

Responsibilities of auditors while undertaking IFC reporting – role of documentation

Seminar on Internal Financial Controls over
Financial Reporting
Organised
By
Western India Regional Council

Presentation
By
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On
Saturday, June 3, 2017

Agenda for the day...

1 Scope and applicability for reporting on IFC

2 Statutory Provisions

3 Process and Control

4 Auditors Approach

5 Auditor's Report

...Agenda for the day

6

Documentation

Standard Operating Procedure (SOPs)

Risk Control Matrix

Authority Signature Matrix

Responsibility Allocation Matrix

7

Practical Difficulties encountered while conducting IFC audit

Verification of Objective of Control

Management Override

Segregation of Duties

Paper Tiger

Scope for reporting on IFCs

Earlier

Companies
(Auditor's Report)
Order, 2015

Adequacy of Internal control over:

- Purchase of inventory and fixed assets
- Sale of goods and services

Now

Companies Act,
2013
Section 143(3)(i)

Reporting on:

- All controls related to financial reporting
- Adequacy and operating effectiveness of such controls

STATUTORY PROVISIONS:

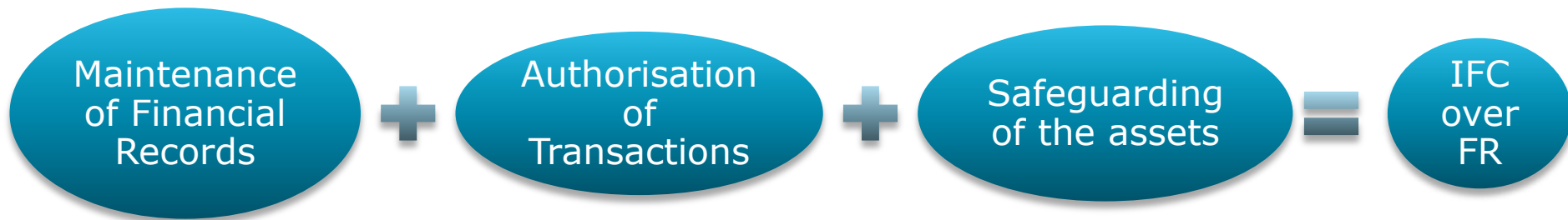
Section 134 (The Companies Act, 2013)

- To state that whether the directors have laid down IFC to be followed by the company and that such controls are adequate and operating effectively

Section 143 (Companies Act, 2013 read with Rule 10 of Companies (Audit and Auditors) Rule, 2014

- To state whether the company has adequate IFC system in place and the operating effectiveness of such controls

IFC over FR vs. IFC



PROCESS AND CONTROLS

- ❑ A **Process** is an action of taking a transaction or an event through an established and usually **a routine set of procedures** or steps
- ❑ A **Control** is an action or activity taken **to prevent or detect misstatements within the process**
- ❑ Example:
 - Process:
 - The billed revenue file is summarised at the month end and the total is recorded into revenue
 - Recording an event or transaction is a process step
 - Control:
 - The control is the activity that is performed to verify that the recording was appropriately performed
 - The Accounts Manager verifies that the billed revenue was properly recorded to revenue by comparing the billed revenue file to the revenue recorded in the general ledger

AUDITORS APPROACH...IFC Design

Planning

Identifying and Understanding:

1. Significant account balances
2. Significant flow of transactions
3. Risks of Material Misstatements (ROMM)
4. Control that addresses the ROMM
5. General IT Controls

Design Implementation

1. Assess Design of controls
2. Assess Implementation of controls
3. Assess Audit impact and plan other audit procedures
4. Plan Operating Effectiveness testing

Operating Effectiveness

1. Plan Nature, Timing and Extent of Operating Effectiveness
2. Perform Operating Effectiveness testing
3. Assess findings and conclude on Operating Effectiveness
4. Form opinion on IFC

Control Reporting

1. Determining New Controls



Step	How to do	What to do	Reference
1	Identify significant account balances or disclosure items	<ul style="list-style-type: none"> Review of Financials is done 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"> Preparation of Process flows based on SOPs Understanding the controls at Entity Level 	1.Process flows of identified areas 2. ELC-Checklist
3	Identify risk of material misstatements	<ul style="list-style-type: none"> Evaluation of Process flows and identification of risks of material misstatements 	Risk Control Matrix
4	Identify controls which addresses risk of material misstatements	<ul style="list-style-type: none"> Identification of controls in place for mitigating the identified risks 	Risk Control Matrix
5	Identify applications, associated IT environment, ITGC	<ul style="list-style-type: none"> Identification of application system used for performing controls in place Identifying IT Risk and Controls 	Risk Control Matrix



Step	What to do	How to do	Reference
6	Assess design of controls	<ul style="list-style-type: none"> Evaluation of design of controls as to its adequacy (Design Effectiveness) for mitigating the identified risks 	Risk Control Matrix and Process flows
7	Assess the implementation of controls	<ul style="list-style-type: none"> By asking queries related to how the control exists and who performs it 	Risk Control Matrix and Process flows
8	Assess audit impact and plan other suitable procedures	<ul style="list-style-type: none"> List down design gaps and decide whether other controls are sufficient for mitigating the risk and accordingly plan OE testing 	Risk Control Matrix
9	Plan operating effectiveness testing	<ul style="list-style-type: none"> Planning the substantive procedures to be performed in testing the controls by Preparing a Questionnaire 	ICQs for substantive Procedures



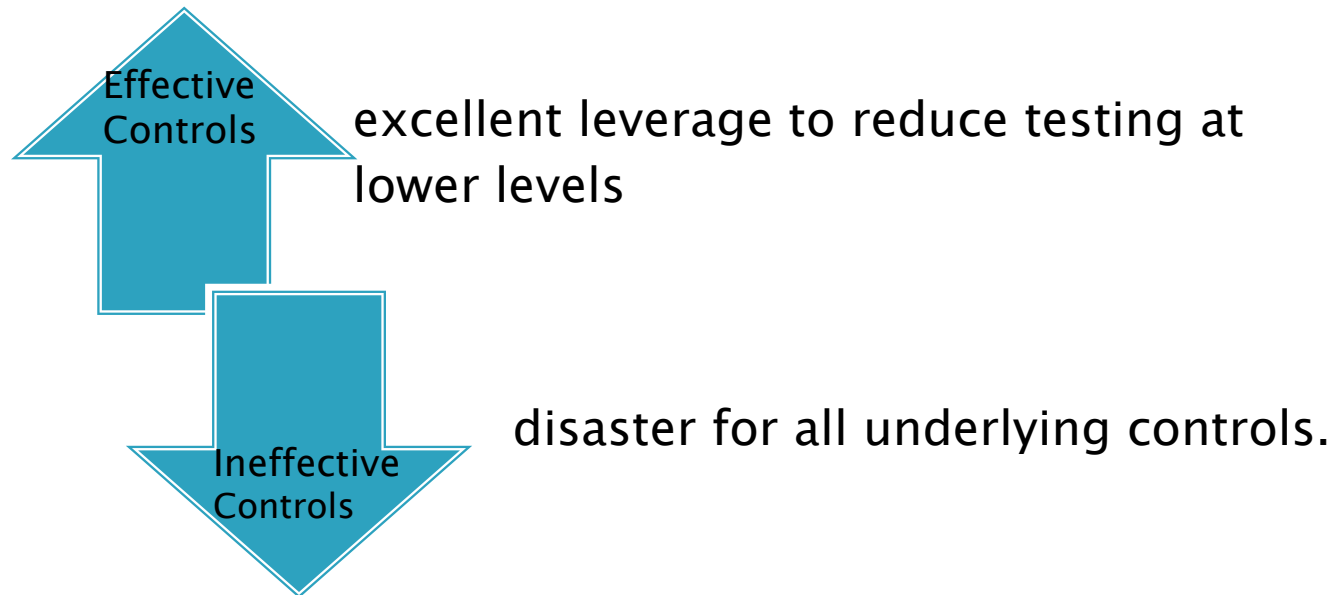
Step	What to do	How to do	Reference
10	Plan nature, timing and extent of testing operative effectiveness	<ul style="list-style-type: none"> Planning the nature, timing and extent of substantive procedures to be performed 	Risk Control Matrix
11	Perform operative effectiveness testing	<ul style="list-style-type: none"> Performing 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	<ul style="list-style-type: none"> Concluding whether the control is performing effectively or not 	Risk Control Matrix
13	Form opinion on IFC	<ul style="list-style-type: none"> Concluding whether the combination of controls is able to mitigate the risk or not and preparing the list of identified deign gap for identified risks 	Risk Control Matrix



Step	What to do	How to do	Reference
14	Determining Control New	<ul style="list-style-type: none"> Based on our Observations and discussion, appropriate plan should be decided 	Design Gaps

...Auditors Approach...

- **Entity level controls (ELC)**, provide the “**tone at the top**” of the organization, and as a result directly or in-directly impact all underlying controls.



- Entity Level Control checklist is attached as:

- [1. ELC - Checklist.xlsx](#)
- [2. FR - RCM.xlsx](#)

...Auditors Approach...

- ELCs may be categorised into three “buckets” align with the distinction of direct controls and indirect controls

Indirect entity-level controls

Those ELCs that **do not themselves directly address risks of material misstatement at the account/assertion level but are important to effective internal control** and therefore relevant in an audit of internal financial controls

Direct entity-level controls that are not **precise enough**

Those ELCs that **directly address a risk of material misstatement but are not precise enough on their own** to fully address a risk of material misstatement at the account/assertion level

Direct entity-level controls that **are precise enough**

Those ELCs that **directly address a risk of material misstatement at the account/assertion level and are precise enough on their own to fully address the risks of material misstatements**

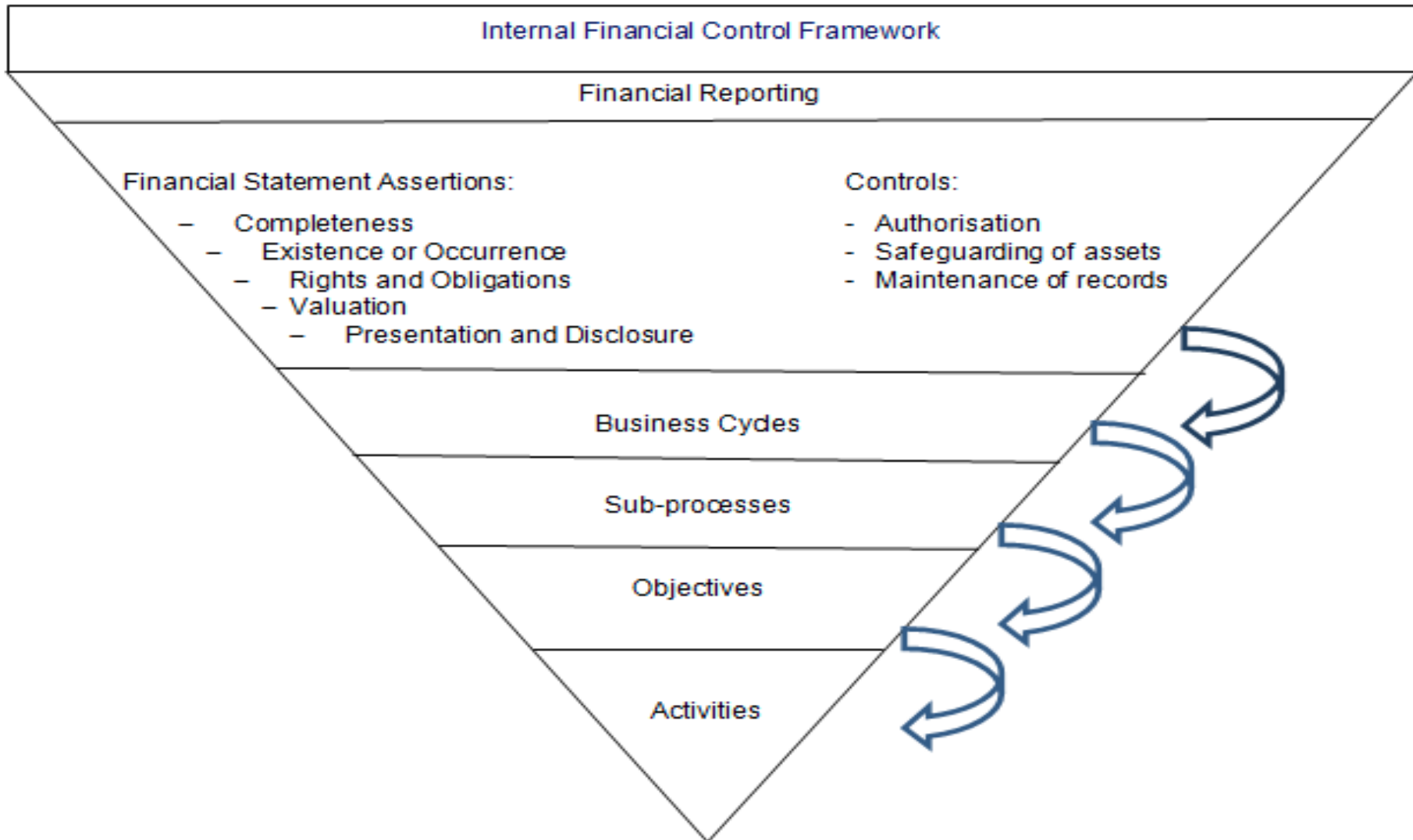
...Auditors Approach...

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

...Auditors Approach

...Top-Down Approach...



Audit's Report...

- 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**

 - **Auditors' Responsibility** –
 - To express an opinion on the company's **IFC over FR**
 - 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

...Auditor's Report...

- ...Auditor's Report - Elements... –
 - **Inherent 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
 - **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**

...Auditor's Report...

□ Modified Opinion if –

- The auditor has identified deficiencies in the design or operation of IC which has been assessed as material weakness
- There is a restriction on the scope of the engagement



...Auditor's Report...

□ Example – Unmodified Opinion

- On the basis of the information and explanation of the Company provided to us, the internal financial control framework, the report of the internal auditors and in our opinion, the Company has adequate internal financial controls in place and the operating effectiveness of such controls.

...Auditor's Report...

☐ Examples -Qualified Opinion...

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

...Auditor's Report...

□ ...Examples – Qualified Opinion...

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

...Auditor's Report...

□ ...Example – Qualified Opinion...

- According to the information and explanations given to us and on our audit, the following material weaknesses have been identified as at 31st March 2016
 - The company did not have an appropriate internal control system for the review of its performance pertaining to execution of controls resulting in customer dissatisfaction and dispute leading to recognition of revenue without establishing reasonable certainty of ultimate collection in earlier years from sundry debtors affecting cash flows adversely
 - The internal auditor of the company has also pointed out in their report material weakness in the internal financial controls stating that the company is not having any ERP system to manage the different operational activities. Due to its present conditions, it is also functioning with some minimum staff strength. Accordingly many of the operations which could have been taken care by a computer system and controls are being managed manually. Hence there is some limitation in control system and processes which have been mentioned in a separate annexure.
- A material weakness is a deficiency...
- In our opinion, except for the possible effects of the material weaknesses described above ...
- We have considered material weaknesses as identified and report above in determining the nature, timing and extent of audit test applied in our audit of March 31, 2016 financial statements of the company and these material weaknesses do not affect our opinion on the financial statements of the company.

...Auditor's Report...

□ ...Example – Qualified Opinion...

- According to the information and explanations given to us and on our audit, the following material weaknesses have been identified as at March 31, 2016.
- At present, the Company is functioning with minimum staff strength in accounting and financial reporting functions. Further, the Company does not have any internal audit as required by Section 138 of the Act. Further, the Company does not have duly constituted Audit Committee as required by Section 177 of the Act. Hence, there is no maker-check concept resulting in some limitation in control system and processes in accounting and financial reporting functions.
- A material weakness is a deficiency...
- In our opinion, except for the possible effects of the material weaknesses described above...
- We have considered material weaknesses as identified extent of audit test applied in our audit of March 31, 2016 financial statements of the Company and these material weaknesses do not affect our opinion on the financial statements of the Company.

...Auditor's Report...

□ ...Example – Qualified Opinion...

- According to the information and explanations given to us and on our audit, the following material weaknesses have been identified as at March 31, 2016.
- At present, the Company is functioning with staff strength of minimal competence in accounting and financial reporting functions. Further, there is no clearly laid down or effective maker-checker concept resulting in some limitation in control system and processes in accounting and financial reporting functions.
- A material weakness is a deficiency...
- In our opinion, except for the possible effects of the material weaknesses described above...
- We have considered material weaknesses as identified extent of audit test applied in our audit of March 31, 2016 financial statements of the Company and these material weaknesses do not affect our opinion on the financial statements of the Company.

DOCUMENTATION...

- ❑ The auditor should comply with the requirements of **SA 230 “Audit Documentation”** to the extent applicable.

- ❑ Requirements are:
 - A sufficient and appropriate record of the basis for the auditor’s report; and

 - Evidence that the audit is in accordance with the Guidance Note, applicable SA and legal and regulatory requirements;

 - Evidence of the auditor’s basis for a conclusion about the achievement of objectives.

...DOCUMENTATION...

Documentation to include:

-
- Standard Operating Procedures (SOPs)
 - Risk Control Matrix (RCM)
 - Authority Signature Matrix (ASM)
 - Responsibility Allocation Matrix (RAM)
 - Design Gaps

...DOCUMENTATION...

- ❑ Small, less complex organisations **may not have SOPs and detailed Process Flow Diagrams, RCMs**, either for all or many of processes

- ❑ The auditor should
 - evaluate controls based on simple flowcharts, checklists, ASM and RAM;
 - understand the flow of transactions and assess effectiveness of built-in controls while carrying out walkthrough tests;
 - resort to observation of activities, inspection of documentation, etc.

...DOCUMENTATION...

□ SOPs...

- A **detailed documentation** of each process that takes place in an enterprise
- Explanation of processes is usually provided in the text form and additionally **assisted by way of flowcharts**
- Help us to study in detail-
 - the process,
 - people involved in the process,
 - segregation of duties,
 - documents involved.

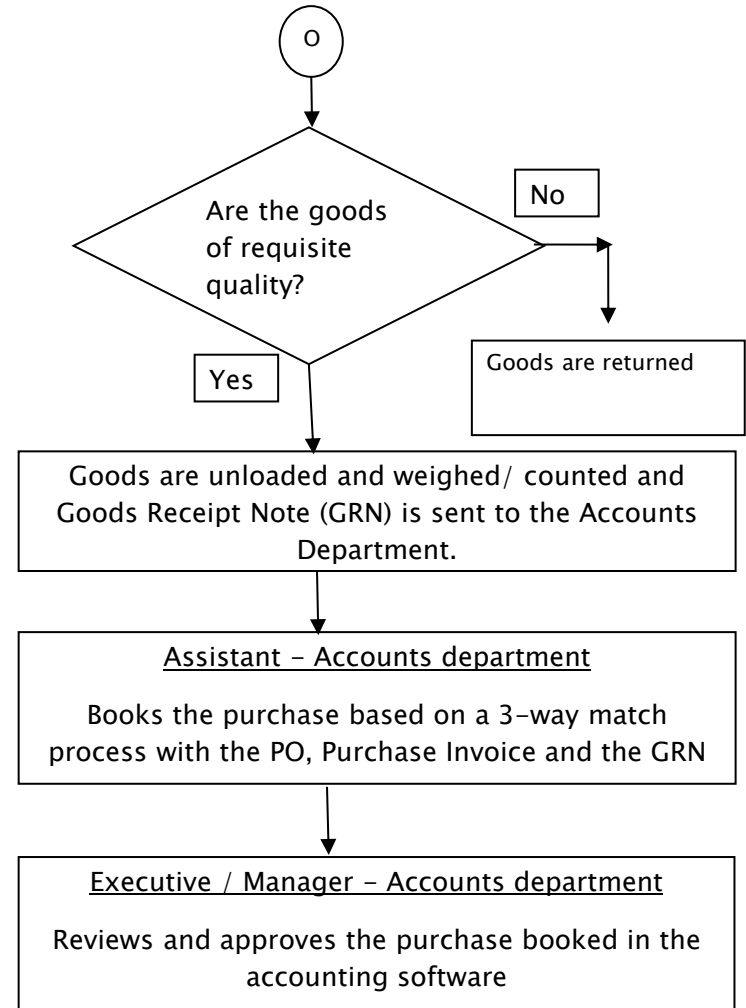
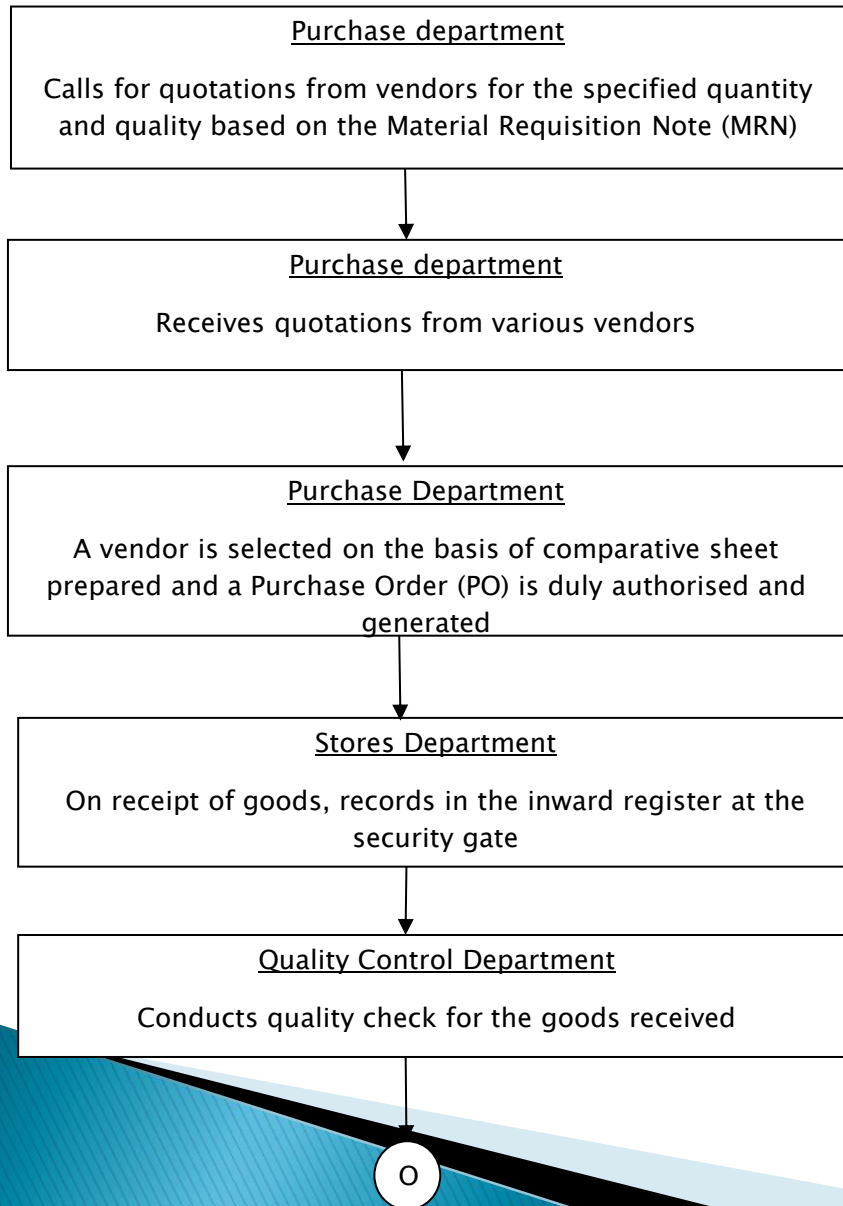
...DOCUMENTATION...

□ ...SOPs...

- **Process Flow Diagrams** are **diagrammatic representations** of SOPs. These diagrams clearly show the flow of documents, persons involved, the controls in place and the Information Produced by the Entity (IPE)

- Process flow diagrams may be a helpful form of documentation for auditors to depict
 - the process to initiate, authorise, process, record and report transactions;
 - the points within the process at which misstatements could occur;
 - and control activities that are designed to prevent or detect such misstatements

Process Flow Diagram for Purchases



...DOCUMENTATION...

□ RCMs...

- Risk Control Matrix (“RCM”) lists down the possible Risks of Material Misstatement (ROMM) along with their assertions and stating the controls in place for each possible and existing ROMM.

- Further, RCM incorporates
 - frequency of controls performed,
 - whether the controls are automated or not,
 - the design and operating effectiveness of the controls

...DOCUMENTATION...

□ ...RCMs

- As a requirement of Design Effectiveness, **completeness of RCM documented for all business cycles to be assessed**

- **Existing RCMs to include :**
 - Review and update RCMs for all financial assertions
 - Controls description to be elaborated
 - Fraud Risk to be highlighted
 - Whether policy or procedure exists or not to be documented
 - Control Owner and responsibility for testing and reporting

...DOCUMENTATION...

□ ASMs:

- Draws out the authorisation at each level for every process that takes place
- ASM typically involves preparing a table for defining authorisation at each level for every process that takes place in the enterprise
- For understandability, a simple format would have
 - the various designations as column headings
 - each procedure as the row inputs and
 - the concerned intersecting cell reflects “No authority” , if
 - the person is not allowed to authorise a transactions, or,
 - the procedure does not involve any authorisation,

An illustrative ASM for some steps of Purchases is outlined below:

Sl. no	Positions Steps	Assistant- Accounts and Finance	Executive- Accounts and Finance or CFO	Stores-in- charge	Executive / Manager- Purchase	Chairman and/ or Managing Director
A.	Vendor Selection and Registration					
1.	Selection of Vendor	x	✓	x	✓	✓
2.	Approval of Vendor Registration Form	x	✓	x	✓	✓
3.	Creation of party ledger	x	✓	x	x	NA
B.	Quotations, Proposals and Purchase Order Generation					
1.	Invite Quotations from new vendors	x	x	x	✓	✓
2.	Purchase order for the Vendor					
C.	Payment Processing					
1.	Summary of payments	Up to ` 1,00,000	Up to ` 2,00,000	x	✓	✓
2.	Generation of cheques	Up to ` 1,00,000	Up to ` 2,00,000	x	✓	✓

...DOCUMENTATION...

□ RAMs:

- It lays down responsibility chart and clearly defines the roles of every person at each level in a department and specifies what is expected of him or her
- RAM brings out segregation of duties
- It also becomes easy for anyone to understand the flow of responsibility in an enterprise

❑ An illustrative RAM for the accounts department :

Designation / Name of the person	Input	Primary Responsibility	Output
Assistant - Accounts and Finance	Approved PO from the Manager – Purchase and the Director	Retrieves purchase challan in the accounting system	Approved PO and Purchase Voucher to the CFO
Executive – Accounts and Finance	Shortage Memo and Debit Memo from Stores in-charge	Prepares Debit Note for claims on quality, rate difference and short quantity	Debit Note to the Director for approval
CFO	Approved PO and Purchase Voucher from Assistant – Accounts and Finance	Verifies Purchase Voucher with supportings	Approved PO and Verified Purchase Voucher to the Director for approval

...DOCUMENTATION...

□ Design Gaps

- A Design of a 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

...DOCUMENTATION...

Test and Conclude Design Effectiveness

Document assessment and evidence of design effectiveness of control

Conclude on Design

Effective

Ineffective

Document conclusion and basis

Evaluate Deficiencies

Assess the risk associated with control

...Design Gaps - Examples...

Sr. No.	Area	Gaps	Action to be taken
1	Shareholders Fund	Bank Reconciliation of Dividends Accounts is done for internal purpose as a rough working	Reconciliation statements shall be made on a quarterly basis
2	Taxes- DT	Deferred Tax Workings and working for provision for Income Tax are prepared by Manager Accounts and reviewed by DGM-Accounts but workings and Journal Vouchers are not signed	A report for all period end Journal Entries will be prepared and signed hereafter
3	Revenue from operations and Trade Receivables	Outward Register or gate pass issued is not compared with sales register	Outward register has been linked with gate pass after applicability of excise duty
4	Taxes- IDT	Journal Entry for Input Tax Credit availed during the month is not signed	Ledger will be attached behind the workings circulated and signed.

...Design Gaps - Examples...

Sr No.	Area	Gaps	Action to be taken
4.	Revenue from operations and Trade receivables	<ul style="list-style-type: none"> • Credit Limit is not set as defined or even proper authentication thereof • Inadequate documentation for noting the credit limit 	<ul style="list-style-type: none"> • Credit limits should be ratified by the specified Sales Executive • Credit limit as per the system and written approval of Sales Executive should be cross verified by the Manager Accounts
		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

...Design Gaps - Examples...

Sr No.	Area	Gaps	Action to be taken
5.	Purchase to Payments	<ul style="list-style-type: none"> 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 the change in rate is mutually agreed 	<ul style="list-style-type: none"> There should be a policy to issue a Credit Note once the change in price is negotiated A copy of the Credit note should be given to the Accounts and Purchase department
6.	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
7.	Property, Plant and Equipment (PPE)	<ul style="list-style-type: none"> No process to intimate the confirmation of CWIP when is put to use Accounts Department is not informed about the capitalisation 	Process of confirmation should be in place
		PPE additions, Depreciation, CWIP, Reconciliation of Books and PPE 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

...Design Gaps - Examples...

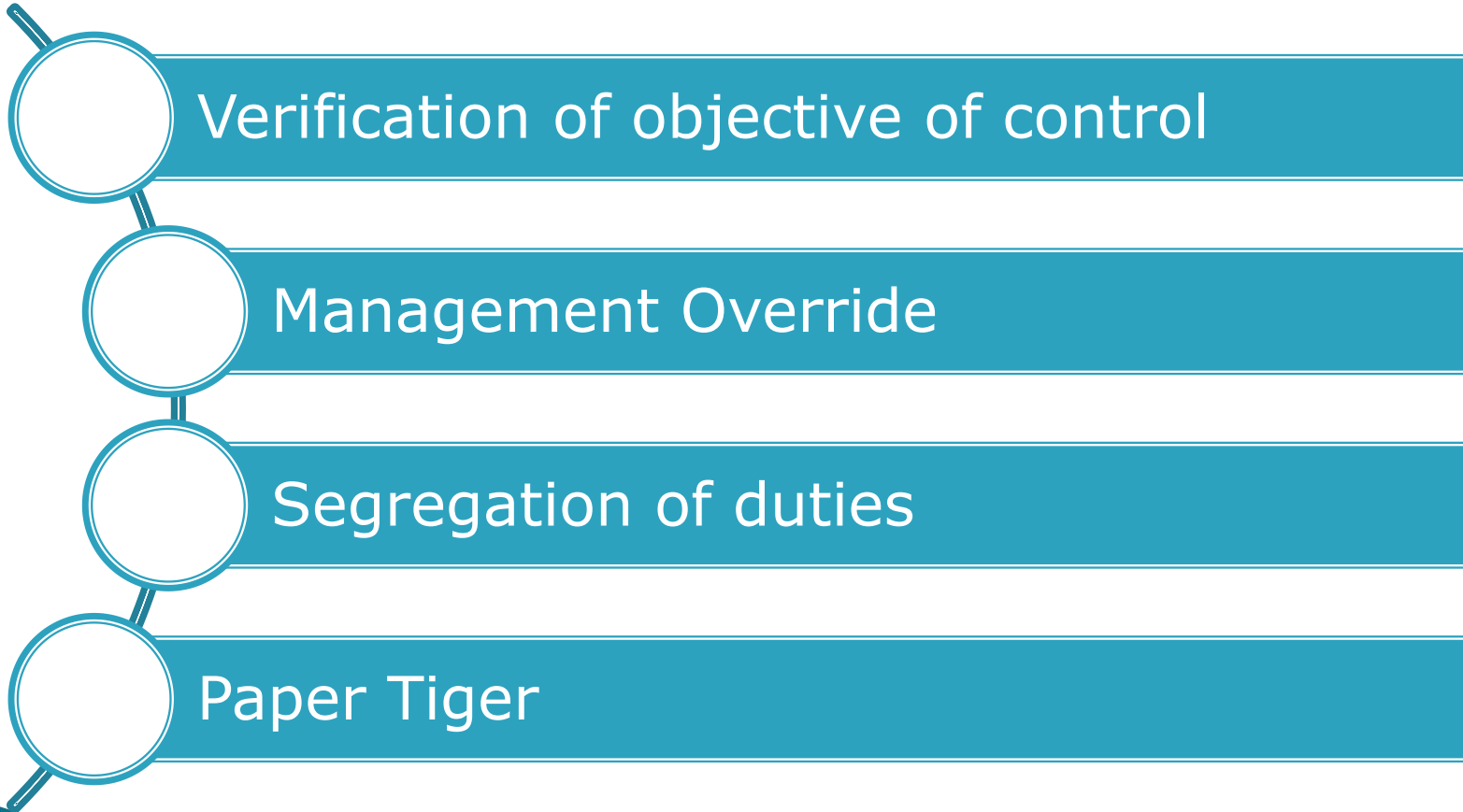
Sr. No.	Area	Gaps	Action to be taken
8	Inventory	Journal Entry for Closing Stock is not Signed by managers preparing and DGM reviewing the workings	A report for all period end Journal Entries will be prepared and signed hereafter.
9	Bank	Except for the month of March, cheques are reversed in month subsequent to month in which check expires.	Reversal of stale cheques shall be done at the month end henceforth.
10	Employee Benefit	Adjustment of advances is reviewed by the personnel giving the advance. No senior person is involved.	Adjustment will be reviewed by Manager Accounts

INHERENT DIFFICULTIES DURING IFC

- ❑ Internal control, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives.

- ❑ Inherent limitations can be such as
 - Management's belief that the **cost of an internal control does not exceed the expected benefits** to be derived.
 - The potential for **human error**, such as, mistakes of judgement.
 - The possibility of **circumvention of internal controls** through collusion with employees
 - The possibility of **management overriding** an internal control.
 - **Manipulations by management** with respect to transactions or estimates and judgements

PRACTICAL DIFFICULTIES DURING IFC...



...PRACTICAL DIFFICULTIES DURING IFC...

□ VERIFICATION OF OBJECTIVE OF CONTROL:

- Objective with control is performed is very important in concluding design and operating effectiveness of controls.

BRS prepared by an
Accounts Manger

Reviewed by CFO
on monthly basis

- The question is whether the objective of manager was to check that
 - reconciliations are being prepared on a timely basis,
 - the nature of reconciling items identified through the process, and
 - reconciling items are investigated and resolved on a timely basis.
- While it can be easily verified that the BRS has been reviewed or not, it is very difficult to comment upon the objective with which the control was performed

...PRACTICAL DIFFICULTIES DURING IFC...

□ RISK OF MANAGEMENT OVERRIDE...

- In smaller, less complex companies,
 - the extensive involvement of owners and senior management in day-to-day activities,
 - fewer levels of managementcan provide additional opportunities for management to override controls or intentionally misstate the financial statements
- For smaller companies, the controls that address the risk of management override might be different from those at a larger company
 - For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override

...PRACTICAL DIFFICULTIES DURING IFC...

□ ...RISK OF MANAGEMENT OVERRIDE

- Smaller, less complex companies can take a number of actions to address the risk of management override. Examples of some of the controls that might address the risk of management override:

- Maintaining integrity and ethical values

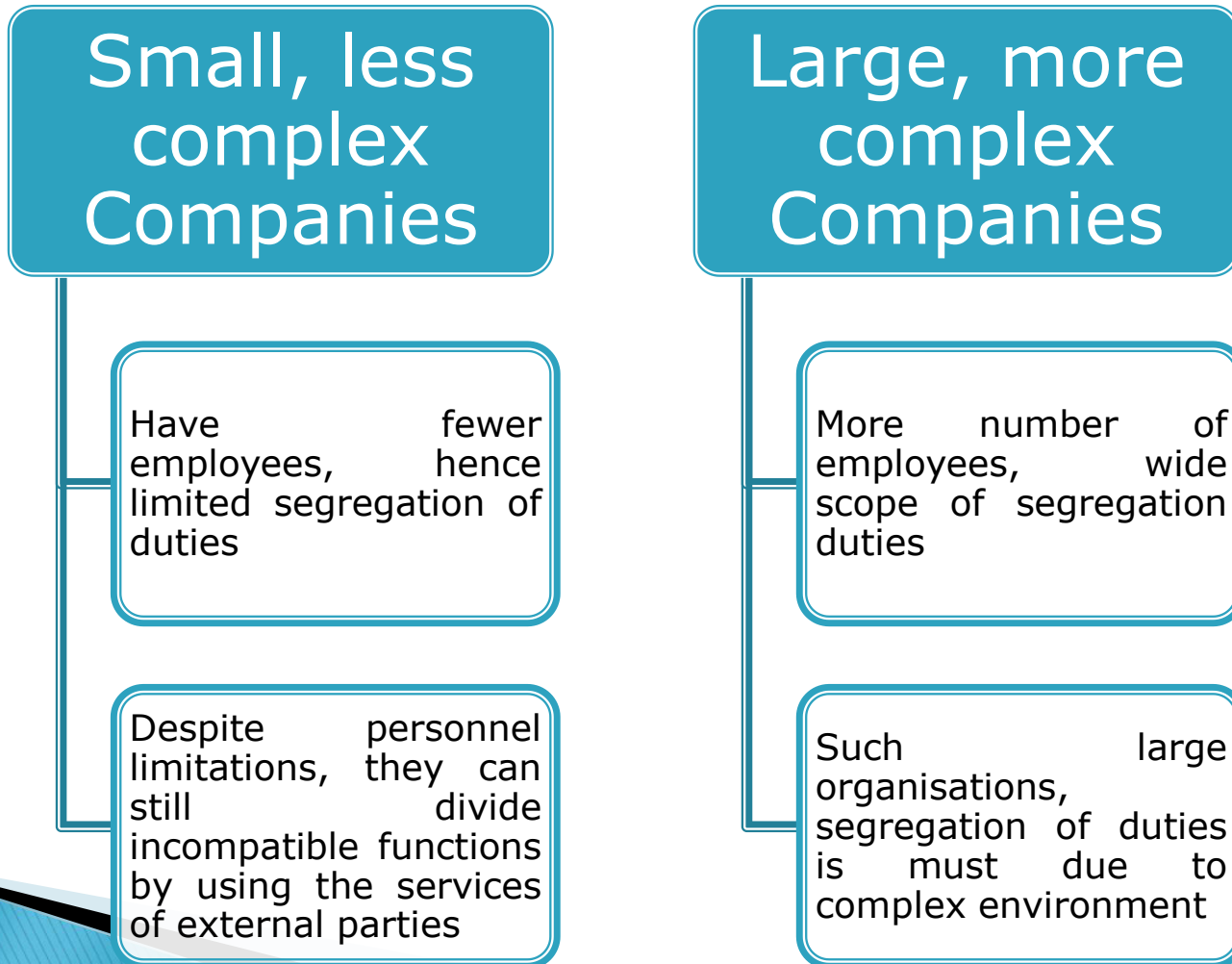
- Active oversight by the audit committee

- Maintaining a whistleblower programme

- Controls over certain journal entries

...PRACTICAL DIFFICULTIES DURING IFC...

□ SEGREGATION OF DUTIES...



...PRACTICAL DIFFICULTIES DURING IFC...

□ ...SEGREGATION OF DUTIES

▪ Example:

- A provider of office furnishings and equipment uses a locked storeroom to store certain key components

Store Person has the following duties:

- access to both the storeroom and the related accounting records.

- to perform periodic spot- checks of the components and

- reconcile them to the general ledger in addition to the inventory ledger

-
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- In such case, the stores person is in a position to both perpetrate and conceal errors or fraud in the normal course
 - For such instances, duties should be segregated and divided among different personnel

...PRACTICAL DIFFICULTIES DURING IFC

□ PAPER TIGER

- Management sometimes design such process which are inspired some excellent policy which is already implemented successfully
- Paper Tiger is when the system has been brilliantly designed but very poorly implemented, and is just on paper, not in effect
- The main reason is that the processes are forced on the employees, instead of explaining the need and sufficient training
- Many times employees are unwilling to perform the required processes due their own incompetence or overwork





Thank you!