Module 15 · Operational Audit and Internal Audit P17 · 15.1–15.7

SM pp. 637–679, exercise 680–686. **24 marks in 7 papers. Operational audit was Q8(a) in Dec'24 and Jun'26** (Module 14 had Q8(a) in the other papers), and **MCQ (ix) was "role of CMAs / operational audit" in Jun'25, Dec'25 and Jun'26**. The ICMAI PTP answer copies SM 639–640.

Paper	Question	Paper	Question
Dec'24	Q8(a) **preparing for an operational audit + its objectives** (= PTP Q8(a))	Dec'25	MCQs: CMA in operational audit reviews **machine utilisation and production planning**; internal auditor = **any professional decided by the Board**
Jun'25	MCQs: internal audit is conducted **throughout the year**; operational audit focuses on **risk identification, process improvement**	Jun'26	Q8(a) **objectives, advantages and disadvantages of operational audit** · MCQ not a feature of operational audit = **transaction based**
Jun'23, Dec'23, Jun'24	—	Dec'26?	s.138 / Rule 13 never asked long; PTP MCQ internal audit throughout the year

DEC'26 PREDICTION

- **MCQ (viii)–(ix) is near certain**: role of CMAs 60%, operational audit 30%, s.138 25%, preparation 20%. Learn the **internal audit vs operational audit table** and the **Rule 13 thresholds**.
- Q8(a) 7 marks (shared with Module 14): preparation 10%, objectives / pros and cons 10%, **internal audit under s.138** 10% (never asked long: who must appoint, who can be appointed, procedure, penalty), CARO internal audit clause 5%.

INTERNAL AUDIT vs OPERATIONAL AUDIT (SM 652)

Internal audit	Operational audit
compliance objective	**risk identification, process improvement**
financial accounts focus	business focus
audit focus	efficiency and improvement focus
transaction-based	**process-based**
policies and procedures focus	risk management focus
cost-centre budget monitoring	accountability for improvement results
policies, transactions, compliance	goals, strategies, risk processes

15.1–15.2 Operational audit: meaning, preparation, objectives · Dec'24 and Jun'26 Q8(a)

- **Rule 13** (s.138) makes some companies appoint internal auditors (see 15.5); the IIA definition stresses **value addition**; understanding the entity's operations is the pre-requisite. [SM 637–638]
- SM WORDS **Operational audit** (residuary approach): **auditing which goes beyond financial transactions and accounting records and examines into the operating, managerial or administrative performance of the entity**; a **future-oriented, systematic, and independent evaluation** of all organisational activities. Objective: **improve the way the business performs**: lower costs, **decrease the turnaround time**, better service and customer satisfaction. It looks not only at how things are but **how things could be**. [SM 638]
- Also called **value-for-money audit**: an organised search for ways of improving efficiency and effectiveness; an **early warning system**. Financial audit says where the entity is; operational audit says **why it is there and how it got there**; it evaluates **planning, organising, directing and**

MODEL ANSWER · DEC'24 Q8(a) / PTP: PREPARING FOR AN OPERATIONAL AUDIT + OBJECTIVES

Preparation (Figure 15.1): there are an **active** and a **passive** approach in all audit assignments, especially operational audit, for a paradigm shift to **"beyond compliance"**: passive = detection, identifying problems; active = **prevention of wasteful activity**, promoting compliance with internal control, benchmarking processes against best practice, to **reduce revenue leakages and cost** → better business performance; from compliance to **strategic partner**. **Risk based audit** prioritises operational risk but does not give holistic coverage of the value chain; operational audit reviews **all** operating activities for the objective. [SM 639]

Objectives = DEMING (after W.E. Deming, TQM): **D**etailed understanding of the existing process to suggest improvement · **E**liminate waste and duplication · **M**erge operations to reduce turn around time · **I**mprove quality,

controlling; it is the primary domain of the internal auditor (financial and compliance audits are supplementary). [SM 652]

- **Triggers**: policy adherence, high sales returns, new product mix, equipment downtime, staff turnover. Set the **scope** first; understand the operations, history, image, workforce, **reporting path**; collect the organisation chart, policies, procedures and past performance reports (over- or under-staffing, control deficiencies, poor rotation); reports factual, timely, to the right level. [SM 653]

MODEL ANSWER · JUN'26 Q8(a) ADVANTAGES AND DISADVANTAGES

Advantages: **objective opinions** that bring quicker production by **lowering TAT** (turn around time), point out **process inefficiencies**, locate areas of **delay or lapses**, give **cost rationalisation / reduction**; a move towards **operational excellence**. **Disadvantage**: the mental fear of **"resistance to change"** in the organisational culture is the only one. (Add the objectives: DEMING, at right.) [SM 640]

volume, revenue · **N**ew methods, techniques, devices · **G**overn man, machine, methods and money. Auditors must spend more time on operation reviews; **"brain power"** replaces "brawn power"; the process integrates people, tools, procedures and technology. [SM 639–640]

Steps: (i) define the scope; (ii) knowledge of the business and processes, formulate the **audit programme**; (iii) evaluate accounting and internal control; (iv) nature, timing and extent of procedures (audit risk, materiality); (v) **documentation** (audit note book, working papers); (vi) opinion; (vii) report. **Techniques**: EDP for gaps, **process flow charting**, discussion. [SM 640]

15.2–15.3 Audit programme · continuous audit · working papers · note book · engagement letter

- **Audit programme**: a **written plan** with exact details of a particular audit; a memorandum of work; a guide against **omissions**. Factors for a detailed programme: previous internal audit observations and action taken; previous checklists; changes in commercial laws; special areas from top management. Contents: objectives per area; staff responsible; time per activity; detailed instructions. [SM 640–641]
- **Advantages**: a ready checklist; work allocated to assistants; progress known; individual responsibility fixed; uniformity; basis for next year; **evidence against a charge of negligence**. **Disadvantages**: work becomes mechanical; unnecessary for a small concern; staff hide behind "not in the programme"; no rigid programme fits every business (remedy: consult assistants, modify with experience). [SM 641–642]
- **Continuous audit**: detailed examination **throughout the year or at regular intervals** (fortnightly, monthly); suits early final accounts, **great volume of transactions**, or a **weak internal check** (SM MCQ: not true that it is "needed when internal control is good", Module 14). **Final (completed, periodical) audit**: after the year is closed. [SM 642]

- **Working papers**: formal documents of procedures, evidence and conclusions; a clear trail; reviewable by regulators and others; standardised; finalised at the end of fieldwork. **Permanent file** (MoA, AoA, agreements, internal control evaluation, ratios, previous statements, accounting policies, past observations, past cost and secretarial audit reports) vs **current file** (reappointment letters, minutes extracts, management letters, analysis of balances, communications, programme, conclusions, adjustments, reconciliations). They are the **property of the auditor**; safe and confidential custody. Retention depends on client agreement, firm policy, engagement, law, litigation. Advantages: evidence of due diligence, future reference, legal compliance, training, external reviews, record of adjustments. [SM 642–644]
- **Audit note book**: a bound book of matters observed; a **permanent record of the auditor**, one per audit: organisation, structure, MoA / AoA points, previous auditors, books kept, methods, controls, KMP, errors and frauds found, queries, points for the report, notes and ideas. Specimen columns: voucher no., account, amount, query, how disposed of. [SM 644–646]
- **Engagement letter**: written agreement on **scope, terms and conditions**, to the audit committee chair or board chair; sent to new clients and when terms change; preferably **before** the engagement. Contents: introduction; objectives (reliable information, compliance, inventory, physical verification, safeguarding assets, follow-up of prior reports); quarterly timetable; team; opening meeting; documents needed; draft observations to HODs, satisfied points dropped, the rest to the final report for the **Audit Committee**. [SM 647–650]

15.4–15.5 Role of CMAs · internal audit under s.138 · MCQs every paper

- **Role of internal audit and CMAs**: the Board expects help in identifying, monitoring and managing **business risks**

- **Who can be appointed**: producer company: a **Chartered Accountant** (s.378ZF); others: a **CA, a cost accountant, or**

(Enterprise Risk Management), insight on culture and ethics, efficiency of operations, compliance, reliable reporting, **safeguarding of assets**, advice; a risk-based plan linked to strategy; technology; business process re-engineering; governance. CMAs blend accounting, management and strategy: they judge operational efficiency, productivity, profitability, waste, **capacity utilisation**, production processes, supply chain, **utilities and energy**, sustainability (= Dec'25 MCQ: machine utilisation and production planning). [SM 651]

- **Legislative background**: first in the 1956 Act for producer companies (s.581ZF); made mandatory by **MAOCARO 1975**; MAOCARO 1988; CARO 2003; CARO 2016; CARO 2020; now **s.138**. [SM 654]

MODEL ANSWER · WHICH COMPANIES MUST APPOINT AN INTERNAL AUDITOR (s.138 + RULE 13)

a. every **listed company**;

b. every **unlisted public company** with, in the preceding FY: paid-up capital **50 crore** or more; or turnover **200 crore** or more; or loans or borrowings from banks / PFIs exceeding **100 crore** at any point of time; or deposits of **25 crore** or more at any point of time;

c. every **private company** with turnover **200 crore** or more, or bank / PFI borrowings exceeding **100 crore** at any point of time.

The internal auditor **may or may not be an employee**; the **Audit Committee or the Board**, in consultation with him, formulates scope, functioning, periodicity and methodology; the Act and rules give no duties. Existing companies: within six months (before 30th September, 2014). [SM 654–656]

another professional decided by the Board (SM MCQs 15 and 18). **Appointment**: only by a **resolution at a Board meeting** (Rule 8(4)), **not by circulation**; **MGT-14** within **30** days (dispensed for private companies, GSR 464(E), 05.06.2015). [SM 655]

- **Cannot be appointed**: the **statutory auditor** (MCA Circular 29 of 1976: the internal auditor is like an employee of management); the **cost auditor** for the period of his cost audit. [SM 655, SM 657]
- **Penalty**: s.138 has none, so **s.450**: **₹ 10,000**, plus **1 thousand** per day of continuing default, maximum 2 lakh (company) and 50 thousand (officer). **Procedure**: written consent → **7 days'** notice of the Board meeting → appoint at the meeting → inform him → MGT-14 within 30 days → intimation. [SM 656–657]
- **Sum-up facts**: IFSC public and private companies: s.138 applies only if the **articles** provide; objectives: protect stakeholders, avoid legal action, compliance and governance; scope: governance, risk, controls, reporting, compliance, **proactive fraud audits**; rights: access to books, information and explanations, check loans are secured; duties: wide audits, assurance and consulting, **annual plan agreed with the Chairman before Audit Committee approval**. [SM 677–679]
- **SM MCQ keys**: the financial auditor reports to **shareholders** · change in stock valuation: **allow with a note** · CAATTs = Computer Assisted Audit Tools and Techniques · no lien on the client's **books** · internal audit **throughout the year** (= Jun'25, PTP) · test checking needs an effective **internal check** (= MQP) · revenue treated as capital = error of **principle** · good internal auditor: right attitude, technical expertise, soft skills · s.138 "at any point of time" applies to **loans and deposits** · borrowings of **₹ 105 Crore** on 30.09.2022 trigger it. [SM 685–686]

15.6–15.7 CARO 2020 and internal audit · internal audit in manufacturing

- **CARO**: 2003 under s.227(4A) of the 1956 Act; s.143(11) of the 2013 Act; CARO 2015 (10 April 2015); **CARO 2020** published 25th February, 2020, applied from the year starting 1st April 2021. **Clause (xiv)**: (a) does the company have an **internal audit system commensurate with its size and nature**? (b) were the **internal auditors' reports considered** by the statutory auditor? [SM 658, SM 660]
- Terms: **internal control** (SA 200); per **SA 315**, internal audit is a component of internal control; **major weakness** (undefined: risk of significant loss or of material misstatement; judgment, materiality); **adequacy** is distinct from major weakness (see the Module 14 model answer); **continuing failure** = a weakness reported last year still existing, or one flagged at planning not corrected by the report date. [SM 658–660]
- **Exempt from CARO**: OPCs, small companies, banking and insurance companies, section 8 companies, and certain private companies. CARO 2020 has **21** clauses ((vi) cost records, (xi) fraud, (xiv) internal audit system, (xx) CSR, (xxi) subsidiaries' CARO remarks). [SM 660–661]
- **Manufacturing risk and control matrix** (Annexure I), production: plan vs sales and raw materials (budget, authority to change, shift data); **consumption norms** (BOM, reason-wise variance, controllable factors, material reconciliation); capacity vs the sales plan; documentation (daily report from DCS, authority to edit data in DCS / SAP); quality control (SOPs, sampling, complaints, rework approval, bagged only after QC); process losses and recycling; preventive vs breakdown maintenance; MIS from source data. [SM 662–664]
- **Contract workmen**: requisitions by skill and approved; competitive contractor selection; **ghost workmen** (ID with photograph, periodical "parole"); wage rates benchmarked. **Purchasing**: authorised advances; goods recorded at the **gate (Goods Inward Register) and the stores (GRN)**, reconciled; billing per quotation; issues on an approved **MRN**; stock levels and insurance. [SM 664–665, SM 674]
- **Solved cases**: (1) **high RM consumption variance**: BOM changed many times, a substitute RM without a BOM, one product code for two coatings, unequal month-end closing (25 to 31 days), BOM still assuming 10% handling loss after a conveyor cut it below 1%, multiple and unapproved BOMs. (2) **Inventory accumulation** (₹ 666 Crores against turnover of ₹ 5000 Crores): project surplus, stock of one plant invisible to another, old products' RM, warranty replacements booked as purchases, missing items, mixed-up piles, no stock levels, transit items,

⚠ THE SM'S CARO EXEMPTION LIST IS GARBLED

A private company is exempt only if it meets **all** of: not a holding or subsidiary of a public company; paid-up capital + reserves **not more than ₹1 crore**; borrowings **not more than ₹1 crore** at any time; revenue **not more than ₹10 crore**. The SM lists these as separate bullets and prints "more than ₹10 crores". The SM's small-company limits (₹50 lakh / ₹2 crore) are also old: see the P13 notes for the current limits.

materials sent out; actions: separate codes, view access before a PR, COO clearance for new products, stronger physical verification, bins, order levels, a **60 days** limit for transit items. [SM 674–677]