

**Roles and Responsibilities  
of  
CAs  
in  
Internal Financial Controls (“IFC”)  
Reporting**

Organised  
By  
WESTERN INDIA REGIONAL COUNCIL  
Of  
Institute of Chartered Accountants of India

Presentation  
By  
PARESH H. CLERK

May 28, 2016

**Presentation Outline**

- 1 **Scope**
- 2 **Management’s Misconceptions**
- 3 **Evaluation of IFC by Statutory Auditor**
- 4 **What is IFC, IFC over FR and IC?**
- 5 **Components under SA 315**
- 6 **Steps to perform**
- 7 **Reporting**

## Scope...

### Management's Responsibility

Section 134(5)(e) <b>IFC</b>	Director's Responsibility Statement	To state that directors have laid down IFC to be followed by the company and that such controls are adequate and operating effectively
Section 149(8) - Schedule IV <b>IFCOFR</b>	Independent Directors ("IDs")	IDs to satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible
Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014	Board Report	To state details in respect of the adequacy of IFC with reference to Financial Statements ("FS")

- Definition as per Section 134(5)(e) encompasses both operational and financial reporting controls - Much broader in scope than **IFC over FR**
- Rule 8(5)(viii) – Requirement – More restricted for listed companies since it covers only controls impacting FS and not operating adequacy

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## ...Scope...

### Auditor's Responsibility

Section 143(3)(i) <b>IFCOFR</b>	Auditor's Report	To state whether the company has adequate IFC system in place and the operating effectiveness of such controls
Section 177 <b>IFCOFR</b>	Audit Committee ("AC")	AC may call for comments of auditors about internal control systems before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and management of the company
SEBI (LODR) Regulations, 2015 <b>IFC</b>	Schedule II, Part C, B-11	Role of AC includes evaluation of IFC and risk management systems

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## ...Scope...

### TCS-14-15

*Directors' responsibility statement Pursuant to Section 134(5) of the Companies Act, 2013, the board of directors, to the best of their knowledge and ability, confirm that:*

*v. ...they have laid down internal financial controls to be followed by the Company and such internal financial controls are adequate and operating effectively...*

*Based on the framework of internal financial controls and compliance systems established and maintained by the Company, work performed by the internal, statutory and secretarial auditors and external consultants and the reviews performed by management and the relevant board committees, including the audit committee, the board is of the opinion that the Company's internal financial controls were adequate and effective during the financial year 2014-15.*

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## ...Scope

Reporting by  
Directors

Listed Co

w.e.f.  
April 1, 2014

Reporting by  
Statutory Auditors

All  
Companies

w.e.f.  
April 1, 2015

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## Management's Misconceptions...

- *Whether anything has changed and are the directors saying that the entity did not have controls earlier?*
  - ✓ **Depends on various factors –**
    - Size and complexity of the entity
    - Nature and extent of existing documentation
    - Management philosophy and operating style
  - ✓ **Fundamental foundation of IFC –**
    - Existence of **documented framework**
  - ✓ Therefore, assessment to be done in respect of –...
    - Is the **Code of Conduct documented** and even if so, whether the same is **communicated** ?
    - Are **Board meetings actually held** or are minutes written just to cover the required agenda matters ?
    - Is **quality time spent** by the Board on important / critical matters having a material impact on the risk ?

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## ...Management's Misconceptions...

- ✓ ...Assessment to be done for ... –
  - **AC does not allot sufficient time** to discuss the interim results or Internal Audit Reports
  - Companies having a turnover of Rs. 500 crore **not having a qualified CA** in its Accounts Department
  - Organisational structure is **not formalised** even though companies have 500 employees
  - Job profiles are **not documented / reviewed** periodically
  - Though there is a documented Risk Management Framework and SOPs, the same operate on a **standalone basis** and the actual activities are conducted based on neither of them
  - The ERP / IT system is **changed regularly without proper justification** and **no IT system audit** has been undertaken for several years
  - The **process of generating MIS is not robust** and is based on incomplete data

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## ...Management's Misconceptions...

- ✓ ...Assessment to be done for ... –
  - Policies and procedures for period and closure of FS are **not adequately documented** - Especially in the case of multi-location and for preparation of consolidated FS
  - **Unusual activities** are not captured, escalated or approved appropriately
  - The information system is **not adequate** resulting in non-escalation of problems from the lower levels to the top management
  - **Lack** of open communication
  - **Ineffective** whistle blower mechanism
  - **Lack of documented controls over preparation and generation of spreadsheets**

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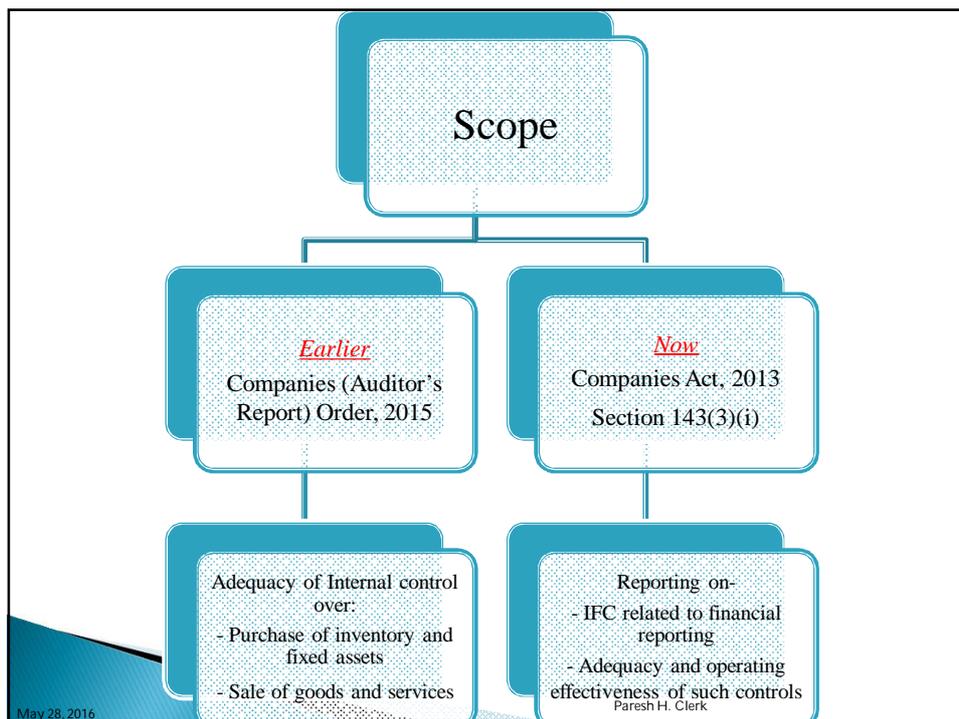
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## ...Management's Misconceptions

- ✓ If no to any of the above matters – *Prima facie* **indicates lack of IC** depending on nature, severity, criticality, materiality of the deficiency
  - Discharge the responsibility in the Board's Report
  - Could result in an **Adverse Opinion on IFC over FR** by auditors
- ✓ Management to do **comprehensive introspection** with regard to **existence and documentation of IFC**
- **Were not the auditors checking and reporting on controls earlier?**
  - ✓ Change in the responsibility of auditors **as to controls**
  - ✓ **Hitherto** – Auditors could not have relied on controls strategy by -
    - Performing more extensive and focussed substantive testing, and
    - Opine on the truth and fairness of FS, even if adequate IC were not prevalent or documented
  - ✓ **This requires a cultural change rather than a compliance change**

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## Evaluation of IFC by Statutory Auditor...

- ❑ **Objective of an auditor**
  - To **express an opinion** on the effectiveness of the company's **IFC over FR** and the procedures in respect thereof
- ❑ Auditor cannot consider a company's IC to be effective if **one or more material weakness exists** – this is so even if the overall FS are not materially misstated
  - Therefore, auditor to **plan and perform the audit to obtain Sufficient Appropriate Audit Evidence (“SAAE”)** to obtain reasonable assurance about whether any **material weakness** exists

### ...Evaluation of IFC by Statutory Auditor...

Is reporting on IFC over FR also required for unlisted companies?...

- ❑ Section 134(5) – Only for listed companies - Directors statement of responsibility over existence of adequate IFC and their operating effectiveness
- ❑ Section 143(3)(i) deals with auditor’s report - **does not restrict such reporting only to listed companies**
  - Does it mean that directors are not responsible in such companies for **IFC over FR**, but only auditors are responsible?
- ❑ Management has the primary responsibility for **designing, implementation and maintenance** of IC relevant for preparation of FS –
  - That give true and fair view free from material misstatements whether due to fraud or error
- ❑ Hence, **designing, implementing and maintaining adequate IFC** also rests with the management

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### ...Evaluation of IFC by Statutory Auditor...

...Is reporting on IFC over FR also required in unlisted companies?

- ❑ Rule 8(5)(viii) of Companies (Accounts) Rules, 2014 –
  - The **Board in all companies to state adequacy of IFC w.r.t. FS**
  - Hence, even if a specific statement is not required for unlisted companies, ensuring adequacy and operating effectiveness of IFC still remains with management and TCWG
  - The GN, therefore, equally applies to reporting on IFC in respect of–
    - Unlisted companies
    - Small companies
    - One Person companies (“OPCs”)

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## ...Evaluation of IFC by Statutory Auditor...

### Reporting in case of small companies / OPCs

- ❑ Such companies have the following qualitative characteristics –
  - Concentration of ownership and management in small number of individuals
  - One or more of the following -
    - Straightforward or uncomplicated transactions
    - Simple record-keeping
    - Few lines of business and few products
    - Few internal controls
    - Few levels of management with responsibility for a broad range of controls
    - Few personnel, many having wide range of duties
- ❑ Evaluation of IFC over FR has to be done in light of the above

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## ...Evaluation of IFC by Statutory Auditor...

### Reporting in case of Consolidated Financial Statements (“CFS”)

- ❑ Section 129(4) – All provisions for preparation, adoption and audit of FS of a holding company also apply *mutatis mutandis* to CFS
- ❑ Hence, reporting u/s 143(3)(i) on IFC also applies to CFS
- ❑ GN – Reporting on adequacy and operating effectiveness of IFC in the case of components would be on basis of the reports submitted by the respective statutory auditors
- ❑ The statutory auditor of the holding company also has to apply the concept of **materiality and his professional judgement** while reporting on this aspect

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### ...Evaluation of IFC by Statutory Auditor...

- ❑ Is evaluation of IFC necessary for all controls within the company or only for controls over financial reporting?
  - Globally, auditor's reporting in IC is together with the reporting on FS and such IC only relate to **IFC over FR**
  - US - Section 404 of Sarbanes Oxley Act –
    - Auditor of a specified class of companies - Additional attestation of the **IFC over FR** – Auditing Standard 5 issued by PCAOB lays down guidelines for the same
  - The 2013 Act - Auditor reporting on IFC only in the context of FS
  - Consistent with the international practice, the term **IFC** in Section 143(3)(i) would **relate only to IFC over FR**

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### ...Evaluation of IFC by Statutory Auditor...

- ❑ Is evaluation of IFC necessary for interim results?
  - Reporting on IFC is a requirement specified under the Act
  - To apply only in case of reporting on FS prepared under the Act and reported to under Section 143
  - Accordingly, reporting on IFC will **not be applicable for interim FS** like-
    - Quarterly or half-yearly results or FS (unless required by any other law or regulation)

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### ...Evaluation of IFC by Statutory Auditor

- ❑ After forming an opinion on the adequacy and operating effectiveness of the company's IFC Reporting–
  - The auditor to evaluate the disclosures that the management and board of directors is required to make under the Act
  - To apply the requirements of SA 720 on “The Auditor’s Responsibility In Relation To Other Information In Documents Containing Audited Financial Statements” (“SA 720”)

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### IFC vs. Enterprise Risk Management (ERM)

- ❑ IFC is not same as ERM
- ❑ IFC - An integral part of ERM
- ❑ Differences –
  - Section 134(3)(n) requires Board report to include statement for development and implementation of risk management policy
  - The existence of an appropriate IFC does not by itself provide –
    - An assurance that the company has developed and implemented an appropriate risk management policy
  - Other Differences –

IFC	ERM
Operates at process level	Operates at strategy level
Applied at processes which contribute to financial reporting	Applied across the entity and involves taking an overall entity level view of risk

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## Combined audit of IFC over FR and FS

- ❑ Statutory Auditor to design testing of controls to accomplish objectives of both audits simultaneously
- ❑ In a combined audit, the auditor expresses opinion on 2 things:
  - IFC Reporting which requires evaluating and opining on -
    - Management's assessment of the effectiveness of IFC
    - Effectiveness of **IFC over FR**
  - FS which involves following all SAs ? Statutory Auditors or Standards on Auditing or Accounting Standards
- ❑ Final objectives are not identical, yet auditor to plan and perform work to achieve both objectives in an **integrated manner**
- ❑ Involves obtaining SAAE to support the auditor's -
  - Opinion on IFC **as at the year-end**
  - Control risk assessments for audit of FS

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## Evaluation of IFC by Statutory Auditor

- ❑ **SA 200** 'Overall objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing' – requires auditor to -
  - Deals with whether FS are prepared in all material respects, in accordance with the financial reporting framework
  - Opinion **does not assure future viability** of the entity nor the efficiency or effectiveness with which the management has conducted the affairs of the entity
- ❑ **SA 315** 'Identifying and assessing the risks of material misstatement through understanding the entity and its environment' – requires auditor to –
  - Identify and assess risks of material misstatement (“RMM”) whether due to fraud or error
  - Understand the entity's environment and IC
    - **The above provides a basis for designing and implementing responses to assessed RMM and reduce these risks to an acceptably low level**

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## What is IFC and IFC over FR?...

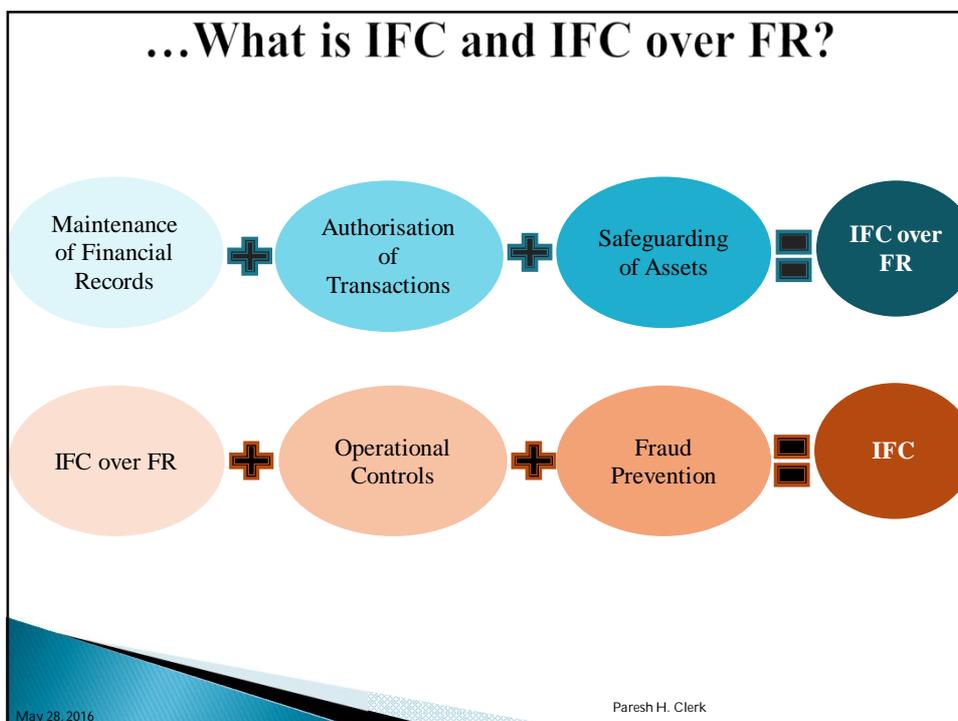
IFC - Explanation to Section 134(5)(e)

- The policies and procedures adopted for ensuring the orderly and efficient conduct of its business, including -
  - Adherence to company's policies
  - Safeguarding of its assets
  - Prevention and detection of frauds and errors
  - Accuracy and completeness of the accounting records
  - Timely preparation of reliable financial information
- **IFC over FR** includes policies and procedures relating to -
  - Maintenance of records to accurately and fairly reflect transactions and disposition of assets
  - Provide reasonable assurance -
    - That necessary transactions are recorded to present FS as per Generally Accepted Accounting Principles ("GAAP") and receipts / expenditures are properly authorised
  - W.r.t. prevention and timely detection of unauthorised acquisition, use or disposition of assets having material effect on FS

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## ...What is IFC and IFC over FR?



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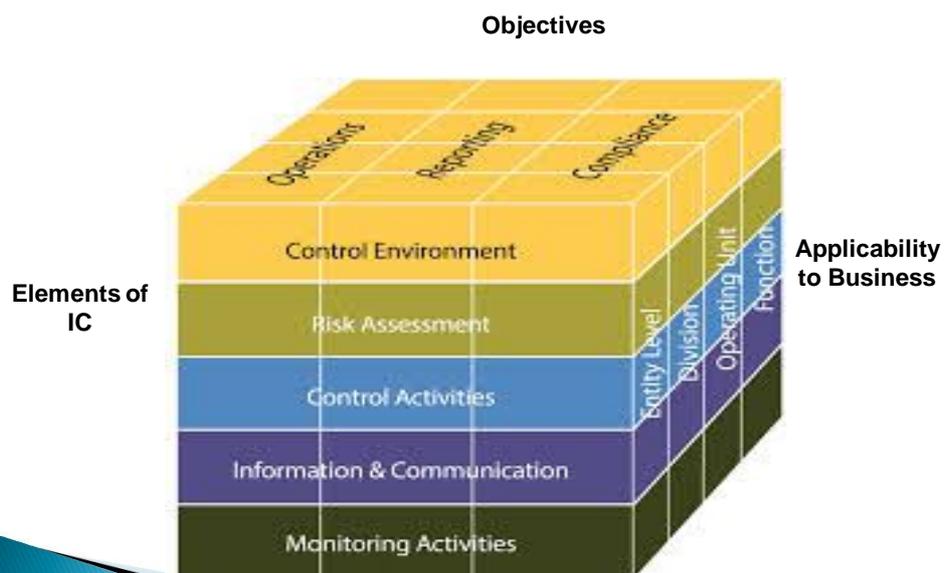
## What is IC?

- ❑ A **process**, effected by an entity’s board of directors’, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to **operations**, **reporting** and **compliance**
- ❑ Means -
  - A process consisting of on-going tasks and activities – a means to an end, not an end in itself
  - Effected by people – not merely about policy and procedure manuals, systems and forms but about people and the actions they take at every level of an organisation to effect IC
  - Able to provide reasonable assurance – but not absolute assurance, to an entity’s senior management and board of directors
  - Adaptable to the entity structure
    - Flexible in application for the application for the entire entity or for a particular subsidiary, division, operating unit or business process

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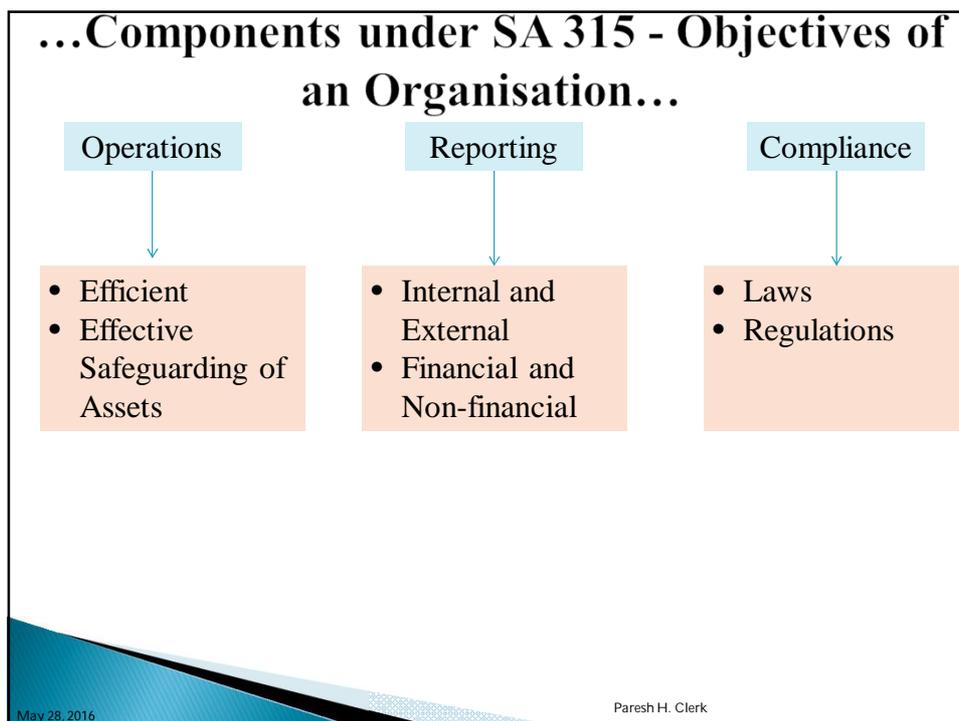
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## Components under SA 315...



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- ### ...Components under SA 315 - Elements...
- **Control Environment**
    - Demonstrates commitment, integrity and ethical values
      - Management philosophy and operating style
    - Ensures that Board exercises oversight responsibility
      - Participation of those charged with governance
      - Structures – Governance – Management function of attitudes, awareness and actions – Mission
    - Establishes structures, reporting lines, authorities and responsibilities
      - Audit committee oversight
      - Assignment of authority and responsibility
      - Whistle Blower mechanism
    - Demonstrates commitment to a competent workforce
      - Human resources, policies and practices
    - Holds people accountable
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## ...Components under SA 315 - Elements...

### ☐ Risk Assessment

- Specifies appropriate objectives
- Identifies and analyses risks
  - Risk naïve / Defined / Aware / Managed / Enabled
  - How management identifies risks on an ongoing basis (significance – impact and probability – likelihood) – Classifies risk and takes actions to manage and mitigate risks
  - What is our Risk Appetite / Risk Tolerance
  - Whether entity Risk Centric – Risk Focussed
  - Gross or Inherent Risk – Residual Risks
  - Tolerate / Treat / Terminate / Transfer
- Evaluates fraud risks
  - Areas of Least / Minimal / Moderate and Most concern
- Identifies and analyses changes that could significantly affect IC

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## ...Components under SA 315 - Elements...

### ☐ Control Activities

- Selects and develops control activities that mitigate risks
- Selects and develops technology controls
  - Spreadsheet controls, data base controls, controls over specific user developed applications
- Deploys control activities through policies and procedures
  - Performance reviews (actual vs. budget, review of functional and activity performance relating to different sets of data to one another, analysing relationships; comparing internal and external data)
  - Segregation of duties – competency of maker and authority of the reviewer



## ...Components under SA 315 - Elements...

### □ Information and communication

- Uses relevant, quality information to support the IC function
- Communicates IC information internally
- Communicates IC information externally
  - Application and IT General Controls:
    - Checking arithmetical accuracy of records edit checks
    - Change Management Controls
    - Access Controls – Authorisations to access programs and data files
    - Anti virus controls
    - Audit trails
    - Migration and implementation of new software
    - Periodic counting and comparison with amounts shown in control records

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## ...Components under SA 315 - Elements...

### □ Monitoring

- Performs ongoing or periodic evaluations of IC (or a combination of the two)
  - Selecting, developing and performing ongoing and separate evaluations
    - Large unusual, non-recurring transactions – Errors difficult to define, anticipate or predict
    - Changing circumstances – Manual intervention and risk of inappropriate manual intervention
    - Potential loss of data
- Communicates IC deficiencies
  - Evaluating and communicating deficiencies
    - Management and regulatory reporting
    - Customer complaints
    - External communications / balance confirmations, receipts

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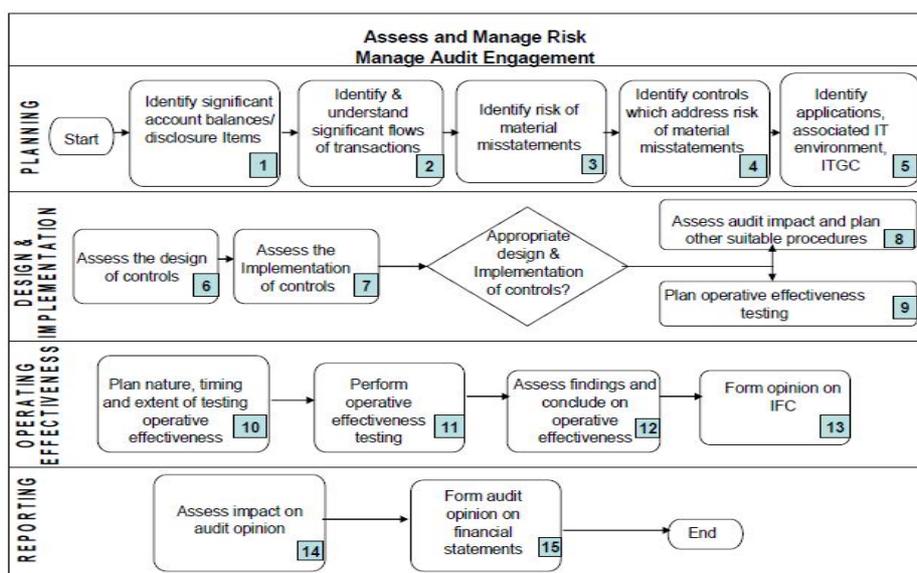
## ...Components of SA 315-Characteristics...

- ❑ IFC should be dynamic due to –
  - Business developments
  - Acquisitions, mergers and divestments
  - Changes in IT and business processes
  - Key managerial personnel
  - New products, new markets and rapid growth
- ❑ Changes in regulations
- ❑ Changes in accounting frameworks / standards / IFRS
- ❑ Audit opinion on IFC **does not ensure the entity’s future viability** or efficiency / effectiveness with which management has conducted company’s affairs

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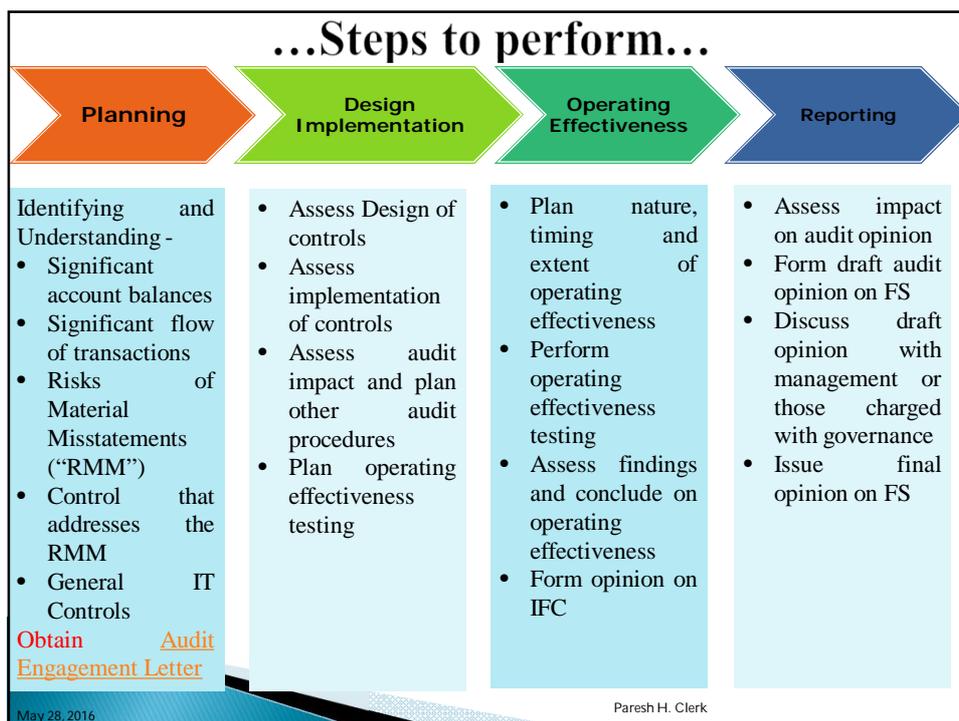
## Steps to perform...



Source – *Guidance Note on Audit Internal Financial Controls over Financial Reporting*

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### ...Steps to perform...

Step	Particulars	Steps performed	Reference
1.	Identify significant account balances or disclosure items	<b>Review FS</b> in order to mark heads as: Significant, Moderate and Low	Determination of Focus Area
2.	Identify and understand significant flows of transactions	<ul style="list-style-type: none"> <li>• Prepare <b>process flows</b> based on SOPs</li> <li>• Understand the <b>controls at Entity Level</b></li> </ul>	<ul style="list-style-type: none"> <li>• Process flows of identified areas</li> <li>• ELC-Checklist</li> </ul>
3.	Identify risk of material misstatements	<b>Evaluate process flows</b> and identification of risks of material misstatements	<u>Risk Control Matrix</u>
4.	Identify controls which addresses risk of material misstatements	<b>Identify controls</b> in place for mitigating the identified risks	<u>Risk Control Matrix</u>
5.	Identify applications, associated IT environment, ITGC	<ul style="list-style-type: none"> <li>• Identify <b>application system</b> used for performing controls in place</li> <li>• Identify <b>IT risk and Controls</b></li> </ul>	Risk Control Matrix

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**...Steps to perform...**

Step	Particulars	Steps performed	Reference
6.	Assess design of controls	Evaluate design of controls as to its adequacy (Design Effectiveness) for mitigating the identified risks	Risk Matrix and Control Process flows
7.	Assess the implementation of controls	Ask queries related to how the control exists and who performs it	Risk Matrix and Control Process flows
8.	Assess audit impact and plan other suitable procedures	List down design gaps and decide whether other controls are sufficient for mitigating the risk and accordingly plan OE testing	Risk Matrix and Control
9.	Plan operating effectiveness testing	Plan the substantive procedures to be performed in testing the controls by Preparing a Questionnaire	ICQs for substantive Procedures

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**...Steps to perform...**

Step	Particulars	Steps performed	Reference
10.	Plan nature, timing and extent of testing operative effectiveness	Planning the nature, timing and extent of substantive procedures to be performed.	Risk Matrix and Control
11.	Perform operative effectiveness testing	Perform substantive procedures as planned in step 9 by answering the questions and documenting the same	ICQs for substantive procedures
12.	Assess findings and conclude on operative effectiveness	Conclude whether the control is performing effectively or not	Risk Matrix and Control
13.	Form opinion on IFC	Conclude whether the combination of controls is able to mitigate the risk or not and prepare the list of identified design gap for identified risks	Risk Matrix and Control

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### ...Steps to perform...



Step	Particulars	Steps performed	Reference
14.	Assess impact on audit opinion	Assess whether there is a risk of material misstatement in FS due to material weakness in internal controls	Audit Report
15.	Form audit opinion on FS	On the basis of the steps performed above, determine whether to give a clean or modified opinion	Audit Report

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### ...Steps to perform...

**Written Representations...**

- Acknowledging management’s responsibility for establishing and maintaining IFC over FR and its operating effectiveness
- Management has evaluated and assessed the adequacy and effectiveness of IFC over FR – Management has specified control criteria
- Management did not use the auditor’s procedures as part of basis of its assessment of IFC over FR
- Management’s conclusion is based on the control criterial as of the balance sheet date
- Management has disclosed to the auditor all deficiencies (including significant deficiencies or material weaknesses) in the design or operation of IFC over FR
- Describing any fraud resulting in a material misstatement of the company’s FS

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## ...Steps to perform...

### ...Written Representations

- ❑ Describing any other fraud not resulting in a material misstatement but involves senior management or those who have a significant role in the company's IFC over FR
- ❑ Control deficiencies identified and communicated to the AC during previous engagements have been resolved or those which have not been resolved
- ❑ Whether there were, subsequent to the date of report, any change in IFC over FR that affect IFC over FR, including any corrective actions taken by management

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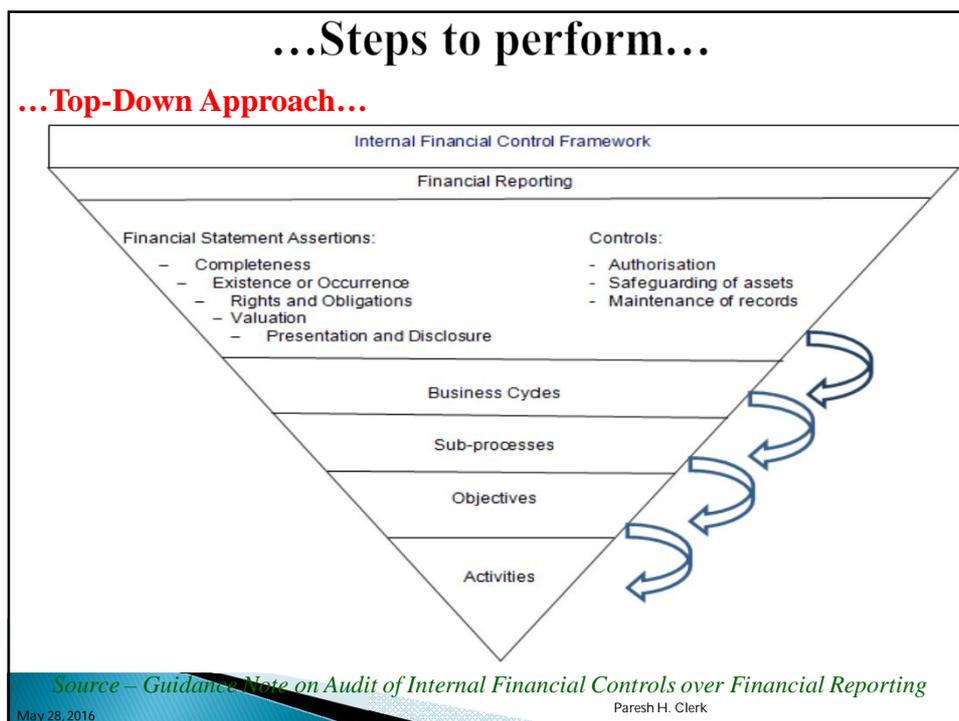
## ...Steps to perform...

### Top-Down Approach...

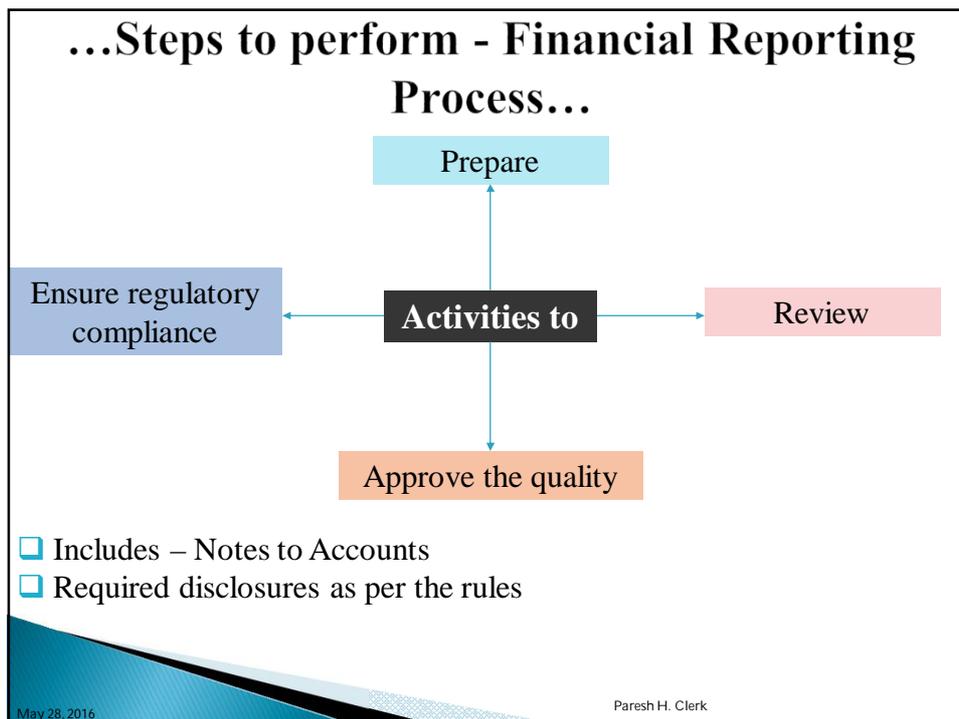
- ❑ Begins at FS level with the auditor's understanding of the overall risks to **IFC over FR**
- ❑ Identify entity-level controls and works down to-
  - Significant accounts
  - Disclosures
  - Their relevant assertions
- ❑ Understand likely sources of material misstatement to the FS and related disclosures
- ❑ Select controls to test
- ❑ Testing controls –
  - Testing design effectiveness
  - Testing operating effectiveness

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- ### ...Steps to perform ...
- Understanding and Evaluating Financial Reporting Process**
    - Understanding Financial Reporting Process
    - Understanding the application systems and controls
    - Understanding accounting policies
    - Understanding the process for recording journal entries
    - Understanding the process for disclosures
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- ### ...Steps to perform - Financial Reporting Process...
- Auditor to -
    - Assess inputs
    - Perform procedures
    - Review process outputs to prepare FS
    - Obtain sufficient audit evidence
  - Use of technology – Interfaces between various systems
  - Management Participation
  - Locations involved
  - Adjusting and eliminating entries – Classification Consistency – Accounting policies and estimates, appropriate disclosures
  - Understanding significant accounts -
    - Flow of accounts
    - Materiality
  - Analytical procedures
  - Analysing business risks
  - What can go wrong – No need no Surprises
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## ...Steps to perform...

### Entity-level Controls...

- Controls that have a pervasive effect on a company's internal control
- Control environment, risk assessments, centralised processing, controls to monitor other controls
- Controls -
  - Addressing significant risks
    - Over selection and application of accounting policies
    - Over adjusting entries
    - Over significant entries w.r.t. occurrence, existence, completeness, valuation, rights or obligations, assertions of presentation and disclosure
    - Over error correction procedures
- IARPR Process – initiate, authorise, record, process and report JVs
- Management estimate for bias
- Training of employees involved
- Oversight of work done by outsourced professionals
- Manuals, flowcharts, questionnaires, job descriptions

## ...Steps to perform...

### ...Entity-level Controls...

- May be classified into 3 buckets –
  - **Indirect entity-level controls** –
    - Do not themselves directly address RMM at the account / assertion level but are important to effective internal control
    - Include controls that fall within the - control environment, risk assessment, monitoring, and information and communication components of internal control system including the general IT controls
  - **Direct entity-level controls that are not precise enough** –
    - Directly address RMM but are not precise enough *on their own* to fully address RMM at the account/assertion level
    - Auditor may identify these as relevant controls and test them
    - Auditor should also identify and test the effectiveness of other controls that in combination with the entity level control address RMM
  - **Direct entity-level controls that are precise enough** –
    - Directly address RMM at the account / assertion level
    - Precise enough on their own to fully address the RMM

## ...Steps to perform...

### ...Entity-level Controls...

- Begin identification of ELCs with discussions between the auditor and appropriate management personnel for –
  - Obtaining a preliminary understanding of each component of internal financial controls
- Assess the level of precision –
  - Whether the control is designed in a manner to prevent / detect on a timely basis misstatements in one or more assertions that could cause the FS to be materially misstated
  - Whether such control is operating effectively
- ELCs include controls –
  - Related to the control environment
  - Over management override

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## ...Steps to perform...

### ...Entity-level Controls...

- Assess the risk of management override – SA 240 – Auditor to perform the following procedures to obtain information to be used in identifying fraud risks –
  - Conduct an engagement team discussion regarding fraud risks
  - Make inquiries of management, AC, if any, and others in the company to obtain their views about the risks of fraud and how those risks are addressed
  - Consider fraud risk factors
  - After identifying fraud risks, the auditor to assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks

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## ...Steps to perform...

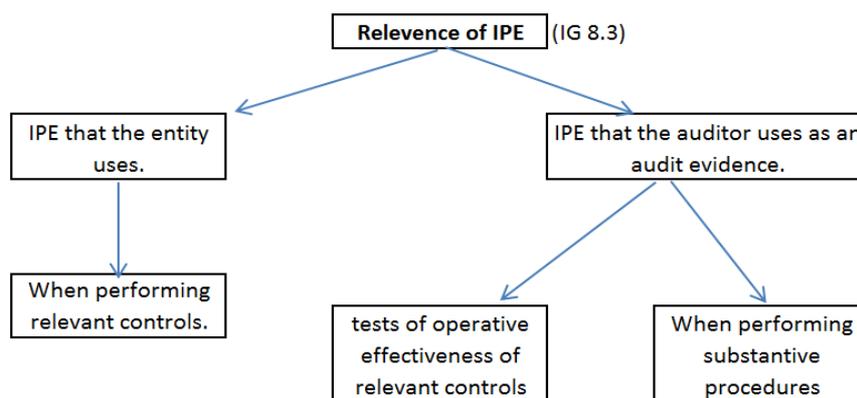
### Information Provided by the Entity (“IPE”)...

- ❑ It is typically in the form of a "report" which may be either –
  - System-generated
  - Manually-prepared
  - Combination of both
  - Example - Download of system accumulated data that is then manipulated in an Excel spreadsheet
- ❑ Direct testing
  - Only in respect of standard parameter driven reports – generated directly from the system
  - Test only the completeness and logic of reports
  - Adopt benchmarking
- ❑ Testing controls that address the accuracy and completeness of the IPE –
  - Test certain specific aspects

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## ...Steps to perform...

### ...Information Provided by the Entity (“IPE”)...



Source – Guidance Note on Audit of Internal Financial Controls over Financial Reporting

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## ...Steps to perform...

### ...Information Provided by the Entity (“IPE”)...

- ❑ Testing of Spreadsheets... –
  - Important consideration
  - Involves interacting with management at an early stage – Since there is lack of awareness of assessing documenting formalised controls
  - Spreadsheets are used to –
    - Generate information to enable monitoring by the management of various activities
    - Preparing FS
  - Document controls as a part of RCM of the individual process and reporting process

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## ...Steps to perform...

### ...Information Provided by the Entity (“IPE”)...

- ❑ ...Testing of Spreadsheets –
  - ❑ Change controls
    - Involves tracking of version changes
    - Testing and approve of updates prior to deployment
  - ❑ Access controls –
    - Spreadsheets to be stored in files – Access to be restricted
    - Formula fields to use cell protection measures
  - ❑ Input controls –
    - Validate inputs when manually entering the data or importing it
    - Reconcile control totals with the source data
  - ❑ Calculation controls –
    - Use automated algorithms with access and change controls
    - Review important formulae periodically

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### ...Steps to perform...

#### Determining Design Effectiveness of a Control

- ❑ A Design of Control is **effective** if -
  - Operated by person possessing necessary **authority**
  - Operated by person possessing necessary **competence**
  - Control satisfies the control **objective**
  - Can **effectively prevent or detect errors or fraud** that could result in material misstatements in the financial statements
- ❑ Procedures the auditor performs include –
  - Inquiry
  - Observation
  - Inspection
  - Walkthroughs that include these procedures are sufficient to evaluate design effectiveness

#### Determining Design Effectiveness of Control

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### ...Design Gaps - Examples...

Sr No.	Area	Gaps	Action to be taken
1.	Revenue from operations and Trade receivables	<ul style="list-style-type: none"> <li>Credit Limit is not set as defined or even proper authentication thereof</li> <li>Inadequate documentation for noting the credit limit</li> </ul>	<ul style="list-style-type: none"> <li>Credit limits should be ratified by the specified Sales Director</li> <li>Credit limit as per the system and written approval of Sales Director should be cross verified by the Manager Accounts</li> </ul>
		Outward Register or gate pass are not compared with the Sales Register	Outward Register should be linked with gate pass after applicability of excise duty
		No provision for Written approval for modification in credit limit by authorised person	All changes in the credit limits should be preapproved by the directors in the written form
		Price list updated by an IT Executive, based on modification sheet, is not signed by the Senior IT Executive	Senior personnel should cross verify the price list updated and sign the same
		No evidence to state that the Provision for Doubtful Debts is reviewed by a senior personnel	Entry for provision for doubtful debts should be verified and signed by the senior personnel at the month end

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...Design Gaps - Examples...			
Sr No.	Area	Gaps	Action to be taken
2.	Purchase to Payments	<ul style="list-style-type: none"> <li>No system of auto debit or policy of issue of credit note when there is difference between the rate as per PO and the Purchase Bill</li> <li>the change in rate is mutually agreed</li> </ul>	<ul style="list-style-type: none"> <li>There should be a policy to issue a Credit Note once the change in price is negotiated</li> <li>A copy of the Credit note should be given to the Accounts and Purchase department</li> </ul>
3.	Investments	Profit Calculation on sale of Investment, Investment register, Working for devaluation of Investments, Total Investment in Mutual Funds may be reviewed by a senior personnel but the processes are not documented	Summary for Profit, Total Investment outstanding and evaluation should be prepared and signed by the senior personnel at month end
4.	Fixed Assets and Depreciation	<ul style="list-style-type: none"> <li>No process to intimate the confirmation of CWIP when is put to use</li> <li>Accounts Department is not informed about the capitalisation</li> </ul>	Process of confirmation should be in place
		Fixed Asset additions, Depreciation, CWIP, Reconciliation of Books and Fixed asset register is reviewed time to time but no documentation is maintained	The processes followed by the management and detailed note on discrepancies and treatment in the books of account should be documented

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### ...Steps to perform...

Risk Relationship to Audit Evidence...

$$AR = IR * CR * DR$$

- AR – Allowable audit risk** – Material misstatement remains undetected
- IR – Inherent risk** – Material misstatement assuming there were no related controls
- CR – Control risk** - Material misstatement could occur and will not be prevented / detected on a timely basis by IC
- DR – Detection risk** – Audit procedures will fail to detect a material misstatement if it exists
- Risk of Fraud**

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## ...Steps to perform...

### ...Risk Relationship to Audit Evidence...

#### ☐ Remediation Testing

- Prior to the balance sheet date, management might implement changes to the company's controls
- If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment - Auditor to test the design and operating effectiveness of those superseded controls
- **To give unqualified opinion if any issues or deficiencies are remediated before the balance sheet date**
- Auditor not to express an opinion on management's disclosure about corrective actions taken by the company after the balance sheet date

#### ☐ Roll forward procedures

- When the auditor reports on the effectiveness of controls as of the balance sheet date and obtains evidence about the operating effectiveness of controls at an interim date
  - He or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary

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## ...Steps to perform...

### Special Considerations for Subsequent years' audits

- ☐ Auditor cannot choose to defer testing of certain controls for the reason that they were tested in the immediate previous year
- ☐ Rotation / cyclical plan for testing **IFC over FR** may be permitted in limited circumstances
- ☐ Auditor may also use a benchmarking strategy for automated application controls

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## ...Steps to perform - Evaluating identified deficiencies...

### Control Deficiency

It exist when “Design or Operation of a control does not allow management / employees to perform designed function in normal course so as to detect / prevent material misstatements on a timely basis”

### Significant Deficiency

- ❑ It is a deficiency, or a combination of deficiencies that is important enough (reasonable possibility of not preventing or detecting misstatement) to merit attention of TCWG
- ❑ Deficiency in design exists when –
  - A control necessary to meet the control objective is missing, or
  - An existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met
- ❑ Deficiency in operation exists when –
  - A properly designed control does not operate as designed, or
  - When the person performing the control does not possess the necessary authority or competence to perform the control effectively

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## ...Steps to perform - Evaluating identified deficiencies...

### ❑ Examples - Significant Deficiencies

- Controls over the selection and application of accounting principles that are in conformity with GAAP
  - To have sufficient expertise in selection and application thereof – qualification and competence of person responsible for the same
- Anti fraud programs and controls
- Controls over non-routine and non-systematic transactions
- Controls over period end financial reporting process
- Controls over procedures to enter transaction totals in GL – initiate, authorise, record and process journal entries into general ledger, record recurring, non-recurring adjustments to FS

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## ...Steps to perform - Evaluating identified deficiencies...

### □ Examples - Significant Deficiencies

#### Qualified Opinion

According to the information and explanations given to us and based on our audit, the following material weakness have been identified as at March 31, 2016;

- a) Internal Financial Control over credit authorization, in the areas where there are cash transaction (SBU- Tours & Travels [T&T]), needs strengthening. While analysing the gaps, it was observed that, preventive control, ensuring independence of cash and accounting function in implant office needs improvement.

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.

#### Other Matter

During the year under audit, the company has initiated a process of having comprehensive model for the streamlining the internal control including internal control over financial reporting incorporating RCM and gap tracking with a description of the objective, process and risk thereof. On walkthrough of the model for testing and making review of adequacy and

## ...Steps to perform - Evaluating identified deficiencies...

### □ Examples - Significant Deficiencies

effectiveness of the system of control in place, some gaps have been identified both in adequacy of design and effectiveness. This is however under the active process of meeting the gaps with effectivity.

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, 2016, based on 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 my / our audit of the March 31, 2016 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

## ...Steps to perform - Evaluating identified deficiencies...

### Severity of Deficiency...

- To **evaluate**, auditor to consider -
  - Likelihood that the deficiency will result in a financial misstatement
  - Magnitude of such an outcome (a potential misstatement)
  
- It does not depend on whether a misstatement actually has occurred

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## ...Steps to perform - Evaluating identified deficiencies...

### ...Severity of Deficiency...

- Risk factors for reasonable possibility of a deficiency -
  - Nature of the FS accounts, disclosures, and assertions involved
  - Susceptibility of the related asset or liability to loss or fraud
  - Subjectivity, complexity, or extent of judgement required to determine the amount involved
  - Interaction or relationship of the control with other controls, including whether they are interdependent or redundant
  - Interaction of the deficiencies
  - Possible future consequences

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## ...Steps to perform - Evaluating identified deficiencies...

### ...Severity of Deficiency...

- ❑ Factors that affect the magnitude of the misstatement resulting from a deficiency-
  - FS amounts or total of transactions exposed to the deficiency
  - Volume of activity in the account balance or class of transactions exposed to the deficiency
- ❑ To determine whether a control deficiency is a significant deficiency or material weakness
  - The auditor to evaluate the effect of compensating controls
- ❑ To have a mitigating effect - the compensating control to operate at a level of precision
  - To prevent or detect a misstatement that could be material.

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## ...Steps to perform - Evaluating identified deficiencies...

- ❑ **Material weakness** - Is a deficiency or combination thereof in **IFC over FR** such that there is a reasonable possibility of a **material** misstatement will not be prevented or detected on a timely basis
- ❑ A material weakness in IFC may exist even when the FS are materially misstated
- ❑ **Examples - indicator of a significant deficiency and a strong indicator of material weakness...** -
  - Ineffective oversight of financial reporting and IC by TCWG
  - Identification by the auditor of a previously unidentified material misstatement
  - An ineffective internal audit function or risk assessment which are important to monitor
  - For complex entities in highly regulated industries, an ineffective regulatory compliance function – material effect on the reliability of financial reporting

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## ...Steps to perform - Evaluating identified deficiencies

### ☐ ...Material Misstatement - Examples-

- For complex entities in highly regulated industries, an ineffective regulatory compliance function – material effect on the reliability of financial reporting
- Identification of fraud of any magnitude on the part of senior management
- Failure to assess the effect of a significant deficiency previously communicated to management or TCWG
- Ineffective control environment – control deficiencies in various other components of IC
- Restatement of previously issued FS to reflect correction of a material misstatement – includes due to error or fraud
- Misstatements involving estimation and judgment require material adjustments and corrections of recorded amounts

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## Reporting...

### ☐ Auditor's Report - elements... –

- **Title** – To include the word independent
- **Management's Responsibility Statement** for –
  - Maintaining adequate and effective **IFC over FR**
  - Assessing the adequacy and effectiveness of **IFC over FR**
- An **identification of the benchmark criteria** used by the management
- **Auditors' Responsibility Statement...** –
  - **To express an opinion** on the company's **IFC over FR** based on his or her audit
  - **Audit was conducted in accordance with the Guidance Note on Audit of IFC over FR (the GN) and the Standards on Auditing ("SAs")**, to the extent applicable

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## ...Reporting...

- ...Auditor's Report – Elements... –
  - ...Auditors' Responsibility Statement... –
    - GN and SAs require that the auditor plan and perform the audit to **obtain reasonable assurance** about whether adequate and effective **IFC over FR** were maintained in all material respects
    - An audit includes **obtaining an understanding** of –
      - **IFC over FR** assessing the risk that a material weakness exists
      - Testing and evaluating the adequacy and operating effectiveness of **IFC over FR** on the assessed risk,
      - Performing such other procedures as the auditor considered necessary in the circumstances
    - The auditor believes the audit **provides a reasonable basis** for his or her opinion

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## ...Reporting

- ...Auditor's Report - Elements... –
  - **Limitations Paragraph** –
    - **IFC over FR** may not prevent or detect misstatements and
    - That 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
  - **Opinion Paragraph** - **Whether the company maintained**, in all material respects, **adequate IFC over FR** and **whether they were operating effectively** as of the balance sheet date, based on the control criteria
  - Signature of the auditor with firm name
  - Place and date of the audit report
    - **Same** as that of the date of the audit report on the FS
  - **Also Firm's Registration and Membership Number (ICAI Notification)**

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## Audit Opinion - Modified...

- ❑ **Pervasive effects on IFC over FR -**
  - Are not confined to IC over specific elements, accounts or items of the FS
  - If so confined, represent or could represent a substantial proportion of FS or impacts the audit opinion on FS
  - In relation to disclosures, are fundamental to users' understanding of FS
- ❑ **Modified opinion –**
  - A qualified opinion
  - An adverse opinion
  - A disclaimer of opinion

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## ...Audit Opinion - Modified...

- ❑ **Circumstances –** When the auditor -
  - Concludes that, based on the audit evidence obtained, **IFC over FR** is designed, implemented or operated in such a way that –
    - It is unable to prevent, or detect and correct material misstatements in FS on a timely basis, or
    - The control is missing
  - Is unable to obtain sufficient appropriate audit evidence to conclude that **IFC over FR** is 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, or detect and correct material misstatements in FS on a timely basis

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## ...Audit Opinion - Modified...

- ❑ Auditor's report to state –
  - **Definition of a material weakness**
  - A statement that a **material weakness has been identified**
  - A **description** of the material weakness
    - To provide the users with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's FS
- ❑ Auditor to determine the effect of modified opinion on **IFC over FR** on opinion on the FS
  - To disclose **whether opinion on the FS was affected by the modified opinion on IFC over FR**

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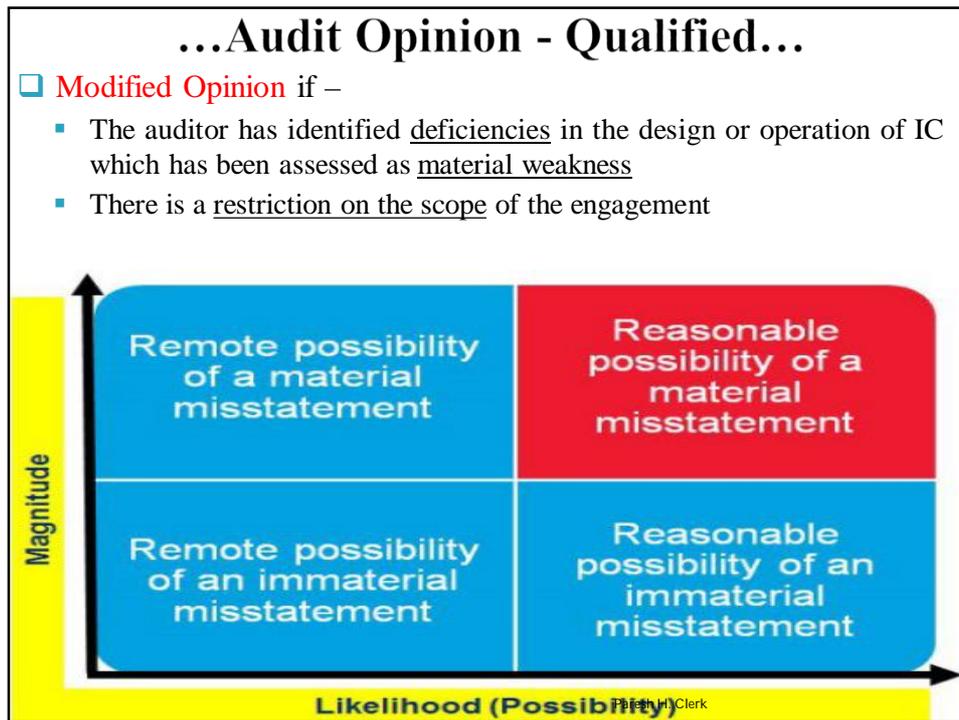
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## ...Audit Opinion - Qualified...

- ❑ **Qualified Opinion** - When the auditor, having obtained sufficient appropriate audit evidence, concludes that –
  - Such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the FS on a timely basis; or the control is missing
  - But the effects/possible effects of the material weakness in such IC are material but is not pervasive to the FS
  - Illustrations

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### ...Audit Opinion – Adverse...

☐ **Adverse Opinion** - When the auditor, concludes that:

- Such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the FS on a timely basis; or the control is missing -
  - The effects of the material weakness in such IC are both material and pervasive, even if the audit opinion on the FS is unmodified; the system of **IFC over FR** adopted by the Company does not consider / adequately consider the essential components of IC or
- The audit opinion on the FS is required to be modified
  - Modification is also consequent to the material weakness in the company's **IFC over FR**
- Illustrations

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## ...Audit Opinion - Disclaimer...

### ❑ **Disclaimer of Opinion** – Situations –

- If the company has not established its system of **IFC over FR** considering the essential components of IC
- The auditor is unable to obtain sufficient appropriate audit evidence to express an opinion on **IFC over FR** –
  - But is able to perform appropriate substantive procedures to express an opinion on FS
- When the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion on the company's **IFC over FR**
  - The auditor concludes that consequent to the material weakness in such IC the possible effects of undetected misstatements could be both material and pervasive

### ▪ Illustrations

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## ...Audit Opinion - Modified

### ❑ **Subsequent interim period financial reporting**

- If the auditor's report for the audit of IFC for the financial year proceeding the interim period was modified consequent to material weakness -
  - Auditor to **consider the effect of such modification** when carrying out a review of interim FS under SRE 2400 or SRE 2410
  - Auditor to **carry out additional procedures** to determine if the material weakness and the **significant deficiency in the IFC have been remediated**
    - **If not remediated** - To **modify report** on the interim FS describing the material weakness reported earlier and stating that based on the procedures carried out, the said material weakness in IC does not appear to have been remediated
- If the interim FS are subject to audit, the auditor should **comply with the Standards on Auditing** -
  - In planning and performing the audit, the auditor to **consider the effect of the significant deficiency or material weakness** reported in the previous financial year on the interim FS

Auditor is **not required to separately test and report on the IFC** in the interim period

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### Format of Independent Audit Report

Illustration	Particulars	References
1	<u>Unmodified Opinion</u> on Standalone FSs, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding internal financial controls (IFC) is required.	Added to Appendix to SA 700
2	<u>Unmodified Opinion</u> on Standalone FSs, Emphasis of Matter Paragraphs, Reporting on clause 143(3)(i) regarding IFCs is not required.	
3	<u>Qualified Opinion</u> on Standalone FSs, Qualification is quantifiable, Reporting on clause 143(3)(i) regarding IFCs is not required.	Added to Appendix to SA 705
4	<u>Qualified Opinion</u> on Standalone FSs, Qualification is not quantifiable, Reporting on clause 143(3)(i) regarding IFCs is not required.	
5	<u>Adverse Opinion</u> on Standalone FSs, Reporting on clause 143(3)(i) regarding IFCs is not required.	
6	<u>Disclaimer of Opinion</u> on Standalone FSs, Reporting on clause 143(3)(i) regarding IFCs is not required.	

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### Audit Report – Other Considerations...

- May issue **separate reports** on the company’s FS and on **IFC over FR**
- Documentation (to comply with SA 230) - To provide –
  - A sufficient and appropriate record of the basis for the auditor’s report
  - Evidence that the audit was planned and performed in accordance with-
    - GN
    - Applicable SAs
    - Applicable legal and regulatory requirements

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## ...Audit Report – Other Considerations

### □ Joint Audits and Branch Audits

- To comply with the requirements of SA 299 on “Responsibility of Joint Auditors”
- Considerations –
  - Division of work
  - Coordination
  - Relationship among joint auditor / branch auditor
  - Reporting responsibilities

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