

Internal Audit (Sec 138)

1. Legislative background

The notes on clauses to the Companies Bill, 2011 read as follows:

“Clause 138. – This is a new clause and seeks to provide that prescribed Companies shall be required to conduct internal audit of functions and activities of the company by internal auditor appointed by the company. Manner of conducting internal audit shall be prescribed by the Central Government.”

Addition of this clause was suggested by the Standing Committee on Finance (2009-10). In 57th Report of the Standing Committee on Finance (2011-12) while dealing with the suggestion that in-house employees shall be allowed as internal auditors, it was stated by the Ministry that “the provisions of clause 138 do not prohibit appointment of inhouse employee. Further, the provisions also empower the Board of relevant company to appoint any professional (even other than a CA or CWA) as internal auditor if it so decides. Hence both the suggestions are already taken care of.”

2. Concept of internal audit

The concept of internal audit was present in the Companies Act, 1956 in the form of Section 581ZF which stipulated that ‘Every Producer Company shall have internal audit of its accounts carried out, at such interval and in such manner as may be specified in articles, by a chartered accountant’.

‘Internal Audit’ was first made mandatory for some of the companies vide the Manufacturing and Other Companies (Auditor Report) Order, 1975 (MAOCARO, 1975). MAOCARO, 1975 required the auditor to certify whether the company has an internal audit system commensurate with its size and nature of its business and also, whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials including components, plant and machinery, equipment and other assets, and for the sale of goods.

Thereafter, MAOCARO, 1988 replaced the MAOCARO, 1975 and MAOCARO, 1988 was replaced by the Companies (Auditor’s Report) Order, 2003. 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.

The Definition of Internal Auditing states the fundamental purpose, nature, and scope of internal auditing. “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by

bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”.*[Definition as given on the website of the Institute of Internal Auditors [https://na.theiia.org/standardsguidance/mandatoryguidance/Pages/Definition-of-Internal-Auditing.aspx]]*

The terms “functions” and activities” used in sub-section (1) of section 138 connote a much wider scope than “Financial Audit” and “Operations Audit”. Therefore, it is clearly evident that the scope of internal audit is very wide and it covers the compliance systems in companies covering all the functions of any company. Internal Audit requires an in depth understanding of the business culture, systems and processes, understanding and improvement of internal controls for effective risk management, understanding the governance structure of the organisation and ability to provide value additions for improvement in governance processes.

The internal audit may contribute in the following areas:

- a) Independent review and appraisal of control systems across the organization (both financial control systems and operational areas where the organization may reap benefits)
 - b) Ascertainment of the extent of compliance of policies, procedures, regulations and legislations. Checking compliance management systems of an organization.
 - c) Facilitate good practices in management of risk. This requires systems for ascertaining, measuring, managing and where possible mitigation or dispersion of the risk.
 - d) Achieve savings by identifying waste, inefficiency and duplication of effort across the organization.
 - e) Structuring programs and activities such that company assets are safeguarded and there are internal check systems which minimize the possibility for reducing fraud / early warning signals for identifying fraud.
3. Class of companies Sub-section (1) of section 138 provides that such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

As per rule 13, the following companies are required to appoint an internal auditor or a firm of internal auditors:

Criterion	Listed Companies and producer companies	Unlisted Public Company	Every Private Company
Paid-up Capital	Internal audit is mandatory	50 crore rupees or more*	Not Applicable

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Turnover	for all listed companies, irrespective of any criterion	200 crore rupees or more*	200 crore rupees or more*
Outstanding loans and borrowing from bank and PFI		exceeding 100 crore rupees or more**	exceeding 100 crore rupees or more**
Outstanding deposits		25 crore rupees or more**	Not Applicable

* during the preceding financial year

** at any point of time during the preceding financial year

Appointment of internal auditor is mandatory for every producer company irrespective of any criterion.

Further, the proviso provides that any existing company which is covered under any of the above criteria shall comply with the requirements of section 138 and rule 13 within six months of commencement of such section.

4. Eligibility for appointment as internal auditor

The following persons can be appointed as internal auditor:

Producer Company	Other than Producer Company
Chartered Accountant (as per section 581ZF of the Companies Act, 1956)	a) Chartered Accountant; b) Cost Accountant; c) Other Professional as may be decided by the Board

The appointment of internal auditor can be done only by means of a resolution passed at the meeting of the Board as specified under rule 8 of the Companies (Meeting of Board and its Powers) Rules, 2014 and accordingly, the company is also required to file Form MGT-14 with the Registrar within 30 days from the date of passing of resolution by the Board. However, filing of resolutions under clause (g) of sub-section (3) of section 117 has been exempted for private companies vide Ministry of Corporate Affairs notification No.G.S.R.464(E) dated 05.06.2015. However, the Private Company is still required to comply the requirements of Section 179.

It is further prescribed under the explanation to rule 13 that term "Chartered Accountant" shall mean a Chartered Accountant whether engaged in practice or not. Further, the internal auditor may or may not be an employee of the company. As provided in section 144, an auditor of the company cannot provide the internal audit service to the company or its holding company or its subsidiary.

The word 'professional' is defined in Black's Law Dictionary [9th Edition, Page 1329] as "A person who belongs to a learned profession or whose occupation requires a high level of training and proficiency". Further, 'profession' is defined [9th Edition, Page 1329] as "A vocation requiring advanced education and training".

Company Secretary may perform the function of internal audit. He interfaces with stakeholders across organisation. Appointment of Company Secretary as internal auditor may facilitate proper interaction between board, its committees, senior management and departmental heads, vendors and suppliers, shareholders and other stakeholder. It will promote effective governance.

5. Scope of internal audit

Sub-section (2) of section 138 gives power to central government to make rules and prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the board. Rule 13 does not provide the scope of internal audit. However, rule 13 prescribed 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

6. Powers and duties of internal auditor

There are no powers and duties of internal auditor prescribed under the Act. 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.

7. Punishment and Compoundability

There are no specific penal provisions provided in this section 138. Therefore the penal provisions under section 450 would apply in case of any non-compliance of this section. Accordingly, for contravention, the company and every officer of the company who is in default shall be punishable with a fine upto Rs.10,000, in case the contravention is a continuing one then the further fine shall be Rs.1,000 every day. The offences under this section are compoundable under section 441 of the Act.

Contents of Geeta Saar, as extracted from ICSI Premier on Company Law, is as per notified law as on 30th September, 2016.