Module 14 · Internal Control and Internal Audit P17 · 14.1–14.3

SM pp. 613–631, exercise 632–634. **43 marks in 7 papers. Q8(a), 7 marks, is Module 14 or 15 in every paper since Dec'23** (Module 14 four times), plus 1–2 MCQs on internal check vs internal control. The MQP answer copies SM 613–615 word for word.

Paper	Question	Paper	Question
Jun'23	Q8(b) **engagement team discussions + documentation** · MCQ COSO components (supervision is not one)	Jun'25	Q8(a) **structure of internal control + factors in designing it**
Dec'23	Q8(a) **necessity of internal audit**	Dec'25	Q8(a) **internal control questionnaire: inventory**
Jun'24	Q8(a) **adequacy of internal controls** · MCQ checks and controls = internal check	Jun'26	MCQ internal controls vs internal checks (= Dec'24, word for word); Q8(a) went to operational audit
Dec'24	MCQ internal control **includes** internal checks; Q8(a) went to operational audit	Dec'26?	MQP Q8(a) **objectives of internal control + internal audit vs internal control** · MQP MCQs · PTP MCQ continuous audit

DEC'26 PREDICTION · Q8(a) 7 MARKS + MCQ

- Q8(a): Module 14 (chance about 45% for 14.1, 15% for 14.3) or Module 15. Write-first: **objectives of internal control + its differences from internal audit** (MQP) · an **ICQ for purchases or sales** (inventory came Dec'25) · **COSO components** · **limitations** · **types of control** · **audit committee's role**.
- MCQ (about 45%): internal check vs internal control (three times) · COSO's five · continuous audit · test checking needs an effective internal check.

THREE WORDS, ONE PICTURE

Internal control = the whole system (financial or otherwise) set up by management. It **includes internal check** (the work of one clerk automatically checked by another, while the work is done) and **internal audit** (an independent review after the work is done). So: control ⊃ check + audit (SM MCQ 2, 3).

INTERNAL CONTROL whole system → **INTERNAL CHECK** during the work → **INTERNAL AUDIT** after the work

14 Introduction · objectives · internal control vs internal audit · the MQP answer

- SM WORDS **Internal Control can be defined as the whole system of controls, financial or otherwise, established by the entity's management; which includes Internal Check, Internal Audit and other forms of control.** It ensures: effectiveness and efficiency of operations; protection of assets; prevention and detection of frauds and errors; accuracy and completeness of financial reporting; adherence to laws. **Five elements**: control environment, risk assessment, control activities, information and communication, monitoring. [SM 613]
- **Review methods**: narrative records, checklist, **questionnaire**, flowchart. [SM 614]
- **Internal audit** (IIA): an **independent, objective assurance and consulting activity designed to add value and improve an organisation's operations**; a systematic, disciplined approach to risk management, control and governance. Appointed by management / the Board; in listed entities the **Internal Audit Head is appointed by, and reports to, the Audit Committee**. [SM 614]
- **Objectives of internal audit**: accuracy and authenticity of records; standard accounting practices complied with; **early detection and prevention of fraud**; transactions recorded after due approval; liabilities only for business causes; review of internal control and report deviations. [SM 614]

MODEL ANSWER · MQP Q8(a) (SM 613–615 = ICMAI's answer)

Objectives of internal control: (1) transactions executed per management's **authorisation / policies**; (2) recorded in the **accounting period** to which they belong; (3) **assets protected** from unauthorised access and use; (4) **recorded assets compared with existing ones** at intervals and differences acted on; (5) **efficiency of performance** evaluated and weaknesses highlighted. [SM 613]

Key differences: [SM 614–615]

1. Internal control = **methods and procedures implemented by management** to control operations; internal audit **reviews the existence and effectiveness** of controls and suggests corrective action.
2. Internal control is a combination of **internal check and internal audit**; the internal audit function is designed by **those charged with governance**.
3. In internal control, checking is done **simultaneously** with the work; in internal audit, work is checked **after** it is performed.
4. Internal control aims at **compliance with management policies**; internal audit aims at **detection of fraud**.
5. The scope of internal control is **wider**: it includes internal audit.

14.1 Internal control: concept, COSO, objectives · Jun'23 MCQ

- SM WORDS Internal Controls are **systematic and procedural steps adopted by an organisation to mitigate risks**, primarily in financial accounting and reporting, operational processing and compliance with laws. The mitigation steps (review, approval, physical count, segregation of duty) are **"Control Activities"**. [SM 616]
- Names: **IFCs** (financial exposure) · **Operational Controls** · manual controls · **IT General Controls** (access) · **Application Controls** (sequential invoice numbers) · **Entity Level Controls** (code of conduct, part of the control environment) · **Process Level Controls** (order processing, payroll). An **Internal Controls Framework** is a benchmark to assess design, adequacy and operating effectiveness. [SM 616]
- **Responsibility**: under the Companies Act, 2013 the **Board of directors** (agents of the shareholders) must ensure appropriate controls and a culture of control. Procedures: physical controls over assets; authorisation and approvals; **segregation of duties**; management design; operational controls. [SM 616]
- **Internal audit and controls**: per **SIA 210** (ICAI) the Chief Internal Auditor plans scope and method, oversees assignments, manages staff and experts, communicates with stakeholders, keeps a quality programme. The internal auditor checks **design, implementation and operating effectiveness** of controls; an opinion follows **SIA 110** "Nature of Assurance"; reviews controls over **key risks** and **compliance** (incl. environmental standards). [SM 617]
- **COSO Internal Control-Integrated Framework: five components**: **control environment** ("tone at the top": the Board and senior executives), **risk assessment**, **control activities**, **information and communication**, **monitoring** (ongoing + periodic, e.g. internal audit). *Jun'23 MCQ: "supervision" is not a component.* [SM 618–619]
- COSO's definition: a **process, effected by an entity's board, management and other personnel, designed to provide reasonable assurance** regarding (1) effectiveness and efficiency of operations, (2) reliability of financial information, (3) compliance with laws. Sponsors: IIA, AICPA, FEI, AAA, IMA. Internal audit is part of **monitoring**. [SM 625]
- **Control objectives, three categories**: **operational** (performance reviews, physical security, training, supervisory sign-offs, division of duties) · **reporting** (authorisation, sign-offs, substantiation, **reconciliation**, passwords) · **compliance** (verification, evaluations, training, policy handbooks). [SM 619–620]
- **Audit objectives for transactions**: occurrence / existence, completeness, accuracy, classification, cut-off / timing, reporting and summarisation. Example, management authorisation of expenses: every expense authorised; records of authorisations kept; correct values; classified per protocol; true dates; shown in reports. [SM 620]
- **Process-level objectives**: authorisation, completeness, accuracy, **validity** (real, lawful events), physical safeguards, **error handling**, segregation of duties. [SM 630]

14.1 Scope, structure, design factors, types, benefits · Jun'25 Q8(a)

- **Scope**: an essential pre-requisite of efficient management; it embraces the **whole system of controls, financial, operational or otherwise**, incl. internal check and internal audit; beyond accounting control (quality control, work standards, budgetary control, periodic reporting, policy appraisals). Four categories: **administrative** (managerial, e.g. records of customers contacted by salesmen) · **operational** (budgetary control, standard costing) · **financial and accounting** (safeguard assets, prevent and detect fraud and error, accurate and complete records, timely reliable information) · **compliance**. [SM 621]
- **Types of control**: **preventive** ("prevention is better than cure"); **detective** (after the event: internal audits, reconciliation, financial reporting, physical verification); **input controls** (completeness, accuracy, existence, validity of data entered). [SM 622] The sum-up adds **corrective** controls (correct what was detected). [SM 629]
- **Benefits**: early warning system; prevents fraud; avoids external audit findings and regulatory fines. [SM 623]
- **Limitations** (only **reasonable assurance**): **judgment** under pressure; bypassing parameters by changing the process flow; overriding attitude; **breakdowns** (misunderstood instructions, mistakes, new technology); **management override** for personal gain (not the same as legitimate management intervention); **collusion**; **cost of controls must not exceed benefits** (e.g. an outside agency to verify daily cash at an outlet whose daily turnover is ₹1000); multiple controls at one point slow the process (maker-checker plus manual sign-off on POs). [SM 629]
- **COSO detail**: control environment = **ICHAMPBO**: Integrity and ethical values, Commitment to competence, HR policies, Assignment of authority, Management's philosophy, Board / Audit Committee participation, Organisational structure. Risk assessment: changed environment, new personnel, new systems, rapid growth, new technology, new lines, restructuring, foreign operations, accounting pronouncements. [SM 630] Control

MODEL ANSWER · JUN'25 Q8(a): STRUCTURE + DESIGN FACTORS

Structure: no uniform approach; it varies with (a) **type of business**, (b) **magnitude** of the business, (c) **infrastructure** available, (d) **potential of the human resources** and their outlook. [SM 621]

Design factors for a successful system: (1) **segregation of duties**: no one person handles a whole transaction; authorising and reconciling by different people; (2) **rotation of duties**, so fraud or error does not stay hidden; (3) **competence and integrity** of people; (4) **appropriate levels of authority**, on a need-to-have basis; (5) **accountability**: controls without strict action on every discrepancy give a **false sense of security**; (6) **adequate resources**; (7) **supervision and periodical updating** for a changing environment. [SM 622]

activities = **PIPS**: Performance reviews, Information processing, Physical controls, Segregation of duties. Information and communication: identify, describe, measure, record in the right period, present, communicate. [SM 631]

- **Weak controls, three management arguments**: one person does everything → use **compensating controls**; "too expensive" → compare with the **cost of a fraud**; "we trust our staff" → it is often the **most trusted employees** who commit frauds. [SM 631]

14.1 Responsibility, audit committee, evaluation, ICQ, adequacy · Jun'24, Dec'25 Q8(a)

- **Responsibility**: under clause **XIV** of CARO 2020, **Rule 18(3)** of LODR 2015 and **section 177(5)**, the **Audit Committee** must review internal controls and brief the Board; the **ultimate responsibility lies with the Board**. [SM 623]
- **Evaluation**: the auditor's time is limited, so the soundness of internal controls decides how deep he goes into routine checking. **Audit Committee** (s.177 + Rule 6 of the Meetings of Board Rules, 2014): every listed company and public companies with paid-up capital **₹10 Crores** or more, turnover **₹100 Crores** or more, or loans, borrowings, debentures or deposits exceeding **₹50 Crores**, as on the last audited statements. [SM 623–624]
- **s.177(5)**: the committee may call for auditors' comments on internal control, scope and observations; **s.177(6)**: power to investigate, seek information from any employee, outside advice. **Roles**: evaluate internal financial controls and risk management; review auditors' performance and adequacy of controls; review the internal audit function (structure, staffing, reporting, frequency); discuss significant findings; review internal investigations of suspected fraud; pre- and post-audit discussion with statutory auditors. It must review internal audit reports on control weaknesses and the **appointment, removal and pay of the Chief Internal Auditor**. [SM 624]
- **Internal control questionnaire**: a list of systematically and logically prepared questions to find out and evaluate the effectiveness of internal control; comprehensive; answered by the officials concerned with **"yes", "no", "not applicable", "explanatory notes" and "comments"**; yes = satisfactory, **no = weakness**. [SM 624]

⚠ THE SM'S CARO AND LODR REFERENCES

CARO 2020 clause 3(xiv) asks whether the company has an **internal audit system** commensurate with its size and business and whether the internal auditors' reports were considered; it has **no internal-control clause** (that reporting moved to s.143(3)(i), internal financial controls). The SM itself prints clause (xiv) this way in Module 15 (SM p. 658). "Rule 18(3) of LODR" is **Regulation 18(3)** read with Schedule II Part C. Write the SM text, then this correction in one line.

MODEL ANSWER · JUN'24 Q8(a) ADEQUACY OF INTERNAL CONTROLS (SM 659, MODULE 15)

Per **SA 200 read with SA 315**, the auditor understands the accounting system enough to identify major classes of transactions, how they start, records, documents and the reporting process. Financial and accounting internal control aims at: (i) **flow of work through stages**; (ii) **segregation of duties**, so no one person handles a job from beginning to end; (iii) **documentation** at each stage; (iv) transactions recorded with **proper amounts, on time**, per accounting policies; (v) **assets safeguarded**; (vi) **access restricted** to authorised persons; (vii) an **organisational chart** to fix responsibility; (viii) a system to **locate deviations and detect frauds and errors automatically**; (ix) **standardised records and formats**; (x) an efficient **MIS**; (xi) **minimum loss and wastage**. Adequacy and "major weakness" are **distinct**: no major weakness does not mean the system is adequate. [SM 659]

⚠ NOT IN THE SM · DEC'25 Q8(a) DRAFT ICQ: INVENTORY (ANSWER YES / NO / N.A. / NOTES)

1. Are purchases made only against **approved requisitions and purchase orders**?
2. Are goods received **counted, inspected and recorded on pre-numbered GRNs** by staff independent of purchasing and stores? Are GRNs matched with the PO and the invoice?
3. Are stores **locked, with access restricted**? Is a perpetual record (bin cards / stores ledger) kept and reconciled with the financial ledger?
4. Are **maximum, minimum and re-order levels** fixed and reviewed?
5. Are issues made only against **authorised material requisitions**; are returns to stores recorded?
6. Is stock **physically verified** periodically by persons **independent of the storekeeper**; are differences investigated and adjustments approved?
7. Are **slow-moving, obsolete and damaged** items identified and provided for; is valuation at **cost or net realisable value, whichever is lower**?
8. Are goods **held for or with third parties** recorded separately and confirmed?
9. Is inventory **adequately insured**; is scrap recorded and sold under control?

14.2–14.3 Internal control and the auditor · evolution and necessity of internal audit · Dec'23 Q8(a)

- **Role of the internal auditor in internal control**: (a) review of the system: does it give **reasonable assurance** that goals will be met efficiently and economically? (b) review of **effectiveness**: is it functioning as intended? (c) review of **quality of performance**: were goals achieved? (d) primary objectives of internal control: reliability and integrity of information; compliance with policies, plans, laws; **safeguarding of assets**; economical and efficient use of resources; accomplishment of goals. Management support is a must. [SM 626]
- **Evolution**: **Chanakya** (350-283 BC), adviser of Chandragupta, in the **Arthasastra** listed **40** types of embezzlement ("how much water the fishes drink"); Greeks, Romans, Egyptians audited; the first US Congress, **1789** (treasury secretary, comptroller, auditor); US **railroads** (travelling auditors) in the late nineteenth century; **Krupp**'s audit manual of **January 17, 1875**. Early aims: **protection of assets and detection of fraud**; a "psychological deterrent". [SM 627]
- The **1940s war economy** (cost-plus contracts) widened it to cost reporting; computers made checking every transaction unnecessary; **Arthur H. Kent**, "Audits of Operations", **March 1948**; operational outlook permanent by the **1970s**; aim moved from finding fraud to **helping management decide**. **Sarbanes-Oxley**: **Section 301** audit committee for listed entities; **Section 404** annual report on internal controls; CEO and CFO certify reports; similar provisions in the Indian Companies Act, 2013. [SM 628]

SM exercise keys: 1 several checks and controls = **internal check** (= Jun'24, postal) · 2 one clerk checked by another = **internal check** · 3 internal control **includes** internal checks (= Dec'24, Jun'26) · 4 not true of continuous audit: **"needed**

MODEL ANSWER · DEC'23 Q8(a) NECESSITY OF INTERNAL AUDIT (SM ORDER)

1. Helps management **strengthen internal controls** by uncovering system vulnerabilities and giving chances to fix them.
2. Aids in **discovering errors and frauds**, with corrective recommendations that prevent recurrence.
3. Acts promptly to curb **misuse of resources**, cutting unnecessary and **infructuous expenditure**.
4. Improves **workflow and processes**; a check on employee morale.
5. The **statutory auditor can rely on internal audit reports**, reducing audit time.
6. Its vigil keeps operating staff **on their toes**, keeping books updated.
7. **Independent review** of operations and business.

[SM 628–629]
Close with the definition: internal auditing gives **independent assurance** on governance, risk management and internal control, objectively, to improve business practices. [SM 628]

when internal control is good" (= PTP) · 5 an internal auditor is more concerned with the **internal control system** · 6 verification = establishing the **accuracy of entries** · 7 investigation: all of the above · 8 the auditor gives his **expert opinion** · 9 not a fraud risk factor: **conservative accounting principles** · 10 client acceptance: management that does not lack integrity. [SM 632–634]

⚠ NOT IN THE SM · JUN'23 Q8(b) ENGAGEMENT TEAM DISCUSSION (SM ESSAY Q4)

The statement is **correct**; it comes from **SA 315**: the engagement partner and key team members must discuss how **susceptible the financial statements are to material misstatement** (incl. fraud, **SA 240**) and how the reporting framework applies to the entity. Benefits: experienced members share their knowledge of the entity; the team understands where misstatement could arise; members see how their work affects others' areas; a basis for passing on new information during the audit. The partner decides what to tell members not present. **Documentation** (SA 315 with **SA 230**): the discussion and the significant decisions reached, kept in the working papers for review and future reference.