transactions are recorded with appropriate amounts and in timely manner and that too as per the applicable accounting policies and practices.
- (v) The assets should be properly safeguarded.
- (vi) The access to the assets should be restricted to only authorised persons.
- (vii) Existence of organisational chart would help in fixing responsibilities.
- (viii) Building up of a system to locate the deviations and departures from the prescribed procedures and to detect the frauds and errors automatically without much loss of time.
- (ix) Standardized records and formats should be evolved. It would ensure availability of right information at right time.
- (x) There should be an efficient Management Information System.
- (xi) Minimization of loss and wastages.
- (xii) Employees should be encouraged to do good work and comply with the procedures. Special attention should be given to the disgruntled employees.
- (xiii) Adequate cut off procedures should be formulated so that the transactions of one period can be separated from the transactions of other period.

(v) Continuing Failure

This expression has also not been defined by the Order. What constitutes ‘continuing failure’ again depends upon the facts and circumstances of each case. For example, if the auditor has identified a weakness in the previous year

and reported the same to the management, but it continues to exist in the current year, then it would constitute 'continuing failure.' Further, where the auditor based on the preliminary discussions with management, intimated the management of the major weakness at the audit planning stage at the beginning of the year, but the same was not corrected even at the time of issuing audit report, this would also constitute a 'continuing failure.'

(vi) Checklist and Specimen Reporting

1. On the basis of the understanding, documentation and validation thereof of the activities in the areas of Inventory cycle, property, plant and equipment cycle, revenue and receivables cycle, review of internal audit reports whether satisfied that there is an adequate internal control system commensurate with the size of the company and the nature of its business for the purchase of inventory and fixed assets and for the sale of goods and services;
2. If not, document the inadequacies and weaknesses thereof and consider implications for reporting;
3. Review the reports of internal audit, minutes of the Board, Audit committee, management committee, if any and any other relevant internal reports to identify major weaknesses in internal controls and whether there is any continuing failure to correct such weaknesses;
4. In the case of continuing failure to correct any major weakness identified, report the weakness and steps taken by the management to correct such weakness, if addressed subsequent to the balance sheet date or the fact of failure to correct such weakness;
5. Consider the implications of such control weaknesses on the nature, extent and timing of audit procedures in those areas and implications, if any, on the adequacy or reliability of the books of account and the overall report.

Applicability of CARO Report

Ministry of Corporate Affairs has deferred the applicability of CARO 2020 from the financial year commencing from 1st April 2021 instead of 1st April 2020 as per its notification of 17th December 2020. It was done to ease the burden on companies and their auditors for the year 2020-21 amid corona virus disease (Covid-19).

Applicability of CARO Report: companies

CARO 2020 applies to all companies, including any foreign company, except for the followings:

- One person company (OPC) as defined in clause (62) of section 2 of the Companies Act, 2013
- Small companies (Companies with paid-up capital less than or equal to ₹ 50 lakhs and with last turnover less than or equal to ₹ 2 crores)
- Banking companies as defined under clause (c) of Section 5 of the Banking Regulation Act, 1949
- Insurance companies, as defined under Insurance Act, 1938
- Companies registered for charitable purposes under Section 8 of the Companies Act.
- Private companies with gross receipts or revenue (including revenue from discontinuing operations) of more than ₹ 10 crores as per financial statements during the financial year.
- Private companies with paid-up share capital and reserves and surplus not more than ₹ 1 crore as on balance sheet date, i.e., at the end of the financial year.
- A private company that is not a holding or subsidiary of a public company.
- A private company that does not have total borrowings of more than ₹ 1 crore from any financial institution, including banks, at any point time during the financial year.

Clause by Clause Reporting under Companies (Auditor's Report) Order 2020

CARO 2020 lays down 21 clauses to report on :

- (i) Property, Plant and Equipment
- (ii) Inventory & Working Capital
- (iii) Details of Investments , Loans and Advances
- (iv) Compliances with Provisions of Section 185 & 186
- (v) Details of Deposits
- (vi) Cost Records
- (vii) Statutory Dues
- (viii) Disclosure of Unrecorded Income
- (ix) Defaults in Repayments
- (x) Money raised through public issue of shares
- (xi) Reporting of Fraud
- (xii) Compliances by Nidgi Company
- (xiii) Compliances with related party transactions
- (xiv) Reporting under Internal Audit System
- (xv) Reporting for Non Cash Transactions
- (xvi) Compliances with RBI Directives
- (xvii) Details of Cash Losses
- (xviii) Details of Resignation of Auditors
- (xix) Economic Viability
- (xx) Compliances of CSR Related Obligations
- (xxi) Unfavourable remark in subsidiary / associate standalone CARO Report

Internal Audit in Companies under Manufacturing Sector

15.7

Internal Audit of Manufacturing Company

Purchase, Store, Production, Sales, Marketing, Security, Lab, are important department of every Manufacturing Company, Internal audit have big role to analyze for smooth functioning of every department. Here is brief function of Internal audit of Manufacturing Company:

Annexure - I

Production

Risk	List of Controls
Production Planning	
1. Untimely production as compared to the marketing requirements resulting in holding of inventory	Timely compilation of Production budget/plan for each of the product variety (e.g OPC, PPC, Non-Trade etc.)
	Pre-defined authority level for review and modification in the production plan
2. Excess/short production as compared to plan	Periodic review of Production Plan vis-à-vis changes in Sales Plan or availability of raw materials & documentation thereof
3. Loss of production due to non-consideration of sales forecast/raw materials availability	Compilation & documentation of reason-wise analysis of actual consumption vis-à-vis standard consumption
	Shift-wise production data logging in place
Consumption standard/norms & actual consumption	
Excess production cost due to excess consumption of raw materials, ingredients, utilities or high process wastage	Compilation of documented consumption standards i.e BOM
	Periodic comparison of actual capacity utilization
	Review of periodicity of comparison of actual consumption and standard consumption and compilation of reason-wise variance analysis for deviation in consumption
	Identification of controllable and non-controllable factors resulting in variation in the consumption norms and department's action plan to remedy the controllable factors
	Verification of overall material reconciliation highlighting total material consumed, standard input-output norms and actual

Capacity Utilisation	
1. Opportunity loss due to inadequate capacity utilization	Periodic comparison of actual capacity utilization with the synchronized 'sales plan'
2. Excessive utilization of production capacity	
3. Interruption in production process	
Documentation & record maintenance:	
1. Inadequate documentation of prodn. data/results, may result in incorrect decision or non availability of timely information	Compilation of Daily Production Report from DCS & its validation by the authorized personnel
2. ambiguous authority levels /access for generation of production documentation resulting in unauthenticated generation of production data	Periodic review of conformance to the ISO requirement
	Pre-defined authority levels to generate, add, and modify production data in DCS/SAP
Quality control and inspection report:	
1. Absence of standard quality control parameters resulting in sub-standard production/ high re-work cost	Standard Operating Procedures for quality control and inspection including in-built process controls
	Review of QC norms periodically to ensure their validity
2. Non-standardized Inspection Reports resulting in inconstancy in inspection of parameters	Adherence to the pre-determined sampling techniques & exception reports for the results deviating from the QC norms
	Review of complaints received by the Production department pertaining to quality/quantity of cement sold in the market or lying at godown/s
	Customer-complaints closed in time for amicable solution
	Engagement of external agency for quality validation are approved and reports are reckoned to pre-empt possibility of quality non-conformity issues.
	The process for re-working QC failed products exists after obtaining due approval from appropriate authority against QC failed product.
	All products are bagged after the same being qualified for /passed by QC
	Variations over standard Bag consumption is measured and monitored
Review of process losses and recycling	
Excessive process losses or inadequate recycling of materials due to improper monitoring of process parameters	Process loss incurred during the period are compared with the standard
	System exists of analyzing the reasons for abnormal process losses, if any and documentation of remedial action plan
	Identification of quantity of material non-conforming to the specification and sent for recycling.
	Preparation of comparative analysis of percentage increase or decrease in the recycling materials and reasons thereof

Preventive & break-down maintenance:	
Non-adherence to the preventive maintenance schedule resulting in process bottleneck / plant shut down/ loss of production.	Compilation of preventive maintenance schedule & its adherence
	Compilation of report on breakdown maintenance and opportunity loss of production are measured
	Ascertainment of the impact of breakdown maintenance on the production schedule
MIS Reports	
1. Inadequate MIS reports resulting in unauthenticated/unreliable production details resulting in improper decision	Compilation of MIS reports from the source data & their approval by the authorized personnel
2. Inconsistency in compilation of production reports due to non-standardized definition of periodicity	

Deployment of Workmen on Contractual basis

Risk	List of Controls
Assessment of requirement and approval	
1. Unskilled labour engaged at the rate applicable for skilled labour;	Skill profiles of labourers are available/maintained and Job Requisitions raised against the specific skill requirement availability.
2. Labour called without requirement for the same;	Requisitions are raised with job description indicating requirement (number of heads) for manpower.
3. Jobs to be done not approved by appropriate authority;	All job requisitions are approved by appropriate authority.
4. Actual engagement not in tandem with requirement	Excess/short engagement in comparison to Requisition is traced, compared for deviations with reasoning.
	Purchase/Service Orders are released against approved Requisitions.
Selection of Contractors and their approval	
1. Non-standard P.O terms;	Standard order terms as to job nomenclature, payment terms etc. are maintained.
2. Un-competitive rates;	Contractors for a job is selected on competitive basis.
3. High Rates;	List of Contractors are maintained for jobs on offer and addition/deletions are considered on approval by appropriate authority.
4. Delay due to nonavailability of Contractor, who can handle the assignment	
Labour identification and authentication	
1. Ghost Workmen; 2. Same workmen deployed by multiple Contractors	Each labour is traceable against identification/ employment number with photograph.
	Periodical “parole” to identify dummy workmen is conducted by HR and Engaging Dept..
	Change/transfer of workmen from one Contractor to another is traced and records updated accordingly.

Wage agreements and adherence	
1. Un-competitive /high rates;	Systematic study as to rate contract fixation is carried out periodically and rates finalized accordingly.
2. Rates applicable are higher than prevalent local rates;	Benchmarking with local rates for pricing/labour contract rate is carried out.
3. Non-update of labour rates for a long time	Effectiveness of fixed rate schedule verified periodically and it's validated from time to time.
	Labour rate agreements with Unions against specific skill/trade etc. are validated from time to time.
Fulfilment of safety requirements	
1. Unsafe working environment;	Details of safety training to be imparted to Contract Workers with varied skill/work engagement is documented.
2. No formal training to safe work mode;	Safety Dept. certifies the training completion of the workmen before allowing to work/job.
3. Inadequate training and follow-up resulted in non-adherence to safety rules/guidelines	Adequacy of safety requirements are validated from time to time for ensuring compliance.
Engagement - Requirement vs. Actual	
1. High rates due to dependency on single Contractor;	List of multiple Contractors as per engagement in different Job area is available.
	Rates applicable are benchmarked and applied for rate fixation/PO.
2. Un-benchmarked rates;	'Work permits' are issued with predetermined strength required for the job and maintained in seriatim.
	Work permits on job completion are signed-off and jobs in Contractor Bills be traced therefrom.
3. Dismal 'work permit' mechanism;	Actual engagement is certified by the engaging Dept.
4. Uncertified jobs paid for;	Same contractor workforce is not allowed to work under 'turnkey' as well
5. Booking for labour supply and turnkey engagement for the same workmen;	'labour supply' to pre-empt possibility of multiple booking against same attendance.
	Lower or higher engagement against requirements or extra time required/booked is compared and deviation with reasoning documented.
6. Uncontrolled entry-exit mechanism	Gate Security certifies entry/exit of workmen or "time recorder" and the same tallied with billing/hours booked/claimed.

Bill Payment and booking	
1. Non-deduction for drawing Co. material;	Reconciliation of materials supplied to Contractors and passing on of appropriate impact against their billing is ensured before payment.
2. Attendance record not verified causing excess payment;	System as to verification of 'Attendance Record' of the labourers maintained by Contractors and reconciliation with time billed/ engaged, for actual booking and that paid by the Contractor exists.
3. Penalty not inflicted;	Penalty for non-fulfilment of contractual obligation i.e. delay, quality adherence etc. are duly accounted for.
4. Wrong passing of bills resulted in extra payment to Contractors;	Checks are carried out before making payment of bills as to : Rates, Attendance, Job, Quality etc.
	All appropriate taxes are levied / deducted and deposited in time.
5. Quality of jobs performed not reflected in certification as well payment;	System of collecting Security Deposit or 'performance guarantee' or 'bank guarantee' to bind the contractor against quality issues exists.
6. Performance guarantee/ BG/SD not applied on Contractors for poor quality of jobs	
Legal compliances under labour laws	
1. Relevant licenses (by Company as well as Contractor) not obtained;	System in place to ensure necessary Licenses under relevant laws prior to engagement is obtained by the Contractor.
	All necessary returns are filed timely by the Company.
2. Failure in filing statutory returns;	Engagement of labourers over stipulated hours are tracked.
	Overtime work is regulated through adequate and timely supply of labour at the 'job area'
3. Engagement over stipulated working hours;	All Applicable statues e.g Minimum Wages, Factories Act etc. are followed and adhered to.
4. Breach of statues in engagement/ payment/ Factories Act	
Principal employer's liability	
1. Wage distribution not certified;	Lack of proof for payment to workmen
2. Workforce interest not protected by Principal Employer; Fines/ Penalties may be inflicted by appropriate authority	P.F, E.S.I (Employee State Insurance) and other statutory dues are monitored by HR/ Admin. to ensure timely deposit and protection of workforce interest.

Fixed Asset

Risk	Control
ASSETS MANAGEMENT POLICY/DOCUMENTATION/SOP	
Policy/SOP for fixed assets not available	Documented SOP's for fixed assets
CAPITAL BUDEGT & APPROVALS	
Capital Expenditure Policy not available	There is a Capital Expenditure Policy highlighting the procedures to be followed for estimation of Capex & pre-defined authority for sanction of the Capital Expenditure budget with value limits.
Inaccurate estimation of capital expenditures	Estimation of capital expenditures /sanction approved.
Technical & commercial feasibility studies not done	Technical & commercial feasibility studies are done before initiation of the specific Capex proposal.
Unauthorised capital expenditure	The Capex is approved as per DOA.
Excessive delays	There is an internal mechanism to ascertain tracking of capital proposals till raising of POs to identify excessive delays.
FIXED ASSETS REGISTER	
Missing Assets	A register of all fixed assets (including fully depreciated assets) is maintained and updated.
	There is adequate description of all assets to identify assets physically available.
	The FA Register is periodically reconciled with the financial records.
No Policy/SOP on physical verification	SOP is established and all procedures are complied with.
	Physical verification of assets is carried out every year.
Company's assets physically not available	There is a set procedure for verification and confirmation of fixed assets lying with third parties.
Discrepancies observed during physical verification not adjusted.	All discrepancies are adjusted after taking approval as per DOA within time.
Title deeds not available	Physical verification of title-deeds is carried out periodically by officers not connected with assets accounting/assets administration.
Assets not being used	Periodic verification of Assets not in use is being done.
FIXED ASSET ADDITIONS	
Purchase of asset not authorised properly/ Non tracking of indent	Request for capital expenditure from user is received in standardized form. There is a separate identification number for each form.
	Formal documented approval as per DOA
	For every acquisition, Purchase order giving full details of fixed asset requirement.

	Every P.O. authorised as per DOA
	Actual transaction is as per P.O.
Lack of audit trail in ERP	Availability of audit trail in ERP/ SAP for all transactions
Unauthorised master record of asset	Master data (class, useful life, rate of depreciation) of new asset created subject to approval
Asset capitalised at WIP stage	Capitalisation only on the basis of 'put to use certificate' by proper person (technical person) only after inspection
Actual utilisation exceed the budgeted allocation	Approval as per DOA is obtained wherever actual utilisation exceed the budgeted allocation
No clear and correct distinction between capital and revenue expenditure	There is clear and correct distinction drawn between capital and revenue expenditure
Unduly delay in installation/commissioning/commencement of warranty	Reasons are documented for delay in installation/commissioning/ commencement of warranty.
VALUATION OF ASSETS	
Wrong valuation of assets	System to ensure that cost consist of purchase price, import duties (if any), other non-refundable taxes & direct attributable cost for bringing the asset to its working condition for its intended use.
	Self-generated asset consist of direct as well as allocable factory expenses allocated on systematic basis.
Wrong valuation of assets	Fixed assets are revalued on adequate independent evidence.
SALE OF ASSETS	
Possibility of sale of performing assets	Disposal request from user.
Unauthorised sale	Approval as per DOA
Items replaced, scrapped or sold not removed/written off.	Items replaced, scrapped or sold are removed / written off from the books?
Profit or loss on sale of fixed assets	Profit or loss on sale of fixed assets is properly disclosed in the accounts
MOVEMENT/TRANSFER OF ASSETS	
Loss of asset / non accountability of asset	The standard form filled by user as well as sending and receiving locations.
	There is a system to track the assets transferred on a temporary basis.
Unauthorised transfer	Transfer of asset should be approved as per DOA.
Transfer not recorded in books	Transfer is properly recorded in the books.
IDENTIFICATION OF IDLE ASSETS	
No system to identify idle assets	Documented process in place to identify the idle assets
	Identification always from user documenting the reason to classify asset as idle asset.

WRITE OFF OF ASSETS	
Write off approval for shortage/missing asset is not obtained	Write off note for any shortage/missing asset is put up for approval as per DOA.
CAPITAL WIP	
Delay in capitalisation leading to deferment of depreciation charge. Under statement of F.A. / depreciation	Capitalisation of asset within two days of its ready to use certificate obtained
	Ageing analysis to find out old WIP & reasons for non- capitalisation
	Projects scrapped is charged off.
CAPITAL ADVANCE	
Advance is given to unauthorised vendor	Request from vendor for capital advance, which should be approved as per DOA
	Analysis of vendor history before granting of any advance
Non availability authentic documentary evidence	Signed agreement for purchase of fixed asset mentions all the terms including advance to be given
	Analysis of unadjusted advances.
Excess payment to capital creditor	System to check any balance in advance account before making any payments.
SECURITY OF ASSETS	
Company's asset not properly Safeguarded	Controls to ensure Physical Safeguarding of Assets.
Company's asset wrongly owned by third party	All invoices/registration cards (for motor vehicle)/title deeds(for land, building etc.) clearly specifies the TCL ownership.
Encroachment of land	Adequate provisions to protect the asset from encroachment.
TRACKING OF INTERNAL RATE OF RETUR	
Gaps between the projected NPV/IRR and actual asset performance	Analysis of asset performance against the projected NPV/IRR is being done.
	Reasons for gaps between the projected NPV/IRR and actual asset performance are documented.
STATUTORY-COMPLIANCES	
Non identification of Impairment to the asset	Documented & approved process in place for identification of Impairment & implementation of same
	Periodical review of the assets for the impairment.
Non-compliance with Companies Act	Depreciation is charged as per provisions of the Companies Act.
No/under cover of insurance for Assets	Sum insured justifies the replacement value of Assets

Sl. No.	Functions
1	Plant Operation
(a)	Yield-Machinery, Manpower & Material
(b)	Budgeted Variance of Production
(c)	Power Analysis
(d)	Labour Analysis
(e)	Production Delay due to unavailability of Resources (Material, Labour, Machinery & others)
(f)	Capacity Utilisation of Machine & Labour
(g)	Transit damaged Material
(h)	Abnormal Losses, if any
(i)	Quality Audit of Inward and Outward
(j)	Review of Man Power Allocation Planning
(k)	Review of Plant HR Policy-Labour Policy
2	Security
	(i) Security Register Abnormal Report Review (Shift Change)
	(ii) Rotation of Security Staff
	(iii) Insurance of Machinery Labour, Factory, Vehicle & Cash in Transit
	(iv) Input & Output Matching with Inward/Outward/Dispatch/Tally etc.
	(v) Audit of Security Gate Process

Sl. No.	Functions
2	Purchase
a	Review of PO Made during the Period
b	Listing of unauthorized Purchase as per Power Limit
c	Review of Contract Made during the period
d	Review of Vendor Selection Process
e	Review of Vendor Payment Policy
f	Overdue PO
g	Vendor Performance
h	Review of Forward Contract

Sl. No.	Functions
3	Stores Audit
a	Inward /Outward of Store Register with Gate Records
b	Review of Inward & Issue Activity
c	Adhoc. Audit of Bin Card Maintenance
d	GRN Date vs. Security Date Review

e	Review of Quality Control Of Stores items
f	Review of Store Management
g	Review of Action taken on Short Delivery
H	Review of Slow/Non-Moving Stock
I	Minimum order Quantity Review
Sl. No.	Functions
4	Statutory compliance
A	Excise Register Matching with Inward & Outward
B	Job work Register
C	TDS Deduction Practice
D	Review of GST
E	Foreign Payment Review
F	PF & PT Review
G	Cases Pending Under Negotiable Instrument Act
Sl. No.	Functions
5	ROC compliance & Corporate Governance
a	Review of Minute Books
b	Review of Filing
c	Review of Power Used by Company Officer
d	CSR activities
e	Any Non-Compliance as per Companies Act
Sl. No.	Functions
6	Ledger Scrutiny
Sl. No.	Functions
7	Cash & Bank Review
a	BRS
b	Physical Verification Cash
c	LC Discounting & Charges
d	Interest & Charges Review
e	Stale Cheque Report
f	Cheque Bounce Report
g	Fund Management
Sl. No.	Functions
8	Corporate HR & Payroll
a	Application of HR Policy
b	Review of Reimbursements
c	Review of Grievances
d	Status of Vishakha Committee Report Implementation

e	Surprise Head Count as per attendance Report
f	Reconciliation of Employee Loan & Advances
g	Review of Staff Welfare (Medical, working Environment, Staff Motivation, Training)
h	Late Coming Report
i	Performance Review of System, Policy & Technology

Sl. No.	Functions
---------	-----------

9	Audit of Exp.
a	Verification of Bills with ERP
b	Approval Review of Bills
c	Review of Bill Supporting
d	Review of Debit Note-To be Raised
e	Trend Analysis according to Sales/Production
f	Forex Gain/Loss Calculation

Sl. No.	Functions
---------	-----------

10	MIS Authenticity
-----------	-------------------------

Sl. No.	Functions
---------	-----------

11	Audit of Sales
a	Verification of Bills with ERP
b	Review of Bill Supporting
c	Review of Credit Note-To be Raise/Raised
d	Review of Transport Challan Attached with Invoice
e	Penalty & Price Variation Review
f	Budgetary Performance
g	C & F Form Status
h	Utilisation of Advance Authorization Licenses

Sl. No.	Functions
---------	-----------

12	Marketing
a	Customer Complaint Addressal Review
b	Target Performance-KAM
c	Debtors Performance-Ageing

Sl. No.	Functions
---------	-----------

13	Business Analysis
a	Industry Overview-Future Prospect of Business
b	Ratio Analysis -In comparison with Industry
c	Technology Review
d	Costing & Pricing of Product

Sl. No.	Functions
14	Capex
a	Capex Bills Review
b	Capitalization Checking
c	FAR Checking
d	Barcode & Tagging Status
Sl. No.	Functions
15	Overview Assurance on Internal Control
Sl. No.	Functions
16	Transporting & Logistic
a	Review of Transportation Contract & Rate
b	Transportation Expense & Pooling Review
Sl. No.	Functions
17	Follow up of Previous Audit
Sl. No.	Functions
18	Stock Audit
Sl. No.	Functions
19	Any other area Requested by management

Purchasing: a high-risk area subject to fraud – where an organisation spent a significant amount of its money and can heavily impact the company’s quality, Environmental & safety objectives & targets. It is the first and most basic nature of expenditure, that any manufacturing company is required to incur, which is in direct proportion to their manufacture/production activity. Hence audit of this area for a manufacturing organisation if of high importance and care to be taken while auditing this area.

During the preliminary survey, the auditor should gain an understanding of how purchasing occurs within an organisation.

Audit Objectives/Checking:

- ⊙ Requisition Note – An internal company document used in the purchasing process to authorize the requisition of materials prior to initiating a purchase order. Purchase indents are audit documents used to track the movement of materials prior to their receipt by the buyer.
- ⊙ Each Purchase made should be supported by a proper Requisition Note, which is properly authorised by the concerned Authorised Person & to check the adequacy, authenticity and completeness of indents w.r.t. cost benefits, desired information, back papers.
- ⊙ If there are delays in receiving the intends and raising of P.O., then identify the reason for the same & report.
- ⊙ The PO must have required terms & conditions mentioned on it, such as Expected Delivery date, Payment due date, Advance to be given if any. All such terms, mentioned on PO must be strictly adhered to.
- ⊙ Item, quantities, or other information relating to the order may be incorrectly recorded on the input document resulting in the requesting department/personnel not getting the material as per requirement.
- ⊙ Compare purchase order prices with vendor catalogues after obtaining at least three vendor’s quotation. And

in case of purchase from a sole supplier or at higher rates, then obtain adequate justification and authorization.

- ⊙ Any advance payment to the vendor should be properly authorized. Invoicing is being done as per P.O. Order and Quotations.
- ⊙ Identify the various types of purchasing transactions and document the flow of those transactions throughout the organisation & prepare a computer system flowchart and review it with the data processing project leader.
- ⊙ Ensure that there are sufficient controls to monitor the receipt, storage and issue of material in the stores department.
- ⊙ All receipts of goods must be recorded in two different stages:
 - At Unit/factory Gate (Goods Inward Register with the Gate-keeper)
 - Before entry in the Stores (Goods Receipt Note – GRN)
- ⊙ The above books must be properly reconciled and the entries in both the above-mentioned records should be exactly the same, in terms of date, quantity, quality of items received and party names.
- ⊙ In case unauthorized goods or services accepted by the company, thus, obligated the company to pay for unwanted items, hence receipt of goods to be verified properly.
- ⊙ The Vendor has billed the company as per the quotations / negotiated rates.
- ⊙ The payments for these purchases are made as per the authorisation and within due dates.
- ⊙ All purchases, receipt & issue of material and payments are accounted for in the books of accounts properly under proper ledger accounts.
- ⊙ The controls in the purchasing department must be capable of generating appropriate documents at each process level. Thereby documenting the complete purchase process.
- ⊙ The issue of material must be supported by MRN (Material Requisition Note), approved by the respective departmental head.
- ⊙ Proper Stock levels must be maintained & Stock must remain insured at all time.

Auditing is a big ocean of ideas and concepts, it is very difficult to draw a complete packaged audit program, so above is an overview for the audit of Purchase Department of an organisation.

Solved Cases

Case Study 1. High RM Consumption Variance – President Production

Points Need to Know:

1. History of BOM for each of the Product.
2. BOM Approval Authority.
3. Any change in major Production Equipment.
4. Any change in Production Process of a Product.
5. Feeding of RM – Manual or Mechanized and any changeover? If so from which Date.
6. Changeover Note for BOM change and approval authority.

7. Actual consumption recording Process and any change made?
8. Whether up-keep/Storage of RM remained same all throughout the period?
9. Whether Production Orders are closed at the end of each run?
10. RM Quality remained constant/same in last couple of years.
11. Booking for consumption i.e how consumption entry is passed?

Production of 'P' started from February 2022, since then the BOM change made for 12 times and significantly RM- & RM-2, the two mother RM BOM consumption varied between 5% to 75%. We are given to understand that the RM Quality yet to be finalized, which causing significant variation in actual consumption.

RM- X, used in 'Product Q' in place of RM-3 due to sudden spurt in price by about 50% (₹ 380 Per Mt. to ₹ 575/- per Mt.) However, BOM yet to be prepared/modified for introduction of the new RM since June 2022.

New Waterbase coating Raw Material is in use on trial basis since last six months. The Oilbase RM is also in use. However, same Product Code is used for booking consumption of both and units produced also not separately recorded.

Since the FG passes through various production processes and each process consumes Raw Materials of fixed volume as per BOM. However, month closing date exercise carried out for different processes not identical and varied between 25 to 31 days. In Process i.e Semi Finished Product volume varies significantly, which in turn causes high variance in consumption when compared with BOM.

W.R.T six Products (A, B, C, X, Y, Z) the BOM consumption was fixed based on manual dozing for which about 10% handling loss was considered. Since last two years, OLBC (Over Land Bulk Conveyor) is in use, which caused losses even less than 1%. The change not given effect in BOM.

In the BOM Database maintained in SAP, multiple BOMs are available for the same Product. The Production Team and approver consider any of available ones not the particular one used. The multiple BOMs having same RM specification varying between 3 p.c to 13 p.c weightage. This caused significant variation with actual consumption.

BOM authorization process was to be there before booking consumption against the related BOM. However, despite elapse six months, some of BOMs in use are yet to be approved.

Case Study 2. Inventory Accumulation

Background

Unfortunate Limited with three Plants located at Uphill, Downhill and Hill. All the Plants are pretty old, except Hill Plant. Hill Plant started operation since 2012. The Management is now facing a huge Working Capital blockage in Inventory worth Rs. 666 Crores. Annual turnover hovers around Rs.5000 Crores.

Highest accumulation reported by the new Plant i.e worth Rs.355 Crores, out of the three. The Company having a valuation policy. As per Policy, more than 5 year old inventory to be value at 10% of cost and balance at Cost. Slow and Non-moving inventories are categorised for holding over 5-years. In last 8 years, no liquidation action for accumulated inventory was considered by the Management.

Management wants that IA Dept. to point out reasons for accumulation and necessary steps to pre-empt possibility of further accumulation. Moreover, steps for unlocking value also need to be decided as per guidance from IA

Dept. The Report to be discussed with Audit Committee in the ensuing meeting. Hence, the Report to be submitted by 31st August 2022.

Root Cause

- ⊙ Lack of control over Project surplus items – accumulated value ₹22 Crores.
- ⊙ Stock position of one Plant is not visible to other Plant/s. Uphill continuously procuring 11 such items, which are not in use since last 7 years at Downhill Plant. Such accumulation at Downhill worked out to ₹44. Crores.
- ⊙ On introduction of four new products viz. NP, PN, P and N in 2018 at all the three Plants simultaneously; the Raw Materials of earlier blockbuster Products namely BP, OP, HP, GP remained at hand. Accumulated value stood at ₹55 Crores.
- ⊙ Pumps, Motors, Generator, Power House etc. received as replacement against failed Equipment within ‘Warranty Period’, considered in Books as fresh procurement. Value of such wrong entries worked out to ₹33 Crores.
- ⊙ Physical verification revealed, Material and Spares having book value amounting to ₹22 Crores not in existence. Last issue date was recorded in ERP Database not even more than 3 years old. We are informed by Stores In-charges of respective locations that the same items recoded as missing, mishandled.
- ⊙ Storage of raw materials was to be made properly. We have noticed, huge piles of Raw Materials in mixed-up condition. Segregation and recovery is remote and can’t be used used in production due to quality, performance will not match expectations. As per Book records, value of such mixed-up inventory worth ₹44 Crores. The item codes found in mixed-up condition, was inwarded frequently and used in Production.
- ⊙ Undefined Stock level (Minimum, Maximum, Re-order and Average), causing accumulation. Based on average annual consumption level, at least 111 item Codes having more than 4-years inventory at hand valuing ₹222 Crores (each item code holding more than ₹1.5 Crores each).
- ⊙ Spare Parts worth ₹55 Crores not recorded in Books as Inventory, shown as transit for more than two years. Advance payment to Vendors already made for the same.
- ⊙ Material Sent for Outside Processing (MASOP) worth ₹88 Crores, yet to be accounted, despite aged over 3-years.

As part of our review process, we have circulated the presentation with necessary documents and discussed at length the ‘Actionable Points’. The ‘Actionable Points’ are circulated separately.

Action Plans

- ⊙ For easy identification and making plan for use in future Projects/requirement, Project surplus items need to be codified separately with regular item code reference in ERP.
- ⊙ View only access to be given to all who are authorized for releasing PR (Purchase Requisition) for assessing stock of the required item Code at other locations. Excess stock at other locations need to be reckoned before Ordering for liquidation and usage in other location.
- ⊙ New Product introduction to be made only after getting clarity /clearance from COO on consumption of RMs required for the old FG. If required, sometime gap may be fixed for the purpose.
- ⊙ Necessary rectification/value adjustment to be carried out for replaced item received against Warranty.

- ⦿ Periodical physical verification process need to be strengthened to avoid 'surprise' w.r.t missing items. Movement of men, vehicles through security gate requires special attention to preempt possibility of theft.
- ⦿ Identified storage location for bulk items , Bins for Spares to be created to avoid mix-up. Necessary wall, dividers to be made available for proper storage.
- ⦿ Average consumption trend with max. safety cushion for order time lag of a month to be considered for Order level. Inventory levels to be fixed for all items.
- ⦿ In-transit and returnable items to be investigated for proper resolution. Maximum period of 60 days from the issue date to be allowed for closing the matters appropriately.

Sum Up:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organisation's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organisations to perform the internal auditing activity.

Charging Provision:- Section 138 of Companies Act, 2013: Such class or classes of companies as may be prescribed in Rule 13 of the Companies (Accounts) Rules, 2014 shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

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.

Applicability

- ⦿ Every listed company and unlisted public company having paid up share capital of 50 crore or more, turnover of 200 crore or more, outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore, outstanding deposits of 25 crore or more at any point of time during the preceding financial year
- ⦿ Every private company having turnover of 200 crore rupees or more, 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

Exception: In case of Specified IFSC Public Company and IFSC Private Company - Section 138 shall apply if the articles of the company provide for the same

Objectives

- ⦿ To protect the interest of the various stakeholders like customers, employees, revenues, management, environment, Directors & officers of the company.
- ⦿ To avoid any unwarranted legal action by the law- enforcing agencies and other persons as well.
- ⦿ To ensure better compliance of laws and enhanced corporate governance.

Benefits and Beneficiaries: Benefits of Internal Audit are Manifold and its Beneficiaries including company itself are many like:

- ⦿ Management
- ⦿ Promoters
- ⦿ Directors
- ⦿ Government Authorities
- ⦿ Investors
- ⦿ All Stakeholders

Scope of Internal Audit: The scope and functions of internal audit is not been defined in Companies Act, 2013 & not in the rules prescribed. The Audit Committee of the company or board shall, in consultation with the internal auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

The report of the Board of Directors of the company falling under the provisions shall contains the details in respect of adequacy of internal financial controls with reference to the financial year.

The scope of internal auditing within an organisation is broad and may involve topics such as:

- ⦿ Organisation's governance
- ⦿ Risk management
- ⦿ Management controls over efficiency/effectiveness of operations (including safeguarding of assets)
- ⦿ The reliability of financial and management reporting
- ⦿ Compliance with laws and regulations
- ⦿ Proactive fraud audits to identify potentially fraudulent acts
- ⦿ Participating in fraud investigations under the direction of fraud investigation Professionals
- ⦿ Conducting post investigation fraud audits to identify control breakdowns and establish financial loss.

Internal auditors are not responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities. As a result of their broad scope of involvement, internal auditors may have a variety of higher educational and professional backgrounds.

Eligibility: Internal auditor can be either an individual or a partnership firm or a body corporate which may or may not be the employee of the company. Thus, an employee of the company may be appointed as an internal auditor of the company and every registered member of the Institute of Company Secretaries of India (CS) or Institute of Chartered Accountants of India (CA) or Institute of Cost Accountants of India (CMA) & firm. of Company Secretaries or Chartered Accountants or Cost Accountant can be appointed as an Internal Auditor of Company.

Exception: Statuary auditor appointed under section 139 of this Act cannot be appointed as an Internal Auditor in the Same Company.

Power and Duties of Internal Auditor: The duties and responsibilities of the internal auditor depend on the size and technology of the organisation.

1. To access the books of accounts and other relevant vouchers at all time during the course of Audit.
2. Right to information & explanations from the officers of the company on various transactions and decisions of the company whether financial or non-financial.

3. To verify from the books of the company that whether loans and advances made are secured or not.
4. To form a view of the true and fair view of the affairs of the company.

Main Duties of an Internal Auditor:

The internal auditor shall:

1. Execute a wide range of audits and reviews in a diverse and highly computerised environment
2. Provide an independent, objective assurance and consulting service to management, with the principal aims
 - a. Of evaluating and improving the effectiveness of risk management, control and governance processes;
 - b. Make recommendations on increasing operational efficiency, having regard to value for money auditing;
 - c. Agree the annual audit plan with the Chairman prior to approval by the Audit Committee
3. Ensure compliance of various laws applicable to corporate with the aim of enhanced corporate governance.

Internal audit is always in the better interest of every corporate management as, an independent professional will manage & certify that the company has carried out all the necessary compliance required under Companies Act, 2013 and which builds an fair image in the minds of all the Stakeholders, Government, Investors etc.

Exercise

A. Theoretical Questions

⊙ Multiple Choice Questions

1. Financial auditor submits reports to the
 - (a) Shareholder
 - (b) Board of director
 - (c) Debtors
 - (d) Employees

2. Auditor finds that there is change in the method of valuation of stock whether he should
 - (a) Allow it
 - (b) Disallow it
 - (c) Allow it with a note to this effect
 - (d) None of the above

3. Audit under any statute in a country is called
 - (a) Final audit
 - (b) Internal audit
 - (c) Proprietary Audit
 - (d) Statutory audit

4. CAATTS is also known as
 - (a) Cost And Accounts Treatments
 - (b) Computer Assisted Audit Tools and Techniques
 - (c) Classification and Accounting of Tax Tools
 - (d) Computer Aided Audit Tools and Techniques

5. Auditor has got no lien on
 - (a) Audit Note Nook
 - (b) Audit working papers
 - (c) Books to Accounts of Client
 - (d) Both (a) and (b)

6. Internal audit is conducted
 - (a) Periodically
 - (b) Throughout the year
 - (c) Once in a year
 - (d) Once in Five years

7. Test checking is done when there is an effective system of _____.
 - (a) Internal control
 - (b) Internal audit
 - (c) Internal check
 - (d) Both (a) and (b)

8. Treating revenue expenditure as capital expenditure is an example of error of
 - (a) Principle
 - (b) Compensating
 - (c) Clerical
 - (d) None of the above

9. Verification of assets involves a critical examination of
 - (a) Ownership
 - (b) Existence
 - (c) All of these
 - (d) None of the above

10. One of the major components of a government audit is/are:
 - (a) Government Revenue
 - (b) Union Budget and Control
 - (c) Government Expenditure
 - (d) Taxation and Fiscal Policies

11. There is no requirement for Audit Working Papers while conducting an audit and they only result in loss of time.
- (a) The Statement is Correct
 - (b) The Statement is Incorrect
 - (c) The Statement is Incomplete
 - (d) None
12. Aspects may be taken into consideration for proper inventory control
- (a) Maximum, minimum and reorder level fixation
 - (b) Fixed order quantity system and different replenishment systems.
 - (c) Fast-moving, slow-moving and non-moving analysis, etc.
 - (d) All of the above.
13. Qualities of a good Internal Auditor are/is
- (a) Right Attitude
 - (b) Technical Expertise
 - (c) Communication and other soft skills.
 - (d) All of the above.
14. NGO(s) are incorporated under
- (a) Societies Registration Act, 1860
 - (b) India Trust Act, 1882
 - (c) As Section 8 Company
 - (d) All of the above.
15. Who can be appointed as Internal Auditor as per the Companies Act, 2013
- (a) A Chartered Accountant
 - (b) A Cost Accountant
 - (c) Such other professional
 - (d) All of the above

16. The management auditor shall consider in the evaluation of capacity utilization –
- (a) Method of measuring base machine capacity
 - (b) Capacity measurement is based on “capital-output ratio” or sundry other factors.
 - (c) Technical terminology like licensed capacity, installed capacity, rated capacity, etc. should be properly defined.
 - (d) All of the above.
17. During F.Y.2022-23, a private company has outstanding loans or borrowings from banks or financial institutions as mentioned below:
- (a) On 30.09.2022 ₹ 75 Crore
 - (b) On 30.09.2022 ₹ 105 Crore
 - (c) On 31.12.2022 ₹ 90 Crore
 - (d) On 31.03.2023 ₹ 60 Crore
- On fulfilment of which of the above mentioned condition, Internal Audit u/s 138 becomes applicable to this private company?
18. For which category of company, only CA can be appointed as Internal Auditor u/s 138?
- (a) Listed Company
 - (b) Producer Company
 - (c) Unlisted Public Company
 - (d) Private Company
19. Internal Auditor is prescribed by
- (a) RBI
 - (b) Ministry of Finance
 - (c) SEBI
 - (d) Companies Act, 2013
20. For applicability of Internal Audit u/s 138, at any point of time, is applicable to which of the following criteria?
- (a) Paid up share capital
 - (b) Turn Over
 - (c) Outstanding Loans or Borrowings and Outstanding Deposits
 - (d) All of the above

◎ **Essay Type Questions**

1. ITC Ltd. organized a three-day International Conference of Accountants in Mumbai. You are asked to conduct an internal audit of the accounts of the conference. Draft the internal audit program for audit of receipt of participation fees from delegates to the conference.
2. You have been appointed as an internal auditor for M/s ELECTROCON Ltd which is a large manufacturing concern. You are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools, and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit program for the above.
3. What is an Audit program? What are the advantages of the Audit Programme?
4. Draft Internal Control Questionnaire Relating to Inventory.
5. What do you understand by Propriety Audit in the Context of Government Audit?
6. What are the points to be considered by the Management Auditor while determining the adequacy of the Budgetary Control System?
7. Discuss in brief regarding Summary Report to Top Management.
8. Draft Internal Audit Programme in respect of Wages.
9. Describe the need for capacity determination.
10. What are the factors to be considered by Cost Auditor while evaluating MIS?
11. Give an Audit program as an Internal Auditor of Wage Audit.
12. As per the Companies Act, 2013, which companies are required to conduct an Internal Audit?
13. Who can be appointed as an internal auditor as per The Companies Act, 2013?
14. What is the Role of Management in Internal Control?
15. Write a note on the “Audit Committee” under the Companies Act, 2013 in brief.
16. Which companies are required to constitute Audit Committees? What is its responsibility regarding the internal audit?
17. What are the qualities of a good internal auditor?
18. KPC Pvt. Ltd took a consortium loan in 2022-23 amounting to ₹ 80 crores of which State Bank of India is the leading Bank for setting up a new plant in Haldia. During the year 2021-22, its outstanding loan was ₹ 70 crores of which repayment was made in the year 2022-23 to the extent of ₹ 20 crores. Should KPC Pvt. Ltd. conduct an internal audit as per the Companies Act, 2013?

Answer:**Multiple Choice Questions**

1.	(a) Shareholder
2.	(c) Allow it with a note to this effect
3.	(d) Statutory audit
4.	(b) Computer Assisted Audit Tools and Techniques
5.	(c) Books to Accounts of Client
6.	(b) Throughout the year
7.	(c) Internal check
8.	(a) Principle
9.	(c) All of these
10.	(c) Government Expenditure Audit of Government Expenditure is one of the major components of government audit conducted by the office of C & AG.
11.	(b) The Statement is Incorrect. Audit working papers are the record of the planning and execution of the audit engagement. Auditors retain a set of working papers for each audit engagement for each year.
12.	(d) All of the above. The following aspects may be taken into consideration for proper inventory control: 1. Maximum, minimum, and reorder level fixation 2. VED analysis 3. Just-in-time (JIT) purchasing 4. Fast-moving, slow-moving, and non-moving analysis.
13.	(d) All of the above. According to 'Technical Guide on Internal Auditing' by The Institute of Cost Accountants of India, Internal Auditors should have the following three traits: – Technical Expertise – Right Attitude – Communication and other soft skills. An Internal Audit team has to have representation from diverse professional fields in order to understand the organisation better.

14.	(d) All of the above. Non-Governmental Organizations (NGO) are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act 1882, or under any other law corresponding to these Acts enforced in any part of India. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013.
15.	(d) All of the above. As per Section 138 of the Companies Act, 2013 an internal auditor, shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.
16.	(d) All of the above. Yes, the management auditor shall consider the following points in the evaluation and measurement of capacity utilization.
17.	(b) on 30.09.2022 ₹ 105 Crore
18.	(b) Producer Company
19.	(d) Companies Act, 2013
20.	(c) Outstanding Loans or Borrowings and Outstanding Deposits