Internal Financial Control over Financial Reporting as in Companies Act 2013

Practical Handbook to Audit Report on "What Can Go Wrong?"

CA K. Gururaj Acharya

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ABOUT KSCAA

Karnataka State Chartered Accountants Association is an association of Chartered Accountants, registered under the Karnataka Societies Registration Act in the year 1957 having the following as its main objects.

1. To encourage friendly feelings and unanimity among the members and to ensure solidarity in the matters of interest concerning all of them.

2. To watch over, promote and protect the mutual interest of members and to better equip them in discharging their professional obligations.

3. To provide an organisation for Chartered Accountants and generally consolidate the interests of the profession and to do all such things from time to time as may be necessary to elevate the status and advance the interests of the profession.

4. To spread knowledge in the art and science of Accountancy in all its branches and in particular relating to matters of professional interest of Chartered Accountants.

5. To endeavor to bring about statutory legislation in any manner for the betterment of members and / or the profession, and / or the students of accountancy and also the public.

There are over 2400 members of the Association spread all over Karnataka. The association is serving the members for the past 58 years.

Activities

The Association regularly conducts seminars, conferences, workshops, study circle meetings of professional interest for members and public. The Association is conducting Endowment lectures also. It brings out News Bulletin for the benefit of members every month.

An abstract of the activities conducted is given hereunder.

Facilities / Activities of KSCAA for the Benefit of Members

- Regular Study Circle Meetings / Seminars / Conferences / Workshops / Endowment Lectures.
- Programmes in Mofussil areas.
- Conducting Corporate Training Programmes for corporate executives in the fields of Accountancy, Taxation, Auditing etc.
- Conducting State Level Conference every year.
- Assistance for members' employment.
- Publication of News Bulletin every month containing Articles of Professional Interest & other useful information.
- Cultural Programmes & Family get-togethers.
- Sports Activities.
- Representation before various Government Departments on general grievances of members.
- Honouring Chartered Accountant Examination Rank holders by giving prizes.
- Distribution of Books to needy and deserving students from the Students Welfare Fund.

PRESIDENT'S MESSAGE

At KSCAA, it is our belief and motto that **"Knowledge is strength"**.

It gives me immense pleasure to place in your hands this publication – **Internal Financial Control over Financial Reporting as in Companies Act 2013, Practical Handbook to Audit Report on "What Can Go Wrong?"** on the eve of 28th Annual Conference our Association.

At KSCAA, it has been our constant endeavor to update and upgrade the knowledge of the members. We fully understand the important role books play in adding to the wealth of knowledge. Books has always been the trusted friend of mankind. Right from the initiation into the basic alphabets to the understanding of the complexities of the science of business, commerce, accounting, auditing, tax and other facets of education, have been possible through the print medium. We also firmly believe that this is the best gift we could give you at this conference apart from knowledge sharing exercise.

CA. Gururaj Acharya K, the author of this publication is a very active member of KSCAA. The learned author has effectively shouldered the responsibility and taken immense pains to bring forth an excellent publication of continuing interest which will benefit a large section of practicing members. It is our pleasure to be part of his first foray into authoring a book at KSCAA. He brings with him a distinctive style of presentation; this book we are sure will be found very useful.

We thank the author for his untiring efforts in authoring this publication.

It is a pleasure to have a sponsor for such a noble cause, we thank M/s. NSVM & Associates, Chartered Accountants, Bengaluru who have sponsored this book.

It is but fair to thank the persons in the background who ensured that the books are published on time, we thank Chairman, Publications Committee CA. Maddanaswamy B.V. and his team for their relentless efforts.

Warm regards,

CA. Dileep Kumar T.M.
President, KSCAA

MESSAGE

I am extremely happy to present you this book on – **Internal Financial Control over Financial Reporting as in Companies Act 2013, Practical Handbook to Audit Report on "What Can Go Wrong?"** on the occasion of 28th Annual Conference of KSCAA.

The Companies Act, 2013 mandates that the statutory auditors of a company should report on the adequacy of Internal Financial Control System in place and whether the same is operating Effectively.

CA K. Gururaj Acharya has dealt the practical aspects of the provisions in this book.

I am grateful and indebted to author, CA K. Gururaj Acharya for sharing his rich experience, exposure and knowledge.

I am thankful to M/s. NSVM & Associates, Chartered Accountants, Bengaluru for sponsoring this publication.

I am also thankful to my publication team convenors and members for their unstinted support.

I do hope that this will provide in depth knowledge and understanding for sharpening of the professional skills of our members.

With warm regards.

CA. B. V. Maddanaswamy
Chairman – Publication Committee

Preface

Audit scenario has been undergoing metamorphic changes. Standard Audit Practices (SAP) has given way to Auditing & Assurance Standards (AAS) and is now called Standards on Audit (SA). All the SAs are statutorily recognized by Companies Act, 2013. Sec. 143(9) states that the auditor shall comply with the auditing standards.

With the business environment becoming more complex, increasing use of Information Technology to process & store data and the increasing recurrence of frauds *(intentional)* & errors *(unintentional)* has made the job of the Auditors onerous.

To address the above and to meet the ever growing expectation of the stakeholder from the statutory auditors, Companies Act, 2013 mandates that the statutory auditor of the company should, inter alia, report if the company has adequate internal financial controls system in place and whether they were operating effectively.

Let us analyze a real life case. A distance of about 300 km is covered in a car by Driver A in 2 hours and Driver B in 5 hours.

And we ask the passengers to choose in which car they would like to travel. Most of them would prefer travelling in the car driven by '*Driver A*' as they would reach the destination faster.

Suppose, we now say that the

- '*Car of Driver A*' Had no brakes ***(Akin to Absence of Control)***

Or

- The brakes are beyond the reach of *'Driver A'* ***(Control Design is not proper)***

Or

- Brakes were there in the car but '*Driver A'* never applied them ***(Akin to Control not being operated effectively)***

And now we ask the passengers to choose in which car they would like to travel?

All rational persons would certainly not prefer *'Driver A and his car'* and would go with the car driven by *'Driver B*' after asserting that the brakes in his car are there and are being applied effectively. This is because the possibility of accident to occur in case of '*Driver A's car'* is higher, although he has not met with any accident in the past.

As auditors, we were in the past required to report only true and fair view of Financial Statements *(akin to time taken & the distance covered in the above case)* but now the auditors are required to comment on the adequacy of control and its operating effectiveness *(akin to whether the brakes are present in the car, the design of the brake is proper and they are operating effectively)* thereby, ensuring that there would be no possibility of material weakness leading to the possibility of a material misstatement of the Company's Financial Statements not being prevented or detected on a timely basis.

The statutory auditor of the company, apart from reporting on “what has gone wrong” with respect to the Financial statements for the period covered in the previous year, would also now be required to report on “What can go wrong” or “What could have gone wrong” as at the balance sheet date.

Since the auditor has to opine about the existence & adequacy of IFC as at the balance sheet date, the IFC audit has to be completed before the balance sheet date. If the audit is done after the year end and it is found that control failure were prevalent on BS date, it cannot be remedied as of BS date and would lead to a modified opinion in the IFC Audit report. Further, the year one challenge would also be humongous.

IFC Audit report would be a “Value added audit report” from the user’s perspective, which from the auditors perspective would require maturity & abundant experience and greater involvement & due diligence.

In order to assist the statutory auditors to carry out the IFC audit, ICAI has come out with a **Guidance Note on Audit of IFC over Financial Reporting (GN)**. The GN provides a detailed guidance to the members to carry out the assignment of reporting on IFC. This book is based on the GN and focuses on the practical aspects on IFC reporting by explaining the intricacies in a crisp manner. In a way, this book acts as a “Guide to the Guidance Note” especially to the auditors of Small and Medium Companies. **This book would in no way be a substitute to the reading of the GN itself.**

This book would not have been possible without the co-operation of my family and my extended family in the office lead by my partner **CA H. Vinay Kumar** and ably assisted by CA. Sunitha Jain and CA. Ashok Kumar.

I would like to thank the President of KSCAA CA. Dileep Kumar who reposed his faith in me and asked me to write this book. This book would not have been written but for the constant pestering from my good friend CA. Niranjan Prabhu who was constantly chasing me to complete the book at the earliest realizing the importance of the topic.

I would like to place on record my sincere thanks to CA. V Balaji, who has initiated me into this subject of IFC and has also permitted me to take some of his material into this book.

My sincere thanks to CA. Manohar Gupta, who did a overnight proof reading and gave me his value added feedback, which I have tried to incorporate. I wish I had more time to make this book more profession friendly.

I earnestly hope that this book would be found useful by the readers who can write to me about their feedback at acharya@kgacharya.com

Happy & purposeful reading.

29th February 2016	**CA. K Gururaj Acharya**
Bangalore	

Index

Section A

GLOSSARY

OF TERMS USED IN THE BOOK

Abbreviation	Description
AAS	Auditing & Assurance Standards
BS	Balance Sheet
CAAT	Computer Assisted Audit Techniques
CARO	Companies (Auditors' Report) Order
Co.	Company
ELC	Entity Level Controls
EOM	Emphasis of Matter
FS	Financial Statements
GAAP	Generally accepted Accounting Policies
GN	Guidance Note
IC	Internal Controls
ICAI	Institute of Chartered Accountants of India
IFC	Internal Financial Controls
IFCOFR	Internal Financial Controls over Financial Reporting
IG	Implementation Guide
IPE	Information produced by the Entity
IT	Information Technology
OE	Operating effectiveness
OM	Other Matter
PL	Statement of Profit and Loss
reg.	Regarding
ROMM	Risk of Material Misstatement
SA	Standards on Auditing
SAAE	Sufficient Appropriate Audit Evidence
SAP	Standard Audit Practices
SIA	Standard on Internal Audit
TOC	Test of Controls
TOD	Test of Design
wrt	With Respect to
Section Number and Rule Numbers referred in this book are with respect to Companies Act 2013 and Rules framed therein.	

Section B

Master Audit Report

AUDITOR'S REPORT SHALL STATE *S.143(3)*

a. Sought & obtained ALL **Information & Explanation;**

b. Proper **books maintained** (#)

c. Branch Auditor's report how dealt with (*)

d. BS & PL – are in **Agreement with books**

e. FS **comply with A/S**

f. Observation or comments of Auditor's on financial transactions or matters which have any adverse effect on the functioning of Co. (*)

g. Director **disqualification U/s. 164(2)**

h. Any qualification, reservation or adverse remarks relating to the maintenance of A/Cs and other matters connected therewith. (#) (*)

i. Adequate IFC in place & operating effectiveness of such control.

j. Such other matter as may be prescribed: - *Rule 11 - 3 points*

- Pending litigation impact
- Material foreseeable losses on long term contracts
- Any delay in transfer to IEPF.

**** Can be dropped if not applicable – See Table below for Gist of ICAI's GN on Reporting.***

 # Inter-connected

Gist of ICAI's G/N on Reporting u/s 143(3) (f) & (h) of Cos. Act

	143(3)(f)	**143(3)(h)**
	Matters having Adverse Effect on Co's functioning ?	**Qln. Reservation or adverse remark relating to maintenance of A/Cs & other matters connected therewith.**
1. Clean – unmodified – SA 700	**No comment required (Drop Para)**	**Generally NO Comment reqd. (Drop Para)** *[Exception when 143(3)(b) reg. maintenance of proper books Para is adversely commented]*
2. Modified (SA 705) or EOM SA 706 Qln, Adverse opinion or disclaimer or EOM a) Matters adversely affecting Co.'s functioning: • Is pervasive affecting going concern or significantly impact the ops. of the Co.	**Comment required**	**EOM – SA 706** **Generally NO Comment reqd. (Drop Para)** *[Exception when 143(3)(b) reg. maintenance of proper books Para is adversely commented]*

b) Other than 'a': • Managerial remuneration st. approval • Management estimate based contract receivable where ultimate collection could be different • Frauds dealt in FS NOT having continuing effect on FS.	**NO comment required (Drop Para)**	**Modified – SA 705: Required**
3. If IFC & OE is commented as NOT OK	**Comment required**	**Comment reqd. only if IFC weakness <u>RESULTS IN</u> modification of Auditor's Opinion in FS**
4. S.143(1) inquiries on certain matters <u>@</u>, if reported	**Comment required**	**NA**

<u>@</u>

a) *L&A made – If secured, is it properly secured & terms are prejudicial to co.*
b) *Transactions rep. by Book entries - prejudicial*
c) *Shares, Debn or other securities are sold at loss.*
d) *L& A made – Is it shown as Deposits*
e) *Are personal exp. – Charged to Revenue Account.*
f) *Shares allotted for cash – Has Cash been received & properly accounted.*

Reports On IFCOFR *[As per Appendix III of GN]*

<u>IFCOFR Report paragraphs</u>

- Annexure to the Main Audit Report
- Report on IFCOFR (Heading)
- Management's Responsibility for IFC
- Auditor's Responsibility
  - obtaining an understanding of IFC
  - Assessing risk of material weakness exists & testing/evaluating the design & operating effectiveness of Internal Controls based on assessed risk.
- Meaning of IFCOFR
- Inherent Limitations of IFCOFR
- Opinion
- Signature of the Auditor
- Date of the Auditor's Report
- Place of Signature

Note:

1. *The underlined text in the master template below refers to the changes made vide SA 700 (Revised) issued by ICAI. The struck off portion is pursuant to IFCOFR reporting requirements effective from 01.04.2015. For illustrative purposes, multiple Reporting Possibilities have been provided for benefit of the readers and suitable option has to be chosen based on Auditor's judgment considering the facts of the case.*
2. *Under the New Companies Act 2013, reporting in "Bold & Italics" by Auditor has been done away with. Phrases in* ***Bold Type*** *are for emphasis only and are not to be considered for reporting purposes*

INDEPENDENT AUDITORS REPORT

[Master Template with IFCOFR]

TO THE MEMBERS OF *ABC COMPANY PVT. LTD.,*

Report on the Standalone Financial Statements

We have audited the accompanying standalone financial statements of **ABC Company Private Limited.,** ("the Company"), which comprise the Balance Sheet as at 31 March, 20XX, the Statement of Profit and Loss, the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information, *[in which are incorporated the Returns for the year ended on that date audited by the branch auditors of the company's branches at (location of the branches)].*

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in Section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance and cash flows of the company in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rule, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these Standalone financial statements based on our audit.

We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made thereunder.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances~~, but not for the purpose of expressing an opinion on whether the Company has in place an adequate internal financial controls system over financial reporting and the operating effectiveness of such controls~~. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by Company's Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our Audit Opinion on the standalone financial statements.

Opinion #

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 2016, and its profit/loss and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2016 ("the Order") issued by the Central Government of India in terms of sub-section (11) of section 143 of the Act, we give in the '**Annexure – A'** a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.
   This report does not include a statement on the matters specified in paragraph 3 of the Companies (Auditor's Report) Order, 2016, issued by the Ministry of Corporate Affairs, in terms of Sec.143(11) of the Act, since in our opinion and according to the information and explanations given to us, the said Order is not applicable to the company.

2. *As required by Section 143(3) of the Act, we report that:*

   a. We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

   b. In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books *[and proper returns adequate for the purposes of our audit have been received from the branches not visited by us]*

   c. *[The reports on the accounts of the branch offices of the company audited under section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report.]*

   d. The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account *[and with the returns received from the branches not visited by us.]*

e. In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Sec. 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

f. On the basis of the written representations received from the directors as on 31st March, 2016 taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 2016 from being appointed as a director in terms of Sec. 164(2) of the Act.

g. With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in **'Annexure - B'**

h. With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us".

   i. The Company does not have any pending litigations which would impact its financial position
   The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer to Note XX to the financial statements;

   ii. The company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.
   The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts–Refer to Note X to the financial statements;

   iii. There were no amounts which were required to be transferred to the Investor Education and Protection Fund by the company.
   There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

For **M/s. __________ & Co.,**
Chartered Accountants
FRN ________

____
Partner / Proprietor
M. No. ________

Date
Bangalore

 # Apart from considering modification to the opinion as per SA 705, the auditor will also have to consider his opinion as in the IFCOFR report at the time of giving his opinion in the Main audit report.

'Annexure – A' to the Auditors' report

Note - The Ministry had set-up a Committee on 16th September, 2015 to examine and recommend matters for inclusion in the statement to be attached with Auditor's Report under Section 143(11) of the Companies Act, 2013 for the financial year 2015-16 onwards. The said Committee has since made recommendations in the matter and the draft Companies (Auditor's Report) Order, 2016 (CARO 2016) was placed on the Ministry's website at www.mca.gov.in. inviting suggestions / comments on 9th February 2016. The last date for Suggestions / comments on the draft along with justification in brief was 23rd February, 2016.

In this section, the clauses of the draft CARO 2016 have been stamped as "New 2016" and the clauses of the existing CARO 2015 which have deleted have been 'Struck-off'.

The annexure referred to in the Auditors' report to the members of **ABC Company Private Limited** ('the Company') for the year ended 31st March 2016. We report that:

1.

(a) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
(c) Whether title deeds of immovable properties are held in the name of the company. If not, provide details thereof.

(a) The company has maintained proper records showing full particulars including quantitative details and situation of fixed assets.

(b) According to the information and explanations given to us, the fixed assets have been physically verified by the management during the year which, in our opinion, is reasonable having regard to the size of the company and the nature of its assets. No material discrepancies were noticed on such verification.

(c) The title deeds of all the immovable properties are held in the name of the Company.

NEW 2016

The title deeds of all the immovable properties are held in the name of the Company except in the following __ cases -

Sl. No.	*Details*	*Amount / Book Value*	*Held in the name of*	*Remarks*

2.

Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, how they have been dealt with in the books of account)

As explained to us, the inventories have been physically verified by the management at reasonable intervals during the year. In our opinion, the frequency of such verification is reasonable. The discrepancies noticed on verification were not material.

~~a. As explained to us, the inventories have been physically verified by the management at reasonable intervals during the year. In our opinion, the frequency of such verification is reasonable.~~

~~b. In our opinion and according to the information and explanations given to us, the procedures of physical verification of inventories followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business.~~

~~c. The Company is maintaining proper records of inventory. The discrepancies noticed on verification between the physical stocks and the book records were not material.~~

3.

> *Whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered by clause of the Companies Act, 2013. If so,*
> *(a) Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;*
> *(b) Whether receipt of the principal amount and interest are regular. If not provide details thereof; and*
> *(c) If overdue amount is more than rupees five lakhs, whether reasonable steps have been taken by the company for recovery of the principal and interest;*

a. We are unable to comment as to whether the terms and conditions of the loans granted to parties by clause (76) of Section 2 of the Companies Act, 2013 are not prejudicial to the company's interest as there has been no stipulation with respect to the same.

b. We are unable to comment on the repayment of loans granted to parties ~~listed in the registers maintained under Section 189~~ covered by clause (76) of Section 2 of the Companies Act, as there has been no stipulation with respect to the repayment of such loans or the payment of interest.

c. We are also unable to ascertain the overdue amount *(**NEW** threshold Rs. 5 lacs)* as there has been no stipulation with respect to the repayment of such loans or the payment of interest.

The company has not granted loans, secured or unsecured, to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act.

~~4. In our opinion and according to the information and explanations given to us, there are adequate internal control systems commensurate with the size of the company and the nature of its business with regard to purchase of inventory, fixed assets and with regard to the sale of goods and services. During the course of our audit, no major weakness has been noticed in the internal controls.~~

4.

> *In respect of loans, investments and guarantees, whether provisions of Section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide details thereof.*

NEW 2016

In respect of loans, investments and guarantees, the provisions of Section 185 and 186 of the Companies Act, 2013 have been complied with.

The company has not given loans, investments and guarantees to which the provisions of Section 185 and 186 of the Companies Act, 2013 apply.

5.

> *in case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company*

The company has not accepted any deposits to which the provisions of Section 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under and the directions issued by the RBI are applicable. Hence paragraph 3 (5) of CARO is not applicable to the company.

6.

Whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained;

We have broadly reviewed the cost records maintained by the company pursuant to the Companies (Cost Accounting Records) Rules, as amended, specified by the Central Government under section 148(1) of the Companies Act and are of the opinion that prima facie the prescribed cost records have been maintained. We have, however, not made a detailed examination of the cost records with a view to determine whether they are accurate or complete.

The central government has not prescribed maintenance of cost records under section 148(1) of the companies Act for any of the products / services of the company. Thus paragraph 3(6) of CARO is not applicable to the company

7.

(a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-Lax, , service tax, duty of customs, duty of excise, value added tax, and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.   *(b) Where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).*

(a) The company is regular in depositing with appropriate authorities undisputed statutory dues including provident fund, employees' state insurance, income tax, sales tax, wealth tax, service tax, custom duty, excise duty, cess and other material statutory dues applicable to it.

According to the information and explanations given to us, no undisputed amounts payable in respect of income tax, wealth tax, service tax, sales tax, customs duty, excise duty and cess were in arrears, as at 31st March 20XX for a period of more than six months from the date they became payable.

According to the records of the company, it is irregular in depositing with the appropriate authorities undisputed viz., Professional Tax. The company had the following arrears with respect to these statutory dues as on the balance sheet date.

Name of the Statute	***Balance outstanding as on 31.3.2015 (Amount in Rs)***
__________	*Rs. _________/- (of this Rs. _______/- is Outstanding for more than 6 months)*

However, the company is regular in depositing with appropriate authorities other undisputed statutory dues including provident fund, employees' state insurance, income tax, sales tax, wealth tax, service tax, custom duty, excise duty, cess and other material statutory dues applicable to it.

(b) According to the information and explanations given to us, there are no dues of income tax, wealth tax, service tax, sales tax, customs duty and excise duty and cess which have not been deposited on account of any dispute.
According to the information and explanations given to us, there are no dues of Sales Tax, Wealth Tax, Service Tax, Customs Duty, Excise Duty and cess which have not been deposited on account of any dispute. The particulars of Income tax which have not been deposited on account of any dispute are as follows:

Name of Statute	*Nature of the dues*	*Amount in Rs. 31.03.20XX*	*Period to which the amount relates*	*Forum where dispute is pending*

~~(c) There were no amounts which were required to be transferred to the Investor Education and Protection Fund by the company.~~

~~8. Whether in case of a company which has been registered for a period not less than 5 years, its accumulated losses at the end of FY are not less than 50% of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;~~

8.

> *Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported (in case of banks and financial institutions, lender wise details to be provided).*

Based on our audit procedures and on the information and explanations given by the management, we are of the opinion that the company has not defaulted in repayment of dues to its bank. **(Old clause 9)**

Based on our audit procedures and on the information and explanations given by the management, we are of the opinion that the company has defaulted in repayment of dues to its bank. The details of default in repayment of dues to its bank are as below:

Sl No.	*Particulars*	*Period of Default*	*Amount of default*	
			Principal	*Interest*
1	*SBI – CC account*	*12 Months*		
2	*Term Loan*	*12 Months*		

In view of the above default, Bank had recalled the entire advance and the loans outstanding were classified as Non-performing Asset (NPA).

9.

> *Whether moneys raised by way of public issue/ follow-on offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays / default and subsequent rectification, if any, as may be applicable, be reported;*

NEW 2016

The moneys raised by way of public issue/ follow-on offer (incl. debt instruments) and term loans were applied for the purposes for which those are raised. **(Old clause 11)**

In our opinion and according to the information and explanations give to us, the moneys raised by way of public issue/ follow-on offer (incl. debt instruments) and term loans were applied for the purposes for which those are raised except to the extent of Rs. __________/- the details of which are as under -

~~10. whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;~~

10.

> *Whether any fraud by the company or any fraud on the Company by its officers/ employees has been noticed or reported during the year; If yes, the nature and the amount involved be indicated.*

Based upon the audit procedures performed and information and explanations given by the management, we report that no fraud ~~on or~~ by the company **and no fraud on the Company by its officers / employees** has been noticed or reported during the course of our audit. **(Old clause 12)**

11.

Whether managerial remuneration has been paid / provided in accordance with the requisite approvals mandated by the provisions of section 197 read with schedule V to the Companies Act? If not, state the amount involved and steps taken by the company for securing refund of the same.

NEW 2016

The Managerial Remuneration has been paid / provided in accordance with the requisite approvals mandated by S. 197 r/w. Schedule V to the Companies Act.

The Managerial Remuneration has been not paid / provided in accordance with the requisite approvals mandated by S. 197 r/w. Schedule V to the Companies Act. The amount involved is Rs. _________ and steps taken by the company for securing refund of the same are as under –

12.

Whether the Nidhi Company has complied with the Net Owned Fund in the ratio of 1: 20 to meet out the liability and whether the Nidhi Company is maintaining 10% liquid assets to meet out the unencumbered liability.

NEW 2016

The Company is not a Nidhi Co. and therefore clause 3(12) of the Order is not applicable to the Company.

13.

Whether all transactions with the related parties are in compliance with Section 188 and 177 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc as required by the accounting standards and Companies Act, 2013.

NEW 2016

The company has not entered into any transactions with the Related Parties during the year and therefore clause 3(13) of the Order is not applicable to the Company.

All transactions with the related parties are in compliance with S. 188 and 177 (where applicable) of Companies Act, 2013 and the details thereof have been disclosed in the Financial Statements etc as required by the Accounting standards and Companies Act, 2013.

14.

Whether the company has made any preferential allotment / private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of Section 42 of the Companies Act, 2013 have been complied and the amount raised have been used for the purposes for which the funds were raised. If not, provide details thereof.

NEW 2016

The Company has not made any preferential allotment / private placement of shares during the year and therefore clause 3(14) of the Order is not applicable to the Company.
The requirements of S. 42 of the Companies Act, 2013 regarding Preferential allotment / Private placement of shares / Convertible debentures made during the year under review have been complied with. Further, the amounts raised have been used for the purposes for which the funds were raised.

15.

Whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether provisions of Section 192 of Companies Act, 2013 have been complied with.

NEW 2016

The Company has not entered into any non-cash transactions with directors / persons connected with him and therefore clause 3(15) of the Order is not applicable to the Company.
The provisions of S. 192 of the Companies Act 2013 regarding non-cash transactions with directors / persons connected with him have been complied with.

For **M/s. __________ & Co.,**
Chartered Accountants
FRN ________

____
Bangalore ***Partner / Proprietor***
___________ **M. No. ________**

'Annexure – B' to the Independent Auditor's Report Of Even Date On The Standalone Financial Statements Of ABC Company Private Limited

Report on the Internal Financial Controls under Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 ("the Act")

We have audited the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20XX in conjunction with our audit of the standalone financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

The Company's management is responsible for establishing and maintaining internal financial controls based on ____ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India".] These responsibilities include the design, implementation and maintenance of adequate internal financial controls that were operating effectively for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditors' Responsibility

Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on our audit. We conducted our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, issued by ICAI and deemed to be prescribed under section 143(10) of the Companies Act, 2013, to the extent applicable to an audit of internal financial controls, both applicable to an audit of Internal Financial Controls and, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance Note require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness. Our audit of internal financial controls over financial reporting included obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the Company's internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Financial Controls over Financial Reporting

<u>Because of the inherent limitations of internal financial controls over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may occur and not be detected.</u> Also, projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that the internal financial control over financial reporting may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinion #

Unmodified

In our opinion, the Company has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 20XX, based on ______ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"].

Opinion #

Qualified Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting

According to the information and explanations given to us and based on our audit, the following material weakness/es has / have been identified as at March 31, 20XX:

a) The Company did not have an appropriate internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognizing revenue without establishing reasonable certainty of ultimate collection.
b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In our opinion, **except for** the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has maintained, in all material respects, adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were operating effectively as of March 31, 20XX, based on ______ [for example "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"].

We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in our audit of the March 31, 20XX standalone financial statements of the Company, and the / these material weakness/es does not/ do not affect our opinion on the standalone financial statements of the Company.

Opinion #

Disclaimer Opinion on Framework for internal Financial Control over financial reporting not established but does not impact the audit opinion on financial statements

According to the information and explanation given to us, the Company has not established its internal financial control over financial reporting on criteria based on or considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India. **Because of this reason**, we are unable to obtain sufficient appropriate audit evidence to provide a basis for our opinion whether the Company had adequate internal financial controls over financial reporting and whether such internal financial controls were operating effectively as at March 31, 20XX.

We have considered the disclaimer reported above in determining the nature, timing, and extent of audit tests applied in our audit of the standalone financial statements of the Company, and the disclaimer does not affect our opinion on the standalone financial statements of the Company.

Opinion #

Adverse Opinion

According to the information and explanations given to us and based on our audit, the following material weakness/es has / have been identified as at March 31, 20XX:

(a) The Company did not have appropriate internal controls for reconciliation of physically inventory with the inventory records, which has resulted in misstatement of inventory values in the books of account.

(b) [list other deficiencies identified]

A 'material weakness' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

In my / our opinion, **because of the effect** of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate and effective internal financial controls over financial reporting as of March 31, 20XX, based on ______ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India".

We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in our audit of the March 31, 20XX standalone financial statements of the Company, and the / these material weakness/es has / have affected our opinion on the standalone financial statements of the Company and we have issued a qualified (/ adverse / disclaimer of) opinion on the standalone financial statements.

For **M/s. __________ & Co.,**
Chartered Accountants
FRN ________

Bangalore
____

____
Partner / Proprietor
M. No. ________

 # Multiple Reporting Possibilities illustrated here are Mutually exclusive i.e., Opinion paragraph is to be selected relevant to the reporting consideration and paragraphs depicting other reporting possibilities are to be deleted.

Reporting Scenarios *(As in Appendix III of Guidance Note)*		
Ex	Opinion on IFCOFR	Opinion on FS (&)
1.0	**Unmodified** (clean)	**Unmodified** (*)
2.1	**Qualified** *Customer related* ***(Adequacy of IFCOFR)***	**Unmodified or Modified** *(#)*
2.2	**Adverse –** *Customer & Inventory related* ***(Adequacy of IFCOFR)*** ($)	
2.3	**Qualified (Op. Effectiveness) –** *Customer related* ($)	
2.4	**Adverse (Op. Effectiveness) –** *Customer & Inventory related* ($)	
2.5	**Adverse** – *Essential components of IFCOFR not considered* ($)	
3.1	**Disclaimer –** *Framework for IFCOFR not established* ($)	**Unmodified or Modified** *(#)*
3.2	**Disclaimer** – *Unable to obtain Sufficient Appropriate Audit Evidence (SAAE) wrt one significant branch* ($)	
3.3	**Disclaimer**- *Unable to obtain SAAE w.r.t the Co.*	**Qualified /Adverse / Disclaimer**
4	**Adverse –** *Inventory reconciliation reg. physical & records not OK*	**Qualified /Adverse / Disclaimer**
5	**CFS – Clean --- unmodified** (@)	**Unmodified or Modified** (#)

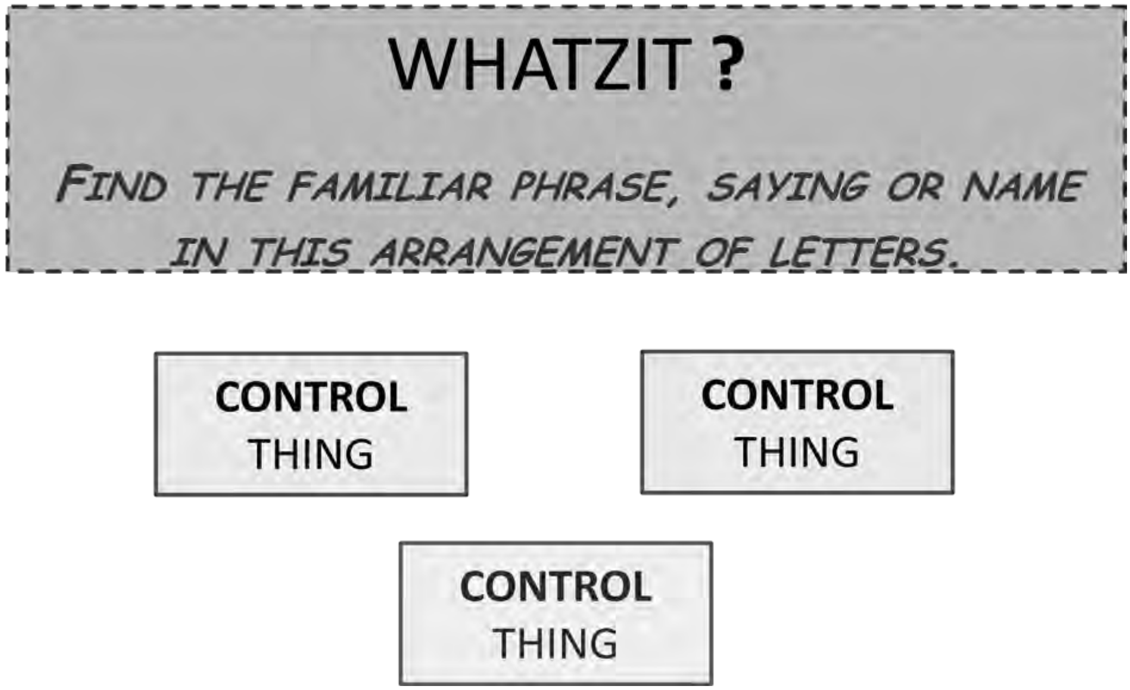
(&) Auditors Opinion on Standalone FS is Independent of his opinion on ICFOFR. *(*) Example in Appendix III of GN of ICAI is Clean Opinion. However, it could also be Modified.* *(#) Based on nature, timing & extent of Audit tests applied (substantive test)* *($) Could result in potential Material Misstatement* *(@) May have 'OM' paragraph.*
IFC report will never have an 'EOM' paragraph
Wordings in IFCOFR Opinion: Qualified (except for…..) / Adverse & Disclaimer (because of…)

Section C

IFC v/s IFCOFR

Applicability and Scope

Internal Financial Controls over Financial Reporting – Background



The answer to the above is **“Everything is under Control”**. Quite difficult to decipher but that is the way an auditor will have to report on concluding his audit of IFCOFR.

The 2013 Companies Act marks a major step towards raising the bar on corporate governance in India. The Act has re-emphasised the importance of a robust internal controls environment by introducing the term ‘Internal Financial Controls-IFC’, and by casting specific responsibilities on the Board, Audit committee, Management as well as the Auditors.

S. 143(3) of the Act has made it compulsory for the Auditor’s to report as to whether the Company has adequate Internal Financial Control System in place & the operating effectiveness of such controls. Reporting on IFC was made optional for FY 2014-15 and is however mandatory for FY 2015-16.

Setting up of IFC and ensuring the operating efficiency is primarily the responsibility of the Company’s management. The Auditor of the Company needs to give his opinion on whether the company has in place the IFCOFR and such IFCOFR were operating effectively as at the year end.

It is imperative for the management to set up the IFC & auditors to start their audit, especially on IFCOFR, right away and much before the Balance Sheet date and correct any control failures which could enable the company with "Remediation" measures by the Balance Sheet date to come out with clean IFC report. IFCOFR Audit cannot be conducted after 31st March of the year as the certification is specifically to state the control were operating effectively and efficiently as at 31st March 2015.

Whilst the testing is carried out on the transactions recorded during the year, the reporting is as at the balance sheet date.

So as an example, if the company's revenue recognition was erroneous through the year under audit but was corrected, including for matters relating to internal control that caused the error, as at the balance sheet date, the auditor is not required to report on the errors in revenue recognition during the year.

On the other hand, if the error continued as at the year end – Control failure rectified as at the signing date, the auditor would still be required to report the control failure as at the BS date in his audit report.

INTERNAL FINANCIAL CONTROL (IFC) – PROVISIONS IN COMPANIES ACT

EQUAL TO SOX OF US

Directors' responsibility statement **(WEF FY 14-15)**	Directors, had laid down IFC to be followed by company and that such **IFC** are **adequate** and were **operating effectively**. [S. 134(5)(e) ***(Only for listed Co's)***] **(4) – Every listed Co. & every other public co. with PUC >= 25 cr.** **(5) – In addition to info. & details specified in sub-rule (4)** Board Report shall also contain the details in respect of **adequacy of IFC with reference to the FS.** [S. 134(3)(q) R/w sub rule 8(5)(viii)]
Auditor's responsibility **(Must WEF FY 15-16)** **Optional for FY 14-15**	**Every Co.** *[Also to Small, Dormant, OPC, etc.]* The auditor's report shall also state - **Whether co. has adequate IFC system in place & the operating effectiveness of such controls;** [S. 143 (3)]

IFCOFR Reporting – Applicability

- To **ALL companies** – *[including small company, OPC, Dormant Co.]*
- Only **for Year-end reports - Not for interim FS.**
- For **consolidated financial statements also.**

  Based on reports submitted by auditors of components of Indian cos.
- As at **the balance sheet date.**

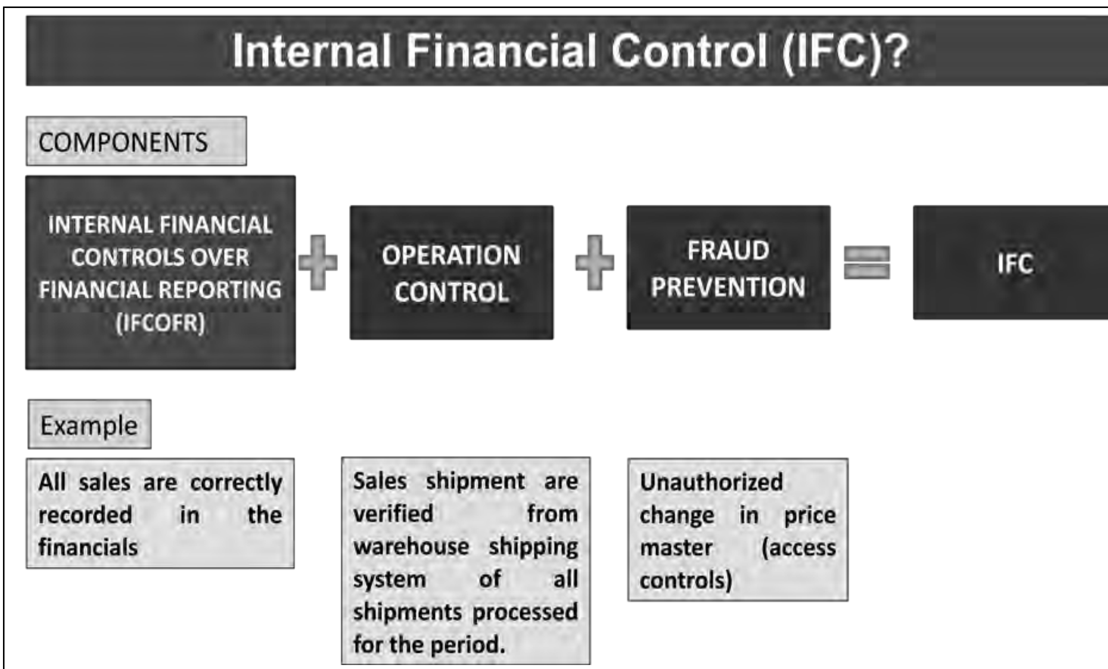
  Although testing is carried on transactions recorded during the year.

INTERNAL FINANCIAL CONTROL (IFC) – PROVISIONS IN COMPANIES ACT

Expln. To S. 134(5)(e)

"**Internal Financial Controls**" means **policies & procedures** adopted by Co. for ensuring orderly & efficient conduct of its business, incl.

- **Adherence to company's policies,**
- **Safeguarding of its assets,**
- **Prevention & detection of frauds & errors,**
- **Accuracy & completeness of accounting records, and**
- **Timely preparation of reliable financial information;**



ICAI GN ON AUDIT OF IFC U/S.143(3)

- IFC for the purpose of Audit report is interpreted by the GN of ICAI as **Internal Financial Controls over Financial Reporting – IFCOFR as IFC** has been defined in the Companies Act only for the purpose of Director's Report U/s 134(5)(e)***.***

  So while the management reports on full IFC, the auditor would restrict reporting on Internal Financial Controls over Financial Reporting only.

IFC > IFCOFR > CARO

- Reported in Audit Report as*:*
  With respect to the adequacy of the internal financial controls over financial reporting and the operating effectiveness of such controls, refer to our separate Report.

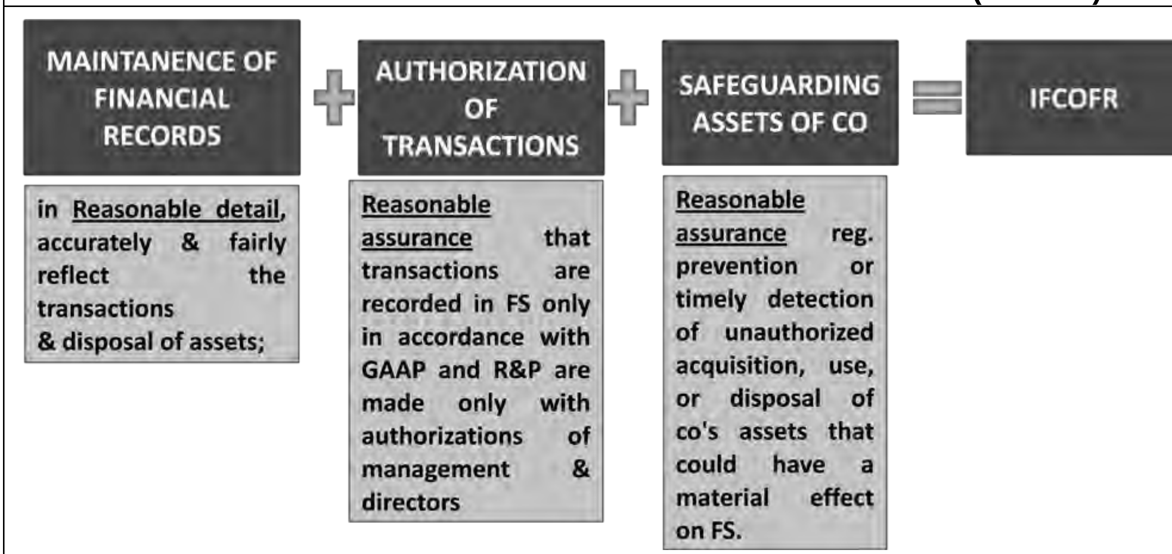
INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING (IFCOFR)?

FOLLOWING ALSO RE-ITERATED AS "MEANING OF IFCOFR" IN IFCOFR AUDIT REPORT FORMAT GIVEN IN GN

Definition:

"A process designed to provide reasonable assurance regarding reliability of financial reporting & preparation of Financial Statements for external purposes in accordance with GAAP"

COMPONENT OF INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING (IFCOFR)



ICAI Guidance Note on Audit of "Internal Financial Controls" over Financial Reporting (IFCOFR)

AASB of ICAI issued a Guidance Note on IFCOFR in September 2015, covering the following aspects:

a. Scope of reporting on IFC under Companies Act 2013,
b. Essential components of internal controls,
c. Technical guidance on audit of IFC,
d. Implementation guidance on audit of IFC,
e. Illustrative Engagement Letter,
f. Illustrative Management Representation Letter,
g. Illustrative Reports on IFC – both for standalone & CFS.
h. Illustrative Risks of Material Misstatement, Related Control Objectives & Control Activities,
i. Text of Standard on Internal Audit (SIA) 5 – Sampling,
j. Examples of Control Deficiencies.

The scope for reporting on IFCOFR is significantly larger and wider than the reporting on internal controls under the CARO. Under CARO, the reporting on internal controls is limited to the adequacy of controls over purchase of inventory & fixed assets and sale of goods & services. As such, CARO does not require reporting on all controls relating to financial reporting and also does not require reporting on the "adequacy and operating effectiveness" of such controls.

Section D

Criteria / Framework By SA 315 – Components Of Internal Control

CRITERIA / FRAMEWORK BY SA 315 - COMPONENTS OF INTERNAL CONTROL

- Cos. must adopt a Criteria / Framework that has components of internal controls. SA 315 is one of the suggested standards in the GN of ICAI as the framework as it contains all the components required for IFC.

- Auditor's IFCOFR report should specify identification of benchmark criteria used by management for establishing IFCOFR.

- Failure by management to establish a system of IFCOFR considering the essential components of internal controls stated in GN would result in a disclaimer of opinion in the IFCOFR Audit report.

CRITERIA /FRAMEWORK BY SA 315: COMPONENTS OF INTERNAL CONTROL

Control Environment	The control conscience of an organization – the "tone at the top"
Risk Assessment Process	The evaluation of internal and external factors that impact an organization's performance
Control Activities	The policies and procedures that help ensure that actions identified to manage risk are executed and timely
Information system and Communication	The process that ensures relevant information is identified and communicated in a timely manner
Monitoring of Controls	The process to determine whether internal control is adequately designed, executed, effective and adaptive

COMPONENTS OF INTERNAL CONTROLS (SA 315)

A. Control environment

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation by those charged with governance.
- Management's philosophy and operating style
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.

B. Entity's risk assessment process

- How management identifies business risks.
- Assesses the likelihood of their occurrence.
- Actions to respond to and manage them and the results thereof.
- Management may initiate to address specific risks or accept the following :-
  - Changes in operating environment.
  - New personnel.
  - New or revamped information systems.
  - Rapid growth.
  - New technology
  - New business models, products or activities - An entity has little experience.
  - Corporate restructurings.
  - Expanded geographic / foreign operations.
  - New accounting pronouncements.

C. Control activities

Policies and procedures that pertain to the following:

- Performance reviews
  - Actual versus budgets comparing
  - Internal data with external
- Information processing

- Physical controls
  - Secured facilities over access to assets and records.
  - Authorization.
  - Periodic counting.
  - Segregation of duties.

  Appropriate higher level policies established by management or those charged with governance.

D. <u>Information system, including the related business processes, relevant to financial reporting, and communication. (IG 8 – Information Produced by the Entity (IPE))</u>

- Business processes
  - Infrastructure
  - Software
  - People
  - Procedures
  - Data

Many information systems make extensive use of information technology (IT).

- Financial reporting system
  - Identify and record all valid transactions.
  - Timely basis and proper classification of transactions for financial reporting.
  - Measure the value of transactions.
  - Determine the time period in which transactions
- Communication
  - Policy manuals, accounting and financial reporting manuals, and memoranda.
  - Communication also can be made electronically, orally, and through the actions of management.

E. <u>Monitoring of controls</u>

Maintain internal control on an ongoing basis whether they are operating as intended & modified as appropriate for changes in conditions.

- Management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. & to operate effectively over time.

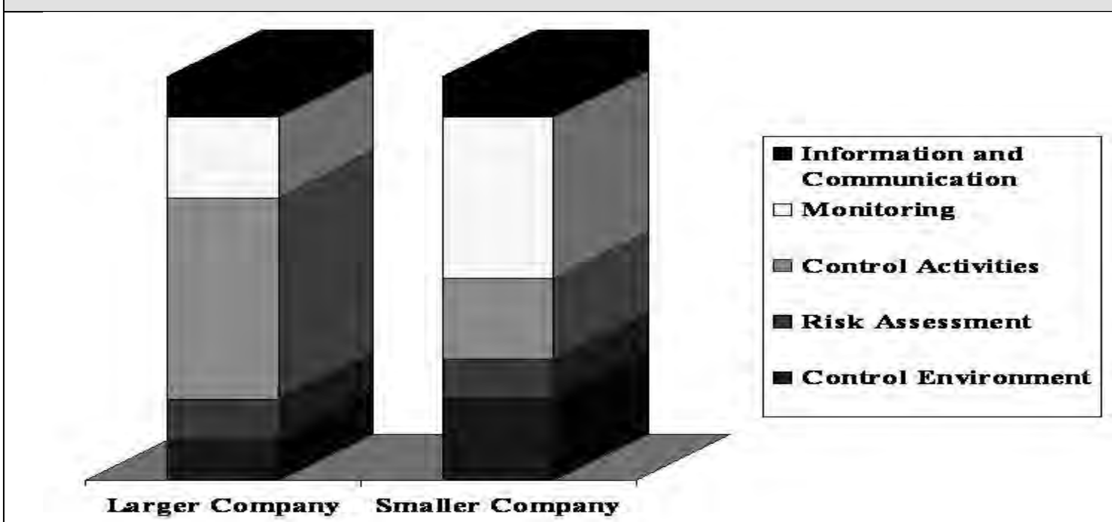
Effective Internal Control

- The control environment sets the tone of an organization, influencing the control consciousness of its people's attitudes, awareness, and actions.
- Evaluating the design of a control involves whether the control is capable of effectively preventing, or detecting and correcting, material misstatements. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.
- The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported.

Limitations of internal control system

- Cost of an internal control does not exceed the expected benefits.
- The potential for human error.
- Collusion with employees or with parties outside the entity.
- Management overriding an internal control.
- Manipulations by management

STRUCTURE OF INTERNAL CONTROL COMPONENTS IN LARGE V/S. SMALLER



Section E

Basis of Reporting

Test of Design / Control – To determine if a deficiency in design exists

- Assess the design for each control selected for testing
- Consider nature & significance of risk
  - *Greater the inherent risk, more precise controls are expected to be.*
- Competence & authority of persons performing the control
  - *Experience level.*
- Frequency & consistency with which control is performed
  - *Routinely or consistently than one performed sporadically.*
- Level of aggregation & predictability
  - *Control performed more detailed is more precise than one performed at a higher level*
- Criteria for investigation and process for follow-up.
- Dependency on other controls or information.

Test the Operating Effectiveness of Controls

Suggested approach for classifying deficiency:

Type of Deficiency	Likelihood of Occurrence		Magnitude of Misstatement
Internal control deficiency	Remote	and/or	Inconsequential
Significant deficiency	More than remote	and	More than inconsequential
Material weakness	More than remote	and	Material

When do you modify the Auditors opinion on IFCOFR?

1. If there is a 'deficiency'.
2. Auditors unable to obtain 'SAAE' to conclude that the IFCOFR are adequate and / or operating effectively to provide reasonable assurance that it is designed, implemented or operated in such a way that it is able to prevent, detect and correct material misstatement in the FS on a timely basis.

- **A deficiency in design exists when**
  a. a control necessary to meet the control objective is missing **or**
  b. an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
- **A deficiency in operation exists when**
  - a properly designed control does not operate as designed or
  - when the person performing the control does not possess necessary authority or competence to perform the control effectively.
- **Severity of a deficiency does not depend on whether a misstatement actually has occurred** but **depends on whether there is a reasonable possibility that the co's controls will fail to prevent /detect a misstatement**.

REPORTING CONSIDERATION – REFER IG 20 FROM GN OF ICAI

➢ Modify the opinion in Audit Report if -

a) Deficiency identified in design or operation of IFC which individually or in combination has been assessed as material weakness.

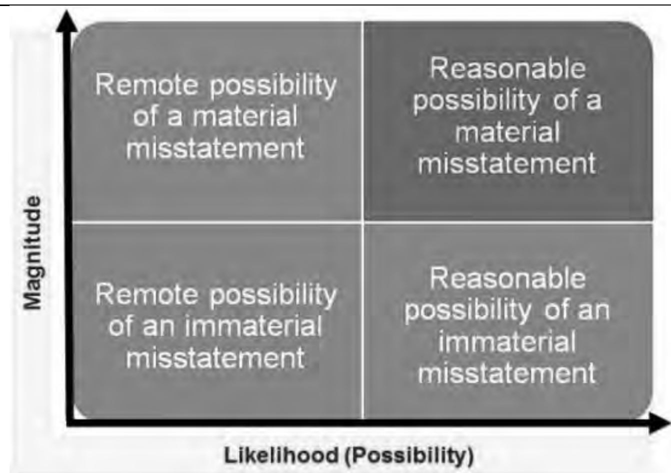
b) Restriction on scope of engagement.

➢ **Deficiency in IC exists**:

- Control is designed, implemented or operated – which is unable to prevent or detect & correct misstatement in the financial statement on timely basis, **or**
- control is missing.

- **<u>Severity of deficiency in IFC</u>**: when do you conclude it is 'material'
  - The likelihood that the deficiency will result in a financial misstatement and
  - The magnitude of such an outcome.
- **Exercise of Risk Analysis**

- Unlike in FS , there are no clear bright line tests based solely on Quantitative measures for assessing a deficiency or combination of deficiency as a -
  - Significant Deficiency or
  - Material weakness
- Qualitative measures must also be considered, and professional judgment is required.



<table>
<tr><th colspan="3">Basis of forming an opinion in the IFCOFR report can be summarized in the following table:</th></tr>
<tr><th colspan="3">Criteria & Nature of Modifications to Opinion in IFCOFR Report of Auditor</th></tr>
<tr><td rowspan="2">Nature of matter giving rise to modification</td><td colspan="2">Auditor's judgment about Effects or Possible Effects of <u>material weakness</u> in such Internal Controls</td></tr>
<tr><td>Material but Not Pervasive to FS</td><td>Material & Pervasive to the FS</td></tr>
<tr><td>- Design, implementation or operation of IFC is unable to prevent, detect & correct material misstatement in FS on timely basis,
or
- control is missing.</td><td>Qualified opinion #</td><td>Adverse opinion # @</td></tr>
<tr><td>Inability to obtain SAAE - Sufficient Appropriate Audit Evidence - for conclusion of IFC opinion
(Scope Limitation)</td><td>Disclaimer of opinion
(Qualified for FS !!)</td><td>Disclaimer of opinion</td></tr>
</table>

@ **Also an Adverse opinion if**
- IFC does not adequately consider the <u>5 essential components of SA315</u> on Internal controls
- Auditors opinion on Financial Statement modified & such modification is also consequent to material weakness in Companies Internal Financial Control

\# **Qualified / Adverse opinion may relate**
- only to the operating effectiveness of such controls OR
- to both the adequacy And operating effectiveness of such controls

Additional Consideration for Auditing IFCOFR

PERVASIVE Deficiency that result in "material weakness"

- Inefficient Control environment *(Considering the risk profile of Company)*
- Inefficient IT Controls or Information system.
- Pervasive lack of segregation of duties without appropriate alternative controls.
- Frequent management override of controls.

Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that control is operating effectively.

Minimum available evidence about the design & operations of IFC – constituting "Scope limitation" on expressing an opinion on IFCOFR including identification of existence of material weakness – Disclaim opinion on IFC.

In spite of the above, opinion of FS could be given based on the SAAE obtained for FS Audit

Meaning of **Pervasive** – ~~FS~~ V/s. IFCOFR

For purposes of ~~the SAs~~ this Guidance Note, the following terms have the meanings attributed below:

Pervasive - A term used, in the context of ~~misstatements~~ control deficiencies, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements , if any, that are undetected due to ~~an inability to obtain sufficient appropriate audit evidence~~ the internal controls not being adequate and/ or not operating effectively. Pervasive effects on the ~~financial statements~~ internal financial controls over financial reporting are those that, in the auditor's judgment:

(i) Are not confined to internal controls over specific elements, accounts or items of the financial statements.

(ii) If so confined, represent or could represent a substantial proportion of the financial statements or impacts the audit opinion on the financial statements of the company; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Adverse:

1. Also when IFC system does not consider adequately the essential component of IFC as stated in SA 315
2. Auditor's opinion on FS has been modified and such modification is also consequent to the material weakness in company's IFC.

Qualified or Adverse opinion on IFC may relate to –

- Only the operating effectiveness of such controls or
- Both the adequacy & operating effectiveness of such controls based on the audit evidence obtained.

Disclaimer of Opinion:

a. If Company has not established IFC system as stated in G/N.

b. SAAE to express an opinion on IFC not obtained

B1. But is able to express an opinion on the FS

B2. Consequent to the material weakness in such control the possible effects on the FS of undetected misstatements, if any, could be both material & pervasive.

Note: If modified report on IFC is given Audit report on IFCOFR **must also include** following additional para.

a. Definition of a 'material weakness' as stated in the G/N.

b. Description of material weakness identified in the company's IFC -

Provide specific information about the nature of material weakness and its actual and potential effect on the Company's FS.

c. The consideration of the effect of the modified opinion on IFC on the Audit opinion on the FS of the Companies.

IG 20.17 *of GN of ICAI*

When an auditor issues an unmodified opinion on the company's financial statements, this is a representation to the users of financial statements that the auditor has followed applicable auditing and related professional standards so as to allow the auditor to conclude with reasonable assurance that the financial statements are in conformity with the generally accepted accounting principles in all material respects. An unmodified audit opinion is not a guarantee of error-free financials, but is rather the conclusion by an auditor – using audit procedures and professional judgement that are reasonable to the circumstances – that the statements are fairly presented.

Section F

Gist of Implementation Guide as per GN from ICAI

Implementation Guide – IG as per GN of ICAI	
No	**Particulars**
1	Multiple Locations Scoping Decisions
2	Process Flow Diagrams - *Flow chart & Narrative*
3	Process *(SOP)* Vs Control *(Action to prevent /detect misstatement within process)*
4	Understanding IT Environment *Identify risks arising from IT (IT Risks)*
5	Entity-level Controls
6	Segregation of Duties –SOD
7	Automated Controls – *More reliable*
8	Information Produced by the Entity (IPE) - *More reliable if system generated*
9	Use of Service Organizations *(Outsourcing)*
10	Techniques of Control Testing
11	IFC – Testing of Design
12	IFC – Walk Through
13	IFC – Testing of Operative Effectiveness
14	Sampling in Test of Controls
15	Roll Forward Testing
16	Rotation Plan to Testing IFC (in subsequent years)
17	Remediation Testing
18	Using the work of internal Auditors & Auditor's Expert
19	Additional Consideration for Auditing ICOFR
20	Reporting Consideration
21	Understanding & Evaluating Financial Reporting Process

IG – 1: MULTIPLE LOCATIONS SCOPING DECISIONS

- Assess the risk of material misstatement to the FS *associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.*

IG – 2: PROCESS FLOW DIAGRAMS

Knowledge of Business ----> Knowledge of Process --- Knowledge of Control

Understanding & Documenting processes through –

a) Diagram – Flow Chart
b) Narrative
Ex of processes: 1) Order processing
2) Shipping & Invoicing
3) Sales Return
(Revenue Business Cycle)

IG – 3: DIFFERENCE BETWEEN PROCESS AND CONTROL

Process v/s control

- Process – Routine set of procedures or steps.
- Control – activity to prevent/detect misstatement within the process
  If Preventive / detective action / steps are taken - then it is Control

Example:

Control description: Company engages an Actuary Firm to prepare the actuarial report.

Pitfall: Hiring a specialist may add competency to management's control and is a process, but it is not a control in itself.

Improved control description: Management reviews and discusses the Actuarial Report, including key assumptions, with the specialist to assess the appropriateness of the assumptions and conclusions reached.

IG – 4: UNDERSTANDING IT ENVIRONMENT

i.e, Identify the relevant risks arising from IT (IT Risks)

IG – 5: Entity-level Controls (ELC's)

1) **Direct**
    a) Precise enough (D&P) - (Budgeted rent v/s Actual paid)
    b) Not precise enough - (Budget v/s Actual. Ex-Purchases)
2) **Indirect:**
    (Control environment, risk assessment, monitoring, misstatements and General IT controls)

IG – 6: Segregation of Duties

Business case of implementing segregation of duties:

- Mitigating fraud risks.
- Compliance with regulatory requirements.
- Implementation of meaningful control strategies.
- Pivotal for adequate access controls in an ERP scenario.
- Integral in case of outsourced operations.

IG – 7: Automated Controls

- Application controls - to achieve business objectives of timely, accurate & reliable information.
- Controls to be manual or automated.
- Automated controls (like system generates NPA's) - more reliable, less susceptible to human judgment & errors and are typically more efficient.

IG – 8: Information Produced by the Entity (IPE)

a) IPE= Report which may be
    - System generated (More reliable)
    - Manually prepared
    - Combination of both (downloaded from system & then manipulated in excel)

b) IPE as "audit evidence" falls into the following -
    - IPE that the entity uses for performing relevant controls
    - IPE that auditor uses as audit evidence
        - For performing operative effectiveness test of relevant controls
        - For performing substantive procedure.

c) IPE must be accurate & complete.

IG – 9: USE OF SERVICE ORGANIZATIONS

Use of service organization *(Outsourcing)* - Obtain evidence by

- Obtaining a service auditors' report on control placed in operation & tests of operating effectiveness
    - Ensure service auditor has reputation, competence & independence
    - Auditor not to refer to service auditors' report when expressing his opinion on IFCOFR.

OR

- Obtain a report on the application of "Agreed Upon Procedure" that describe relevant tests of controls -
    - Perform tests of user organizations' control over the activities of the service organization
    - Perform tests of controls at the service organization.

IG 9.8 of GN of ICAI:

- *When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed.*
- *The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report.*

If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal financial controls. The auditor should also evaluate whether the results of other procedures performed indicate that there have been changes in the controls at the service organization.

IG – 10: TECHNIQUES OF CONTROL TESTING

Techniques of control testing

- Corroborative Enquiry *(mouth)*
- Observation *(eyes)*
- Examination & Documentation *(hands)*
- Re-performance (For application controls *Ex. Counting*)

IG – 11: IFC – TESTING OF DESIGN

- The objective of testing the design of a control is to determine if a deficiency in design exists.
- Appropriateness of the control considering the nature and significance of the risk – The greater the inherent risk, the more precise the controls are expected to be.

- Competence & authority of person(s) performing the control – experience level.
- Frequency and consistency with which the control is performed – routinely or consistently than one performed sporadically.
- Level of aggregation and predictability – a control that is performed at a more detailed level generally is more precise than one performed at a higher level.
- Criteria for investigation and process for follow-up.
- Dependency on other controls or information.
- Testing design effectiveness – A Test of Design (TOD) of a relevant control includes inquiry of personnel involved in the performance of the control, supplemented by a mix of observation of how the control is performed and inspection of the relevant documentation related to the performance of the control. The test of designing of relevant controls confirms the auditor understands of the controls and provides the basis to evaluate whether the controls are designed effectively.

IG – 12: IFC – WALK THROUGH

Walkthrough: Auditor follows a transaction from origination through the company's processes, including IT until it is reflected in company's financial records, using the same documents & IT that company personnel use.

- 1st Year: Detailed & for All
- Subsequent year: For significant changes in process or to validate that no significant changes have occurred.

IG – 13: IFC – TESTING OF OPERATIVE EFFECTIVENESS

- Is the control operating as designed? *(And for the period of intended reliance)*
- Whether the <u>person performing the control</u> possesses the necessary authority & competence to perform the control effectively?

If the answer is "NO" to any of the above questions then it is a <u>'Deficiency'</u> in Operating Efficiency.

- Auditor must assess the risk associated with the control as either "Higher" or "Not higher" & use this assessment to plan the nature, timing & extent of TOC.
  - As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Factors:

- ➢ Significant Risk of material misstatements (ROMM) ex: 3 way match (less risky) than review type (impairment)
- ➢ Significant amount
- ➢ Significant change in volume or nature of transactions
- ➢ Complexities of controls (Financial Instruments)
- ➢ Availability of evidence
  - o External better than internal
  - o Internal effective evidence is better than others
  - o Evidence directly by auditor is better than evidence obtained indirectly
  - o Original is better than copies etc.

Dual purpose tests: For both substantive & internal controls objective

- ➢ Performing <u>substantive tests</u> of transaction concurrently with a <u>test of control</u> relevant to that transaction.
- ➢ While no misstatement in substantive tests does not provide sufficient evidence of IC effectiveness. Identification of misstatements in substantive test indicates the relevant controls are not effective.

Professional Skepticism + judgment involved

IG – 14: SAMPLING IN TEST OF CONTROLS

<u>IG 14.4 of GN of ICAI</u>

For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of internal control sufficient to plan an audit do not involve sampling. Sampling generally is not applicable to test of controls that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented controls. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system. For example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control.

a) **Sample Selection must be from an appropriate population that is representative of the risk being tested.**

Example – A risk that sales may not be recorded for all goods dispatched (Assertion: Completeness)

✓ Test based on population of dispatch documents and

x Not from the population of recorded sales.

b) **Selection Method** – ideally the one which has potential for selecting items from the entire period under Audit.

IG 14.15 of GN of ICAI

Generally, any failure in the operation of a control from
(1) established policy and procedure
(2) a regulatory requirement or
(3) the expectation of the operation based on peer or industry comparison

is likely a deviation (which is then further evaluated as described below).
Examples of instances in which a failure in the operation of a control may not be a deviation may include the following circumstances:

a) When the control operates effectively in mitigating the risk, even though the control does not operate completely in accordance with the prescribed procedure (e.g., an authorization form was not properly completed and signed off, but there is other evidence that clearly reflects the transaction was authorized).

b) When the departure from policy or procedure is authorized by the appropriate level of management based on particular circumstances (e.g.., in an employee's absence, the normal control process was not followed, however, management is aware of this and has compensated for it).

If a document is selected that has been validly cancelled prior to operation of the control (i.e, the document does not constitute a deviation), it may be excluded from the sample and an appropriately chosen replacement may be examined. However, if the deviation related to a document that cannot be located, the auditor makes every possible effort to locate it or to ascertain, using suitable alternative procedures that the control in this specific instance was operating properly. If evidence supporting operation of the control for the selected sampling unit is not available, another sampling unit cannot be substituted for the missing unit and it is generally necessary to treat this item as a deviation from the prescribed control.

c) Consideration relevant when considering the level of "Acceptable" deviation (i.e control deficiency does not exist)

- Risk associated with control – if High Risk, control needs to be more reliable.
- Extend of reliance on control – if Sole control, control needs to be more reliable.
- Testing approach – Sampling v/s Entire population – if sampling, control needs to be more reliable.
- Nature of control -
  - Relative importance of deviation to the overall performance of the control
  - Whether misstatements have actually occurred.
  - Whether deviation has a potential effect on the effectiveness of other controls.

d) Based on above Consideration, Deviations are evaluated & concluded as either -

- Only a deviation & not a deficiency
- A deficiency (Further evaluated to assess its severity & implication on FS audit)

IG – 15: "ROLL FORWARD" TESTING (ROLL FORWARD PERIOD = REMAINING PERIOD) (EXTRAPOLATING)

Tested up to interim date but reporting on effectiveness of control as of a later B/S date.

Additional evidence – Factors to be considered:

a) Specific control tested on interim date – Risk associated, nature of control & results of those tests.

b) Sufficiency of evidence obtained on interim date.

c) Gap between the period.

d) Possibilities of significant change in IFC during gap period by virtue of -
   - New control implementation
   - Significant modification to design of existing control

e) Change in monitoring process giving rise to -
   - New ROMM
   - Modification to existing risks

f) Significant change in business or entity's financial reporting.

IG 15.7 of GN of ICAI

Key activities for performing procedures to roll forward interim conclusions of design and operating effectiveness:

a) Perform procedures to determine whether there have been any significant changes to the business or the entity's financial reporting that would give rise to new or affect existing risks of material misstatement, which would necessitate the entity's implementing new controls or modifying the design of existing controls.

b) Test the design and operating effectiveness of new or modified relevant controls.

c) Obtain appropriate evidence of operating effectiveness that the controls tested at interim date continue to operate effectively for the roll forward period.

d) Document the roll forward procedures performed, basis for professional judgements, and conclusions for each of the relevant controls.

e) Log any deficiencies for classification as to severity and further evaluation of their impact on the risk assessment and audit of the financial statements.

Approach to plan Roll – Forward Procedure:

a) Non-High Risk Areas –

Inquiry alone is sufficient evidence of the continuing operative effectiveness of relevant controls tested as of an interim dates.

b) High Risk areas –

Additional procedures beyond inquiry are necessary.

IG 15.21 of GN of ICAI - Documentation:
The purpose of this section is to provide auditors with documentation considerations relative to planning and performing roll forward procedures.

Considerations include:

a) *A description of the planned procedures that clearly describes the (a) nature (b) timing and (c) extent of roll forward procedures for each control, including procedures to test relevant IPE.*

b) *Assessment of monitoring controls that the auditor intends to test and rely upon, including the rationale for how the controls selected to corroborate the operating effectiveness of the monitoring controls were chosen, giving consideration to the different business processes and controls within the business process and how that sample is representative of the population.*

c) *The roll forward procedures performed and the evidence obtained, including:*
- *A description of the procedures performed, including whether they were inquiry, observation, and examination of documents, re-performance, or some combination. The documentation of inquiries includes*
  1. *To whom the auditor made inquiries*
  2. *The specific inquiries made &*
  3. *The result of those inquiries.*
- *When the interim testing of the controls was performed (e.g., the month or quarter)*
- *Identification of and reference to testing of any IPE.*
- *A statement that there were no exceptions or a clear description of any deviation noted.*

d) *The procedures, findings, and conclusions related to assessing finding and concluding on design and operating effectiveness, including:*
- *A clear statement about whether the control is effectively designed and operated.*
- *If auditor's conclusion is that the control is ineffective, consideration of the effect of the conclusion on tests of other controls that may depend on the control tested and the design of the substantive tests.*
- *The basis for the conclusions reached.*

IG – 16: "ROTATION PLAN TO TESTING IFCOFR (IN SUBSEQUENT YEARS)

IFCOFR Test work can be categorized as:

1) Understand the process flow (walk through).	Every audit period (s.t IG 12)
2) Testing design & implementation of controls.	Every audit period
3) Testing operative effectiveness of control.	Rotation plan may be considered subject to (#)

(#) Broad criteria to be met for adopting rotation plan for testing operating effectiveness of controls:

- Consider test of controls of prior audit + evidence obtained in TOC in current period + Test of operating effectiveness of other controls performed in the current period
- No changes in Business, Controls, Process, etc.
- In spite of above ensure that at least once in every 3rd year audit, Auditor must test completely.

IG – 17: REMEDIATION TESTING

a) Any issue or deficiency - either relates to design or operating effectiveness of controls - if they are REMEDIATED (Rectified) before the balance sheet date, then the Auditor can still express an unqualified opinion.

b) Under ordinary circumstances, control remediation that occurs after the year end will not mitigate an identified deficiency for reporting purpose.
Auditors should not express an opinion on management disclosure about corrective actions taken by the Co. after the B/S date.

IG – 18:USING THE WORK OF INTERNAL AUDITORS & AN AUDITOR'S EXPERT

Auditor is solely responsible for audit opinion expressed and that responsibility is not reduced by Auditors use of the work of Internal Auditors.

IG 18.7 *of GN of ICAI*

Auditor's expert is an individual or organization possessing expertise in a field other than accounting or auditing, whose work in the field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

IG 18.8 *of GN of ICAI*

The key consideration for an auditor in using the work of an Auditor's expert are:

- *Determining the need for the expert.*
- *Nature, timing and extent of audit procedures to be performed by the expert and the auditor.*
- *The competence, capability and objectivity of the auditor's expert.*
- *Obtaining an understanding of the field expertise of the auditor's expert.*
- *Agreement with the auditor's expert.*
- *Evaluating the adequacy of the auditor's expert's work.*

IG – 19: ADDITIONAL CONSIDERATION FOR AUDITING IFC OVER FR

(IG -19 of GN of ICAI give lot of Guidance for Audit of SMC's)

Consider Complexity of Co. (Small or big) & customize the audit

a) Integrate IFCOFR audit & FS audit to achieve objective of both.

Small Entities: Common feature as per IG 19.3 of GN of ICAI

a) Fewer business lines.
b) Less complex business processes and financial reporting systems.
c) More centralized accounting functions.
d) Extensive involvement by the owners and senior management in the day-to-day activities of the business.
e) Fewer levels of management, each with a wide span of control.

- Points to be considered for audit of small Co.
  1) Use of entity level controls provide substantial amount of evidence.
  2) Risk of management override is high (leading to ROMM due to FRAUD)
  3) Limited segregation of duties – so alternative controls
  4) Use of off the shelf packaged software using application controls built in.
  5) 3rd party reliance for maintenance of financial Reporting – Consider their competency.
  6) Less formal documentation.
  7) Encounter numerous or pervasive control deficiency because of lesser no. of employees, process level controls, etc.

IG 19.6 of GN of ICAI

The auditor's decision about relying on controls in an audit of financial statements may depend on the particular facts and circumstances. In some areas, the auditor might decide to rely on certain controls to reduce the substantive testing of accounts and disclosures. For other areas, the auditor might perform primarily substantive tests of the assertions without relying on controls. For example, the auditor might test a company's controls over billings and cash receipts processing to cover the entire period of reliance in order to reduce the extent of confirmation of accounts receivable balance but might perform primarily substantive tests of the allowance for doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal financial controls.

For some significant accounts, the auditor might decide that a relevant assertion can be tested effectively and efficiently through substantive procedures without relying on controls. For example, the auditor might decide to confirm on outstanding loan payable with the lender rather than rely on controls. In that situation, the auditor may test controls of the relevant assertions only as necessary to support his or her opinion on the company's internal financial controls at year-end.

To obtain evidence about whether a selected control is effective, the control must be tested; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, is one of a number of factors that inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Assessing the precision of entity level controls – Factors

a) Purpose of control: Preventive/Detective misstatement or identity/explain differences.
b) Level of aggregation: more granular or higher level.
c) Consistency of performance.
d) Correlation to relevant assertion: Direct or indirect.
e) Criteria for investigation: lower threshold v/s near or at threshold.

f) Predictability of expectation.

Higher entity level controls & its Operating Effectiveness can result in reduction of test of other controls over corresponding relevant assertions.

<u>Controls to address the risk of management override</u>

a) Maintaining integrity & ethical values (through code of conduct or ethics)
b) Active over sight by ACB (independent ACB)
c) Maintaining a whistleblower program (appropriate responses)
d) Control over certain Journal entries (access restriction, dual authorization, etc)

<u>Assertions for ICOFR</u>

1. Existence or occurrence;
2. Completeness;
3. Valuation or allocation;
4. Rights and obligations;
5. Assertions relating to presentation and disclosure
6. Cut off
7. Validity
8. Accuracy

<u>IT controls</u>

Complex software or IT environment requires auditor to devote more attention to IT controls. IT controls can be built in the software like:

- Maintain segregation of duties.
- Prevent certain data input error.
- Ensure that certain types of transactions are properly recorded.

<u>Categories of IT controls.</u>

A. General IT control

1. Security & Access (To Applications & database)
2. Computer Operations (Performed as intended, Continuity, effective backup and recovery procedure)
3. System Development and System Changes

   (Ensure new systems are appropriately developed, configured, approved & migrated) TOC to above include - examining the process.

B. Application Controls

Transactions are properly initiated, authorized, recorded, processed & reported.

C. End user computing controls

User based computer application, including spreadsheets, database, ad-hoc queries, stand – alone desktop applications, and other user based applications.

- Reviewed for process integrity
- Testing of controls over spreadsheet formulas or logic of queries & scripts

<u>Consideration of financial reporting competencies & their effectiveness on IFC</u>

- ➢ Understanding & evaluating a Company's financial reporting competencies -
  - Prior audit experience can be considered w.r.t Financial Reporting risks.
  - Appointment / training procedures of people in department
  - Periodic review by Audit Committee Board / BOD.
  - Appropriate tools / resources provided

    (Personnel need not be EXPERTS but must be sufficiently competent)
- ➢ Supplementing Competencies with assistance from outside professionals.
  - Auditors may consider the combined competency of Company personnel & other parties that assist with functions related to financial reporting.
  - How is the management determining the competence of outside professional
  - Whether management has established controls over the work of outside professional.

<u>Documentation for IFC – Inter alia</u>

- ➢ Audit program – plan basis – As risk associated with the control being tested increases, the evidence that the Auditor should obtain also increases.
- ➢ Documentation of process & controls -
  - In-depth policy manuals & system flowchart of processes.
  - Memorandum, Questionnaires, software manuals, source documents or Job descriptions.
  - Walk through procedures.
- ➢ Documentation of operating effectiveness of controls
  - Evidence of controls tested for transaction affecting relevant assertions.
  - Documentation of the work of others/management – Auditor to identify & fill the gaps.

PERVASIVE Deficiency that result in "material weakness"

- Inefficient Control environment (Considering the risk profile of Company)
- Inefficient IT Controls or Information system.
- Pervasive lack of segregation of duties without appropriate alternative controls.
- Frequent management override of controls.

Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Minimum available evidence about the design & operations of IFC – constituting "Scope limitation" on expressing an opinion on IFC including identification of existence of material weakness – Disclaim opinion on IFC.

In spite of the above, opinion of FS could be given based on the SAAE obtained for FS Audit.

IG – 20: REPORTING CONSIDERATION

- Refer Section E for details -

IG – 21: UNDERSTANDING & EVALUATING FINANCIAL REPORTING PROCESS

Understand the flow of transaction & processes of the significant accounts & disclosures

- BEGIN WITH – The Initiation of the transaction
- CONCLUDE WITH – It's Presentation in FS.

Typically Bifurcated as

- The Accounts /Assertion level process
- The Financial Reporting Process.

Section G

IFCOFR Audit Process

GUIDANCE ON AUDIT OF INTERNAL FINANCIAL CONTROLS OVER FINANCIAL REPORTING *[SEC 143 (3)(i)]*

- If one or more material weaknesses exist, the company's internal financial controls cannot be considered effective.
- A significant deficiency or material weakness in internal financial controls over financial reporting may exist even when financial statements are not materially misstated.

(*The text shown in italics in this Section of the Guidance Note has been reproduced from Auditing Standard (AS) 5, An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements, issued by the Public Company Accounting Oversight Board (PCAOB), in June 2007. The copyright of the so reproduced material rests with the PCAOB*.)

Combining the audits OF BOTH IFCOFR & FS ALTHOUGH objectives of the audits are not identical

Obtaining sufficient evidence to support control risk assessments for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. (*So controlled Risk assessment reduced / decreased situation audit*).

The following chart explains the steps involved in setting up and testing the Internal Financial Control in a capsule form:

IFC Steps

Objective: To plug, "What can go wrong?"

Technique: Risk And Control Matrix

1.	**Go through the process *(incl sub process) for every significant activity***	
	→	**Preferred through process flow chart**
2.	**Identify possible Risk in each process**	
	→	**Could be more than one**
3.	**Establish controls to mitigate each risk**	
	→	**Could be more than one**
4.	**Test of controls**	
	→	**w.r.t to design of controls**
5.	**Test of operating effectiveness of controls**	

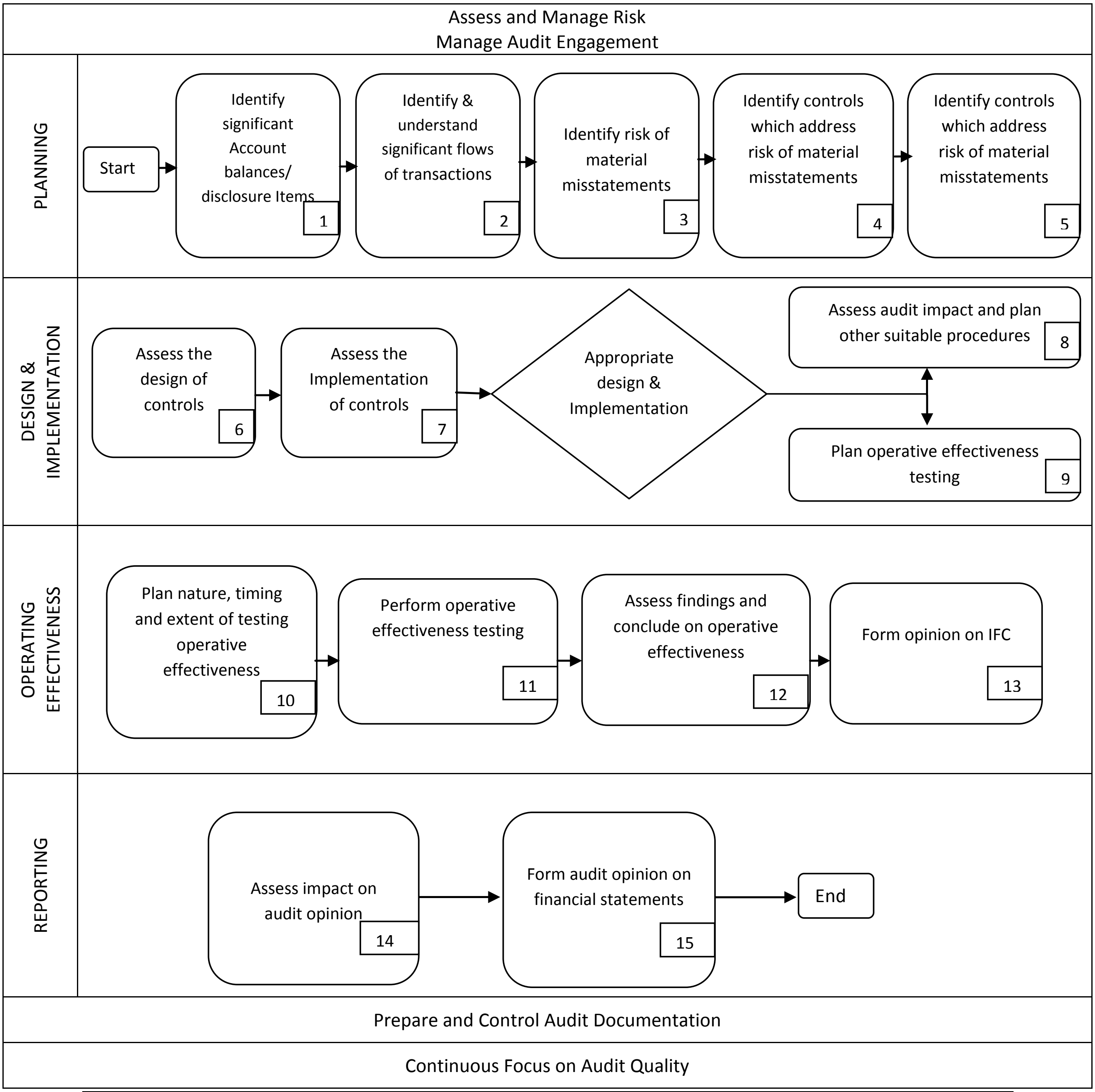
Affirmations

1. **Are all significant activities identified based on Materiality?**
2. **Are all risk identified w.r.t the process?**
3. **Are controls established for all Risks?**
4. **Are Controls sufficient to mitigate the Risk?**
5. **Are controls operating effectively as designed?**

Management Responsibility		**To follow above steps and give Affirmations.**
Auditor's Responsibility		**To verify affirmation and give opinion in his audit report.**

Future audits would be "Control based qualitative" audits rather than "Substantive quantitative" audits. This would require involvement of seniors who are qualified & experienced in audit as the auditor in the new scenario has to "Hear what is not being said" to report whether control process is complete & Robust. The year one challenges would also be humongous.

Flowchart below Illustrates Typical Flow of Audit of Internal Financial Controls over Financial Reporting



Planning the Audit

- Properly plan the audit of internal financial controls.
- Properly supervise any assistants.
- Agreeing the terms of the engagement.

Role of Risk Assessment

The auditor should focus more of his or her attention on the areas of highest risk.

Customizing the Audit

Improvement depending on the complexity of the company, its business processes and business units.

Addressing the Risk of Fraud

The auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls.

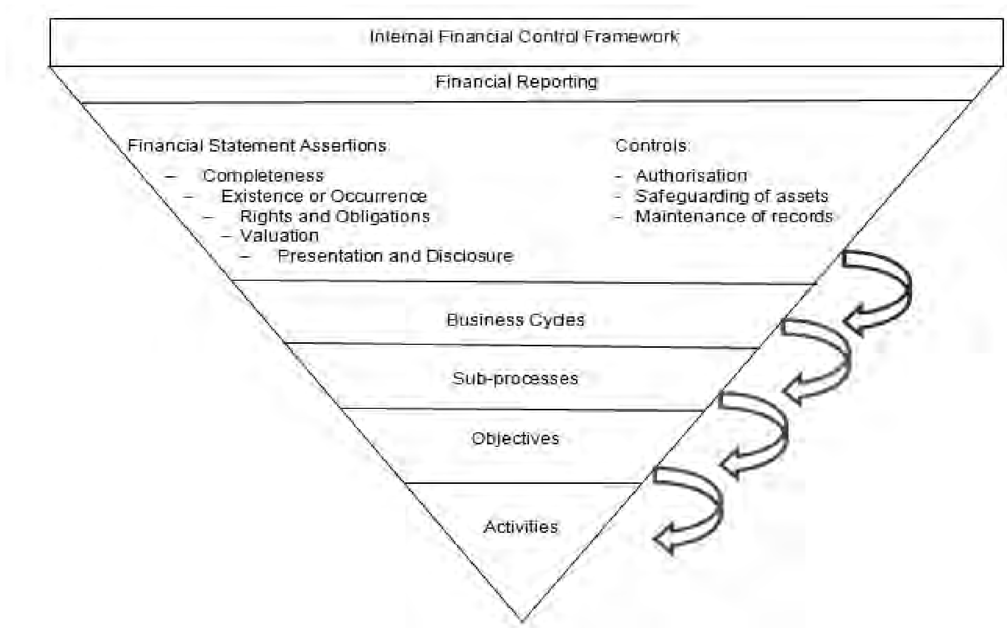
Controls that might address these risks include:

- Unusual transactions
- Journal entries and adjustments period-end financial reporting
- Related party transactions
- Significant management estimates
- Mitigate incentives for, and pressures management manages financial results.

Using the Work of Others (*Refer IG 18*)

"Using the Work of an Auditor's Expert" apply in a combined audit of internal financial controls over financial reporting and financial statements. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of the internal auditors.

Using a Top-down Approach



Identifying Entity-level Controls (Refer IG 5, IG 19.7, IG 19.8, 19.15 & 19.20)

Entity-level controls include:-

- Controls over management override;
- Centralised processing and controls, including shared service environments;

Identifying significant accounts and disclosures and their relevant assertions

- The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated.
- The financial statement assertions
- The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.
- Substantive auditing procedures.
- Multiple locations or business units.

Understanding likely sources of misstatement

- Process flow - Flow of transactions authorized.
- Risk assessment - Material.
- Identify control - Identify the controls.
- Prevention or timely detection.

Note: Controls within IT is not a separate evaluation

Performing walkthroughs is the most effective way of achieving the objectives in paragraph 100. Walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls. (Refer to IG 12)

These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively.

Selecting controls to test

- Entity-level control
- Transaction-level control
- Control activity
- Monitoring control
- Preventive control
- Detective control

Testing controls-testing design effectiveness (Refer IG 11 and IG 12)

- Entity-level control
- Transaction-level control
- Control activity
- Monitoring control
- Preventive control
- Detective control
- Test the design effectiveness of controls.

Relationship of risk to the evidence to be obtained

- Effectiveness of controls each individual control.
- The auditor's objective is to express an opinion on the company's overall internal financial controls over financial reporting.
- These vary the evidence
- Timing of tests of controls. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Closer to the balance sheet date.
- Extent of tests of controls. The more extensively a control is tested, the greater the evidence obtained from that test.

Special considerations for subsequent years' audits (Refer IG 16 & IG 20)

- After taking into account the risk factors identified in paragraphs 113 and 124, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.
- Not expected to adopt a rotation / cyclical plan for testing controls.
- To defer testing of certain controls for the reason that they were tested in the immediate previous year which may be permitted in limited circumstances as more fully described.
- Introduce unpredictability into the testing and respond to changes in circumstances.
- Test controls at a different interim period, increase or reduce the number and types of tests performed or change the combination of procedures used.

Evaluating identified deficiencies

(significant deficiencies or material weaknesses)

- Significant deficiencies – 21% to 50%
  - Important enough to merit attention of those charged with governance since there is reasonable possibility.
  - A deficiency in design so that, even if the control operates as designed, the control objective would not be met.
  - A deficiency in operation properly designed control does not operate as designed.
- Material weakness – 51% -100%
  - Reasonable possibility

- The severity of a deficiency depends on
  - Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure.
  - The magnitude of the potential misstatement resulting from the deficiency or deficiencies.
- Compensating controls

Communicating Certain Matters

- Must communicate, in writing to management charged with governance all material weaknesses and any deficiencies, or combinations of deficiencies that are significant deficiencies identified during the audit.
- Evaluation of the implementation of the components of internal control ineffective, auditor must communicate that conclusion in writing to the board of directors.
- Because audit of IFCOFR does not provide the auditor with assurance that he has identified all deficiencies, less severe than a significant deficiency, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

Subsequent Events

But before the date of the auditor's report.

Obtaining Written Representations

- Stating that management did not use the auditor's procedures performed during the audits of internal financial controls over financial reporting or the financial statements as part of the basis for management's.
- Disclosed to the auditor all deficiencies in the design or operation such as deficiencies, significant deficiencies or material weaknesses.

The auditor should ensure that the board of directors approving the financial statements of the company also approve the management assertion and conclusion on the adequacy and operating effectiveness of internal financial controls over financial reporting and also take on record the deficiencies, significant deficiencies and material weaknesses identified by the management, internal auditors and the auditor.

Reporting on Internal Financial Controls over Financial Reporting

- A material weakness exists.
- A paragraph stating that, because of inherent limitations, internal financial controls over financial reporting may not prevent or detect misstatements and those projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Modified Opinion

Result in one or more material weaknesses, the auditor must evaluate the need to express a modified opinion.

Report Date

The date of the audit report on internal financial controls over financial reporting should be the same as that of the date of the audit report on the financial statements.

Considerations for using this Guidance for Internal Financial Controls Over Financial Reporting Assessments on behalf of Company's Management

Any member or other professionals should consider this guidance to the extent applicable in carrying out internal financial control over financial reporting assessments on behalf of the company's management.

Section H

Entity Level Controls

Process Level Controls

Illustration of Risk of Material Misstatement (ROMM) from GN of ICAI

Entity Level Controls as Control Activity

Entity Level Controls

- Entity-level controls include controls over control environment

Categories of ELCs:

- Indirect entity-level controls
- Direct entity-level controls that are not precise
- Direct entity-level controls that are precise

Entity Level Controls:

- Tone at the TOP
- Board of Directors and Audit Committee Charters
- Risk Management
- Integrity and Ethical values
- Assignment of Authority and responsibility
- Organization structure
- Management's Philosophy and Operating style
- Human Resource management
- Monitoring

ELCs are generally not direct and precise and accordingly may not be controls addressing specific risks for our IFCOFR audit opinion.

Evaluation of ELCs can result in increase / decrease in testing that auditor otherwise would have performed on other controls

Process Level Controls: Risk And Control Matrix		
1.	**Process**	***Refer to Table 1***
2.	**Sub-process**	***Refer to Table 2***
3.	**Risk Number**	**PPR1, PPR2, PPR3 .. …. … .. .**
4.	**Risk Description**	***What could go wrong***
5.	**Risk Ranking**	***High / Medium / Low***
6.	**Control Activity Number**	**PPC1, PPC2, PPC3 .. …. … .. .**
7.	**Control Activity Description**	**- - - - - - - - - - -**
8.	**Existing / Recommended**	**Existing or Recommended**
9.	**Significant Account Balances**	**Affected account(s)**
10.	**Supporting IT applications**	**Like SAP, Tally . . . . . .**
11.	**Control Assertions**	***Accuracy / Completeness / Cut Off / Validity***
12.	**Control Type**	***Detective / Preventive / Preventive – Anti Fraud***
13.	**Control Type**	***Automated / Manual / IT Dependent***
14.	**Control Frequency**	***Annual / As and when / Monthly / Ongoing Quarterly / Weekly / Monthly***

Table 1

Order to Collect	Hire to Retire	Procure to Pay *(2)*
Prepaid Expenses	**Payroll**	**Operating Revenue**
Inventories	**Investment**	**Financial Reporting**
Income Tax	**Fixed Assets**	**Cash / Bank Balances**

Table 2

Master Creation	**Receipt of material**
PO Processing	**Bill Booking**
Pymnt Processing	

Illustrative Example of Risk of Material Misstatement (ROMM) from GN of ICAI

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
Core Risks and Controls				
Recording of Sales	Sales and trade receivables are recorded: • That do not relate to valid sales/dispatches • At the incorrect amount • In the incorrect period.	• Occurrence • Accuracy • Cutoff	Invoices are generated only upon matching the purchase order and shipping documents, completing a 3-way match. The 3-way match process is performed within an ERP system that identifies the purchase order and dispatch note and generates an invoice within established tolerances. **(Preventative)**	Trade receivable [Existence; Valuation and Allocation; Completeness]
			AND/OR	
			Proof of delivery is provided by third-party carriers for all dispatches/deliveries made. The proof of delivery is required in order for the invoice to be generated. **(Preventative)**	Trade receivables [Existence; Valuation and Allocation; Completeness]
Recording of Sales	Supplementary agreements or credit memos exist that are not known to accounting.	Occurrence	Representations are received on a quarterly basis from sales personnel and management regarding the existence of customer side agreements or credit memos not yet communicated to accounting. **(Detective)**	Trade receivables [Existence]
			AND/OR	
			Credit notes issued after period-end are scrutinised by management for association with supplementary agreements and proper accounting. **(Detective)**	Trade receivables [Existence]
Recording of Sales	Sales are recorded prior to all necessary revenue recognition criteria being met.	Occurrence	Sales agreements are reviewed by personnel with requisite experience to determine if the revenue recognition criteria are met.	Trade receivable [Existence]
Recording of Sales	Goods are dispatched to customers and no invoice is generated and recorded.	Completeness	**Dispatches** of goods to customers are logged. The log is used to determine that all shipments dispatches are invoiced and that all invoices are recorded. **(Detective)**	Trade receivables [Completeness]
			AND/OR	
			Management reviews relevant sales, trade receivables, costs of sales, and inventory reports related to order entry, dispatch, and invoicing; significant, unusual relationships are monitored and acted upon. **(Detective)**	Trade receivables [Completeness]
			AND/OR	
			Invoices are generated only upon matching the purchase order and dispatch documents, completing a 3-way match. The 3-way match process is performed within an ERP system that identifies the purchase order and dispatch note and generates an invoice within established tolerances. **(Preventative)**	

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
Recording of Sales	Sales are not classified appropriately as per Schedule III to the Companies Act, 2013	Classification	Finance personnel review the nature and type of sale transaction and appropriate account. Management reviews the supporting documentation, and journal entry before the journal entry is recorded. **(Preventative)**	
Sales Returns and Credit Memos	Credit notes are not issued and recorded for goods returned by customers.	Occurrence	All returned goods are logged when received. Return details per the log are compared to credit notes issued to determine that credit notes are issued in accordance with company policy. **(Detective)**	Trade receivables [Existence; Rights and Obligations]
			AND/OR	
			All returned goods are logged when received and the returned goods log automatically generates the credit notes. **(Preventative)**	
Sales Returns and Credit Memos	Credit notes are issued or committed to the customer but not recorded.	Occurrence	All returned goods are logged when received. Return details per the log are compared to credit notes issued and recorded to determine that credit notes are issued in accordance with company policy. **(Detective)**	Trade receivables [Existence]
			AND/OR	
			Representations from operations and sales personnel are obtained indicating that no verbal or unrecorded credit memos exist that have not been reported to finance management. **(Detective)**	Trade receivables [Existence]
Sales Returns and Credit Memos	Credit notes are issued to customers without the receipt of returned goods.	Completeness	All returned goods are logged when received and the returned goods log automatically generates the credit notes. **(Preventative)**	Trade receivables [Completeness]
			AND/OR	
			All returned goods are logged when received. Credit notes issued are compared to the return log to determine that credits issued are for valid returns. **(Detective)**	Trade receivables [Completeness]
Sales Returns and Credit Memos	Credit notes are issued for the incorrect amount.	Accuracy	Credit notes are generated by the ERP system. Credit pricing information is obtained from the original sales invoice. **(Preventative)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			ERP system validates the amount of the issued credit note against the original invoice. Credit memos issued in excess of the original invoice are flagged and must be reviewed and approved by management. **(Preventative)**	Trade receivables [Valuation and Allocation]

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
			AND/OR	
			Policy requires that credit notes are not issued in amounts in excess of the original invoice amount; compliance with this policy is monitored by management. **(Preventative)**	Trade receivables [Valuation and Allocation]
Sales Returns and Credit Memos	Sales returns reserves are not accurately estimated as a result of: • An inappropriate methodology • Significant assumptions [*specify assumptions*] being inappropriate, lacking sufficient basis, or lacking sufficient support.	• Accuracy • Accuracy	Sales return methodology, significant assumptions, and supporting documentation are reviewed by management prior to recording the journal entry. **(Preventative)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			Management performs a retrospective review supporting the appropriateness of the methodology and significant assumptions. **(Detective)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			Sales returns are analysed on a monthly basis and compared to budget. Explanations are obtained for any significant variances and differences. The analysis is reviewed by senior management and taken into consideration when estimating the sales return reserve. **(Detective)**	Trade receivables [Valuation and Allocation]
Sales Returns and Credit Memos	Sales return transactions occurring around period-end are not recorded in the correct period.	Cutoff Completeness	Returned goods received and credit memos issued at, before, or after the end of an accounting period are scrutinised and/or reconciled to make certain the sales return is recorded in the appropriate accounting period. **(Detective)**	Trade receivables [Existence; Completeness]
			AND/OR	
			Manual sales return entries made to the general ledger are reviewed and approved by management for proper inclusion in the correct accounting period. **(Detective)**	Trade receivables [Existence; Completeness]
Other Possible Risks and Controls				
Recording of Sales	Invoices are generated and sales recorded for dispatches to fictitious customers.	Occurrence	Invoices can only be generated for customers that exist in the customer master file. Access to add, change, or delete information in the customer master file is limited to approved personnel. **(Preventative)**	Trade receivables [Existence; Valuation and Allocation]

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
			AND/OR	
			The customer master file generates an exception report listing new and deleted customers, shipping address changes, etc., and the report is reviewed by the credit manager and controller. **(Detective)**	Trade receivables [Existence; Valuation and Allocation]
			AND/OR	
			Customer master file data is periodically reviewed by management for accuracy and ongoing pertinence. **(Detective)**	Trade receivables [Existence; Valuation and Allocation]
Recording of Sales	Invoices are issued and recorded for dispatches to non-customer offsite locations.	Occurrence	The ERP system only permits invoices to be issued for dispatches to valid customer locations based on information contained in the customer master file. **(Preventative)**	Trade receivables [Existence]
			AND/OR	
			The customer master file is reviewed for ongoing relevance. **(Detective)**	Trade receivables [Existence]
Recording of Sales	Invoices are generated and recorded for sales of consigned inventory based on incorrect data provided to the entity by the consignee.	Occurrence; Accuracy	Consigned inventory is confirmed and confirmations are reconciled to inventory records and the general ledger. Randomly, consigned inventory is physically verified by company personnel. **(Detective)**	Trade receivables [Existence; Valuation and Allocation]
			AND/OR	
			Customers who receive consigned goods are specifically identified as consignment customers in the ERP customer master file. The ERP system generates a report of invoices to consignment customers that are scrutinised by management for proper revenue recognition. **(Detective)**	Trade receivables [Existence; Valuation and Allocation]
Recording of Sales	Inventory held on consignment and subsequently sold has not been invoiced and recorded as a sale and receivable.	Completeness	Consigned inventory is confirmed and confirmations are reconciled to inventory records and the general ledger. Randomly, consigned inventory is physically verified by company personnel. **(Detective)**	Trade receivables [Completeness]
			AND/OR	
			Inventory consignee (third party) provides periodic reporting of consigned inventory held. These reports are reviewed and reconciled to internal records, and differences are investigated. **(Detective)**	Trade receivables [Completeness]
Recording of Sales	Sales transactions are recorded without being appropriately adjusted for	Accuracy; Occurrence	Management (1) analyses significant sales contracts for revenue recognition considerations such as customer approval, delivery terms (e.g.,	

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
	unearned (or deferred) revenue, or they are adjusted at the incorrect amount.		FOB destination), and (2) references the applicable accounting framework and principles to support the amount recorded as revenue and unearned revenue for significant sales transactions. **(Preventative)**	
			AND/OR	
			Sales transactions, volumes, and values are analysed on a monthly basis and compared to budget. Explanations are obtained for any variances above *X*% and differences are analysed. The analysis is reviewed by senior management. **(Detective)**	
Recording of Sales	Sales are made to customers with poor credit, which may affect revenue recognition criteria being met and the ultimate write-off of uncollectible accounts.	Occurrence	Credit limits are established by the credit manager based on the customer's ability to pay and past collection results, and are reviewed on a regular basis. **(Preventative)**	Trade receivables [Valuation and Allocation]
Recording of Sales	Invoices are generated in excess, individually or in the aggregate, of customer credit limits, which may affect revenue recognition criteria being met and the ultimate write-off of uncollectible accounts.	Occurrence	ERP system suspends purchase orders that individually or aggregately exceed customer credit limits. Approval by the credit manager is required prior to the ERP system recording the purchase order. **(Preventative)**	Trade receivables [Valuation and Allocation]
Sales Returns and Credit Memos	Credit notes are issued at an amount in excess of the original invoice.	Completeness; Accuracy	Policy requires that credit notes are not issued in amounts in excess of the original invoice amount; compliance with this policy is monitored by management via review of credit memos prior to issuance. **(Preventative)**	Trade receivables [Valuation and Allocation; Completeness]
			AND/OR	
			ERP system validates the amount of the issued credit note against the original invoice and creates an exception report for credit notes in excess of the original invoices. Management reviews, then approves or corrects, items on the exception report based on documentation and support provided. **(Detective)**	Trade receivables [Valuation and Allocation; Completeness]
Sales Returns and Credit Memos	For sales transactions that trigger promotional allowances or volume discounts, the promotional allowance or volume discount is not appropriately recorded.	Occurrence	For sales transactions that trigger promotional allowances or volume discounts, the calculation for promotional allowances and volume discounts and supporting documentation are reviewed by management prior to recording the journal entry. **(Preventative)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			For customers receiving promotional allowances or volume discounts, management periodically analyses goods returned that may indicate inappropriate recording of promotional allowances or volume discounts. **(Detective)**	Trade receivables [Valuation and Allocation]

Revenue from Operations				
Transaction Type	**Risks of Material Misstatement ("What Could Go Wrong")**	**Assertion(s)**	**Example Control(s)**	**Other Affected Account(s)**
			AND/OR	
			Promotional allowances and volume discounts are analysed on a monthly basis and compared to budget. Explanations are obtained for any significant variances and differences. The analysis is reviewed by senior management. **(Detective)**	Trade receivables [Valuation and Allocation]
Sales Returns and Credit Memos	Provisions for promotional allowances or volume discounts are not accurately estimated as a result of: • An inappropriate methodology • Significant assumptions [*specify assumptions*] being inappropriate, lacking sufficient basis, or lacking sufficient support.	• Accuracy • Accuracy	The methodology for accruing for promotional allowances/volume discounts, significant assumptions used, and supporting documentation are reviewed by management prior to recording the journal entry. **(Preventative)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			Management performs a retrospective review supporting the appropriateness of the methodology and significant assumptions. **(Detective)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			Promotional allowances and volume discounts are analysed on a monthly basis and compared to budget. Explanations are obtained for any significant variances and differences. The analysis is reviewed by senior management and taken into consideration when estimating the reserve for promotional allowances and rebates. **(Detective)**	Trade receivables [Valuation and Allocation]
Recording of Sales	Foreign sales and trade receivables are translated at the incorrect foreign exchange rate.	Accuracy	Foreign sales and trade receivables translation is prepared by staff personnel and reviewed/approved by management. Analysis reviewed/approved by management includes supporting documentation for the translation rate calculation. **(Preventative)**	Trade receivables [Valuation and Allocation]
			AND/OR	
			ERP system calculates the foreign sales and trade receivables translation, which is independently verified by management. **(Preventative)**	Trade receivables [Valuation and Allocation]

Section I

Appendices as per GN from ICAI

Appendix to GN contains		
1.	**Engagement Letter** Format	by Auditor before commencing audit explaining objective, scope, limitation, responsibility, procedure, etc.
2.	**Management Representation Letter** Format	Issued by Company management.
3.	**IFC Audit Report Format**	Issued by Auditor under various scenarios both for Standalone Financial Statements & Consolidated Financial Statements.
4.	**Risks of Material Misstatement, Related Control Objectives & Control Activities.**	Illustrative list and illustrative work paper templates for testing controls provided in CD accompanying Guidance Note for around 20 a/c balances & processes.
5.	**Examples Of Control Deficiencies**	Ex. of: Deficiencies in design of controls, failure in operation of Internal Control, significant deficiencies & material weakness.
6.	**SIA 5 – Sampling**	Reproduced.

Appendix I: Engagement Letter
Agreeing the terms of audit engagement for the audit of internal financial controls over financial reporting

Agreeing the terms of audit engagement for the audit of internal financial controls over financial reporting

Given by the Auditor to the Board of Directors of Company -

- Explaining the objective & Scope of audit
- Audit of IFCOFR based on standard on auditing, GN on audit of IFCOFR
  - Meaning of IFCOFR
  - Procedure for such audit
- Inherent limitation in an Audit of IFCOFR
- Management Responsibility
- Reports
- Other info such as fee, billing, other specific term *(Optional)*

APPENDIX II: Mgmt Rep. Letter
For Matters Relating Audit of IFCOFR

Given by the company's management to Auditor

Appendix III: Reports On IFCOFR

Reporting on IFCOFR by Auditor's

- Standalone Financial Statement.
- Separate Report in case of CFS.

IFCOFR Report paragraphs

- Annexure to the Main Audit Report
- Report on IFC (Heading)
- Management's Responsibility for IFCOFR
- Auditor's Responsibility
  - → obtaining an understanding of IFCOFR
  - → Assessing risk of material weakness exists & testing / evaluating the design & operating effectiveness of internal control based on the assessed risk.
- Meaning of ICOFR
- Inherent Limitations of ICOFR
- Opinion
- Signature of the Auditor
- Date of the Auditor's Report
- Place of Signature

APPENDIX IV:
Risks of Material Misstatement, Related Control Objectives & Control Activities

- For each class of transactions and account balances - Risk of material misstatement & relevant controls could be -
  - I. Core Risks & Controls (Applicable to All)
  - II. Other possible Risks Controls (May or may not be applicable)
- Illustrative list of Risks of Material Misstatement *[Refer to Section I for Illustrative Risk Control Matrix]*

  Control Objectives - Control Activities and illustrative work paper templates for testing controls have been provided in a CD along with the Guidance Note for the following account balances and processes:

  1. Cash/Bank Balances
  2. Prepaid Expenses
  3. Trade Receivables
  4. Inventory
  5. Fixed Assets
  6. Goodwill and Intangible Assets
  7. Trade payables
  8. Provision for expenses
  9. Loans/Borrowings
  10. Employee Benefits
  11. Income Taxes
  12. Deferred Taxes
  13. Provision for Income taxes/Advance Income taxes
  14. Share Capital
  15. **Revenue from Operations** ***[Refer Section K for Illustrative Risk of Material Misstatement Matrix]***
  16. Cost of Sales
  17. Depreciation/ Amortization and Other Expenses
  18. Finance Cost
  19. Journal Entries
  20. Financial Reporting

APPENDIX V: Examples Of Control Deficiencies

A. Example of Deficiencies in the design of controls
B. Example of failure in the operation of Internal Control
C. Example of significant deficiencies
D. Example of material weakness.

APPENDIX VI: Standard on Internal Audit (SIA) 5 – Sampling

List of SIA's issued by IASB - (SIA's are presently recommendatory)

2. *Planning an Internal Audit*
3. *Basic Principles Governing Internal Audit*
4. *Documentation*
5. *Reporting*
6. *Sampling*
7. *Analytical Procedures*
8. *Quality Assurance in Internal Audit*
9. *Terms of Internal Audit Engagement*
10. *Communication with Management*
11. *Internal Audit Evidence*
12. *Consideration of Fraud in an IA*
13. *Internal Control Evaluation*
14. *Enterprise Risk Management*
15. *IA in an Information Technology Environment*
16. *Knowledge of the Entity and its Environment*
17. *Using the Work of an Expert*
18. *Consideration of Laws & Regulations in IA*
19. *Related Parties*

- **Objective**

  To ensure that audit procedures performed & sample results evaluated provide SAAE to meet objective of audit engagement unless otherwise specified by the client.

- **Definitions**
  - → '**Audit sampling**' – means: < 100% Audit procedures to form a conclusion concerning the population.

    Applying IA procedures with population having a particular characteristic (Ex. all item > x Rs. is not a true representation of entire population or w.r.t item < x Rs.)
  - → **Stratification:** Dividing the population into sub- population.
  - → **Tolerable error**: Maximum acceptable error in the population. "Smaller the tolerable error, greater the sample size will need to be"
  - → **Selection of sample:** All items (sampling units) in the population must have an opportunity of being selected.

- **<u>Methods</u>**
  a. Random selection and use of CAAT's
  b. Systematic selection
  c. Haphazard selection *(not appropriate when using statistical sampling techniques)*
  d. Block selection : selection of a block of adjacent or contiguous item from within the population (may not be ok for internal audit because items in sequence can be expected to be similar characteristics to each other)

- **<u>Evaluation of sample results</u>**
  - ✓ Analyze the nature & cause of any errors detected
  - ✓ Project errors to populated
  - ✓ Re-asses sampling risk
  - ✓ Consider possible effects on Internal Audit objective/engagement

➢ **<u>Documentation -</u>** *To support the opinion / findings of Internal Auditor.*

Documentation may include

i. Relationship between the design of the sample vis-à-vis specific audit objectives, population from which sample is drawn and the sample size.
ii. Assessment of the expected rate of error in the population to be tested vis-à-vis auditor's understanding of the design of the relevant controls
iii. Assessment of the sampling risk and the tolerable error.
iv. Assessment of the nature and cause of errors.
v. Rationale for using a particular sampling technique and results thereof.
vi. Analysis of the nature and cause of any errors detected in the sample.
vii. Projection of the errors found in the sample to the population.
viii. Reassessment of sampling risk, where appropriate.
ix. Effect of the sample results on the internal audit's objective(s).
x. Projection of sample results to the characteristics of the population.

Appendix to SIA – 5 Sampling

1. Examples of Factors Influencing Sample Size for Tests of Controls (TOC)

Factor to be considered by Internal Auditor	Effect on sample size
An increase in the extent to which the ROMM is reduced by the operating effectiveness of controls	Increase
An increase in the rate of deviation from the prescribed control activity that the internal auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribed control activity that the internal auditor expects to find in the population	Increase
An increase in the internal auditor's required confidence level	Increase
An increase in the number of sampling units in the population	Negligible effect

Notes –

a. Other things being equal, the more the internal auditor relies on the operating effectiveness of controls in risk assessment, the greater is the extent of the internal auditor's tests of controls, and hence the sample size is increased.

b. The lower the rate of deviation that the internal auditor is willing to accept, the larger the sample size needs to be.

2. Examples of Factors Influencing Sample Size for Tests of Details (TOD)

Factor to be considered by Internal Auditor	Effect on sample size
An increase in the internal auditor's assessment of the risk of material misstatement	Increase
An increase in the use of other substantive procedures by the internal auditor, directed at the same assertion	Decrease
An increase in the total error that the internal auditor is willing to accept (Tolerable Error)	Decrease
Stratification of the population when appropriate	Decrease
An increase in the amount of error which the internal auditor expects to find in the Population	Increase
An increase in the internal auditor's required confidence level	Increase
The number of sampling units in the population	Negligible effect

3. Methods of Sample Selection

4. Frequency of Control Activity and Sample Size

Frequency of control activity	Minimum sample size Risk of failure	
	Lower	Higher
Annual	1	1
Quarterly (including period- end, i.e., +1)	1+1	1+1
Monthly	2	3
Weekly	5	8
Daily	15	25
Recurring manual control (multiple times per day)	25	40

Note – Although +1 is used to indicate that the period–end control is tested, this does not mean that for more frequent control operations the year-end operation cannot be tested.

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About the Author

CA K. Gururaj Acharya

CA K. Gururaj Acharya hails from the temple town Udupi brought up in the Iron City Bellary and is now well settled in the Knowledge City of Bangalore. He qualified as a Chartered Accountant after completing articles under M/s. Guruprasad & Co., Bellary in 1992 and thereafter joined the firm as a partner. He then founded M/s. K.G. Acharya & Co, Chartered Accountants in the year 1998 of which he is currently the Senior Partner.

Academic Achievements:

B.Com	1st Rank – University
CA Entrance	Obtained highest marks in Entrance Examination for South India.
CA Inter	21st Rank - All India
CA Final	10th Rank - All India (qualified in 1992 May exam)
ICWAI Inter	1st Rank - All India
ICWAI Final	3rd Rank - All India (qualified in 1991 June exam)

Other details:

He is a Director on the Board of Directors of State Bank of Mysore and is also Chairman of the Audit Committee of the Board.

He is Member of the Bangalore – Financial Reporting Review Group, formulated under Financial Reporting Review Board of ICAI, New Delhi.

He was Co-opted member of Expert Advisory Committee constituted by ICAI, New Delhi during the year 2014-2015 and Committee on Accounting Standards for Local Bodies constituted by ICAI, New Delhi during the year 2006-2007 & 2008-2009.

He was a Member of the Karnataka State Level Audit Advisory Board.

As a resource person, he presented papers at various seminars & workshops, provided training program to executives of various public sector and private sector enterprises, in Accounting Standards and Standards on Auditing, Companies Act, 2013 and LLP, Corporate Finance and Financial Analysis, Corporate Tax and Tax Audit.

He likes to travel with family and has visited the Grand Canyon, Empire State Building, Statue of Liberty, Coliseum, Eiffel Tower, Leaning Tower of Pisa, Burj Al Arab, The Great Wall of China, etc. He plans to cover the other wonders of the world within the next few years.