

**Implementation Guide on Audit of
Internal Financial Controls over
Financial Reporting with Specific
Reference to Smaller, Less
Complex Companies**



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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FOREWORD

The Companies Act, 2013 had introduced Section 143(3)(i) which requires the statutory auditors of companies to report on adequacy and operating effectiveness of internal financial controls system of the company. In September 2015, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India had issued the Guidance Note on Audit of Internal Financial Controls over Financial Reporting to provide guidance to the members on this new reporting requirement.

I am happy that the Auditing and Assurance Standards Board has now brought out this “Implementation Guide on Audit of Internal Financial Controls over Financial Reporting with Specific Reference to Smaller, Less Complex Companies” for the benefit of the members. The Implementation Guide is written in a simple language in the form of frequently asked questions arising from practical difficulties faced by auditors in the audit of internal financial controls in case of smaller, less complex companies.

At this juncture, I wish to place my appreciation for CA. Shyam Lal Agarwal, Chairman, CA. Sanjay Vasudeva, Vice-Chairman and other members of the Auditing and Assurance Standards Board for their initiatives in bringing out such Implementation Guides for guidance of the members.

I am sure that members would find this publication immensely useful.

August 22, 2016
New Delhi

CA. M. Devaraja Reddy
President, ICAI

PREFACE

The Companies Act, 2013 has introduced some new reporting requirements for the statutory auditors of companies. One of these requirements is reporting on 'internal financial controls' under Section 143(3)(i) of the Act. During the last year, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India had issued the "Guidance Note on Audit of Internal Financial Controls Over Financial Reporting" for providing appropriate guidance to the members on this reporting requirement. The Guidance Note provides guidance for reporting on internal financial controls in case of all types of companies and is quite comprehensive in its approach. Some members requested the ICAI to come out with a simpler guidance for reporting on internal financial controls in case of smaller, less complex companies.

It gives me immense pleasure to place in your hands this "Implementation Guide on Audit of Internal Financial Controls over Financial Reporting with Specific Reference to Smaller, Less Complex Companies" brought out by the Auditing and Assurance Standards Board. The Implementation Guide is in the form of frequently asked questions (FAQs) arising from practical difficulties faced by auditors in the audit of internal financial controls in case of smaller, less complex companies and the responses to those FAQs. However, the members may note that this Implementation Guide should be read in conjunction with the aforesaid Guidance Note while carrying out audit of internal financial controls in case of smaller, less complex companies.

At this juncture, I wish to place on record my gratitude to all the members of Delhi Study Group viz. CA Harinderjit Singh (Convenor), CA Ridhima Dubey, CA Charan Sevak Gupta, CA Lokesh Vasudevan, CA Sujoy Chakrabarty, Shri Rahul Lovell, CA Yogesh Gupta and CA Nitin Kohli for sparing time out of their other preoccupations for developing this

Implementation Guide. I would also like to thank all the members of Jaipur Study Group viz. CA Bhupendra Mantri, CA Vijay Kumar Jain, CA Vishnu Mantri, CA Vikas Gupta, CA Prahalad Gupta, CA Jugal Agrawal, CA Shailendra Agarwal, CA Keshav Garg, CA Rohit Ruwatia, CA Pramod Kumar Boob, CA P D Baid, CA Dinesh Kumar Jain, CA Sanjay Kumar Maheshwari, CA Mukesh Gupta and CA Sandeep Jhanwar for their dedicated efforts in reviewing and finalising this Implementation Guide. My special thanks to CA M. P. Vijay Kumar and CA Dhinal Shah, Central Council Members and the convenors of the study groups for revision of the “Guidance Note on Audit of Internal Financial Controls Over Financial Reporting” for their contribution in finalising this Implementation Guide as well.

I wish to express my sincere thanks to CA M. Devaraja Reddy, President, ICAI and CA Nilesh S. Vikamsey, Vice President, ICAI for their guidance and support to the activities of the Board.

I wish to place on record high appreciation of CA Sanjay Vasudeva, Vice Chairman of the Board for his dedicated efforts in finalising this guidance. I also wish to place on record my sincere thanks to all the Board Members and all the Council Members for their suggestions, support and guidance in finalising this Guide as well as other pronouncements of the Board. I also wish to thank CA Megha Saxena, Secretary to the Board and other officers and staff of AASB for their efforts.

I am confident that the Implementation Guide would be well received by the members and other interested readers.

August 23, 2016
Jaipur

CA. Shyam Lal Agarwal
Chairman,
Auditing and Assurance Standards Board

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INTRODUCTION

Section 143(3)(i) of the Companies Act, 2013 (the “Act”) requires the auditor to report on whether the company has adequate internal financial controls and that they are operating effectively for all companies and is applicable for financial periods commencing on or after April 01, 2015. In this regard, the Institute of Chartered Accountants of India (ICAI) has issued the Guidance Note on Audit of Internal Financial Controls over Financial Reporting (hereinafter referred as the “Guidance Note”) in September, 2015.

This Implementation Guide should be read in conjunction with the Guidance Note while carrying out the audits of internal financial controls over financial reporting in case of smaller, less complex companies.

This Implementation Guide discusses how the guidance given in the Guidance Note may be applied to audits of internal financial controls over financial reporting in case of smaller, less complex companies and addresses some of the practical difficulties that may arise in audits of internal financial controls over financial reporting of such companies. The Guidance Note explains under various paragraphs about audit of internal financial controls over financial reporting for smaller, less complex companies and specially Para 79 of the Guidance Note deals with customizing the audit as under:

“Customising the Audit

79. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Customising is most effective as a natural extension of the risk based approach and applicable to the

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audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.”

This Implementation Guide can further help auditors to design and execute the audit strategy. However, it should be noted that this Implementation Guide does not address all of the requirements or all issues that may be encountered in audit of internal financial controls over financial reporting in case of smaller, less complex companies and does not intend to replace auditor’s judgement that needs to be exercised during the course of audit.

This Implementation Guide is in the form of Frequently Asked Questions (FAQs) arising from practical difficulties faced by auditors in the audit of internal financial controls over financial reporting for smaller, less complex companies.

The responses and illustrations given in this Implementation Guide do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal financial controls over financial reporting.

This Implementation Guide is divided into following specific sections:

1. Understanding and Scoping.
2. Considerations of certain characteristics.
3. Reporting considerations.
4. Appendices containing illustrations of controls and auditor’s reports.

SECTION 1

UNDERSTANDING AND SCOPING

Question 1: What are the Characteristics of Smaller, Less Complex Companies?

Response - The Guidance Note uses the term 'Smaller' rather than 'Small' to signify that it is a relative term covering a wide range of companies that may possess some or similar characteristics. It may also be noted that many smaller companies have less complex operations. Factors that may indicate less complex operations include:

- Concentration of ownership and management in a small number of individuals;
- Straightforward or uncomplicated transactions;
- Simple record-keeping/centralized accounting;
- Few lines of business and few products within business lines;
- Few internal controls;
- Few levels of management with responsibility for a broad range of controls;
- Few personnel, many having a wide range of duties;
- Use of less complex IT systems;
- Extensive involvement by the owners and senior management in the day-to-day activities of the business.

These qualitative characteristics are not exhaustive, nor are they exclusive to smaller companies. Also, all smaller companies need not necessarily display all of these characteristics. The auditor will need to apply judgment to

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determine whether the company is a smaller, less complex company

Question 2: What are the considerations generally to be followed by the auditor in respect of auditing the IFCFR of such companies?

Response - Some of the areas where the audit of internal financial controls over financial reporting of a smaller, less-complex company may require special consideration considering nature of business, size of operation and organisational structure of the entity are given below :

- Obtaining sufficient appropriate audit evidence for companies having limited/less formal documentation;
- Assessing Entity Level Controls to sufficiently address risks of misstatement;
- Evaluating the 'risk of management override' and its mitigating actions;
- Evaluating controls implemented in lieu of segregation of duties;
- Evaluating financial reporting competencies.

Question 3: Is materiality and risk assessment for an audit of IFCFR different from the general risk assessment for financial statement audit?

Response – As stated in paragraphs 86 and 97 of the Guidance Note, in planning the audit of IFCFR:

- the auditor should use the same materiality considerations as used in planning the audit of the company's annual financial statements as provided in SA 320 "Materiality in Planning and Performing an Audit".
- risk factors considered for the identification of significant accounts and disclosures and their relevant assertions are also the same in the audit of IFCFR as in the audit of

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the financial statements. Accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

In view of above, the materiality and risk assessment for an audit of IFCFR will be similar to that of the general risk assessment for financial statement audit.

Question 4: Can the auditor rely on the work of Internal Auditor for the audit of IFCFR?

Response – Reliance on work of an internal auditor can be placed in accordance with the requirements of SA 610, “Using the Work of Internal Auditors”. The auditor, where considered relevant, should determine:

- Whether, and to what extent, to use specific work of the internal auditors; and
- If so, whether such work is adequate for the purposes of the audit.

In accordance with the requirements of SA 610¹ the auditor assesses the competence and objectivity of internal auditors and may also consider, where appropriate, direct assistance of internal auditors.

Question 5: What could be audit consideration in case of IFCFR related to discontinued operation?

Response In respect of discontinued operation, the auditor will need to test, those controls which are relevant as at the year-end (e.g. disclosures related to discontinued operations) and which relates to period during which the component was operating (e.g. sale/purchase).

Question 6: What could be the approach for a combined audit of IFCFR and financial statements?

Response –The audit of IFCFR should be combined with the audit of the financial statements. This means that the

¹ For use of work of an internal auditor, reference should be made to Standard on Auditing 610 (Revised), ‘Using the Work of Internal Auditors’, effective for audits of financial statements for periods beginning on or after April 1, 2016.

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auditor should plan and perform the work to achieve the objectives of both audits, which are as follows:

- *Audit of the financial statements:* To express an opinion on the fairness with which the financial statements present, in all material respects, financial position, results of operations, and its cash flows in conformity with financial reporting framework;
- *Audit of IFCFR:* To express an opinion on the effectiveness of the company's internal control over financial reporting.

While the objectives of the audit of internal controls over financial reporting and audit of financial statements are not identical, the auditor can plan and perform the work to achieve the objectives of both the audits in an integrated manner. Therefore, in a combined audit of internal financial controls over financial reporting and financial statements, the auditor should design testing of controls to accomplish the objectives of both audits simultaneously.

An illustrative approach for combining the audit of IFCFR with the audit of the financial statements is given below. It should be noted that this is an illustrative approach and it is not intended to present all of the procedures that are required for a particular audit.

Illustrative Audit Approach towards combined audit (Also refer Flow Chart on page 45 of the Guidance Note)

The audit process can be broadly summarized in following steps after performing preliminary engagement procedures like agreeing the terms of engagement etc:

Step 1: Audit Planning

- Make a preliminary judgment about materiality. The judgment about materiality is the same for both the audit of the financial statements and the audit of internal financial controls over financial reporting.

Understanding and Scoping

- Develop a preliminary audit strategy covering matters such as general scope and timing of engagement and audit plan based on understanding of the company and its environment.

Step 2: Risk Assessment Procedures

Obtain an understanding of the company and its environment, including its internal control by performing following procedures:

- walkthroughs, or other procedures, to understand the likely sources of misstatement,
- preliminary analytical procedures and procedures to assess the risk of material misstatement due to fraud or error;
- determine relevant assertions and significant accounts and disclosures basis whether there exists a reasonable possibility that they could contain misstatements that could cause the financial statements to be materially misstated;
- use a top-down approach to the audit of internal financial controls over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal financial controls over financial reporting.

Step 3: Auditor response, including tests of accounts and controls

The relationship between tests of controls and substantive procedures is important to the integration of the audit of internal financial controls over financial reporting with the audit of financial statements and thus auditor should consider following approach considering nature of business, size of operation and organisational structure of the entity:

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- Develop an overall response to risks which may affect certain aspects of the audit such as assignment of staff, level of supervision, need for using the work of others (example specialist), appropriateness of planned audit strategy and scope;
- Determine an appropriate mix of the nature, timing, and extent of testing based on the associated risks and other factors;
- Perform testing of design and operating effectiveness of relevant controls; and
- Perform substantive procedures for all relevant assertions, regardless of the assessed level of control risk.

Step 4: Completion and Reporting

In this phase, the auditor should evaluate the results of testing, particularly for identified misstatements and control deficiencies. The auditor should evaluate the misstatements and control deficiencies, individually and in the aggregate to form an opinion that can be expressed in terms of combined audit in accordance with the Guidance Note.

SECTION 2

CONSIDERATION OF CERTAIN CHARACTERISTICS

2.1 Assessing Entity Level Controls to Sufficiently Address Risks of Misstatement

Question 7: Is it necessary that all five components of internal control should be present and functioning?

Response - In general, a system of internal control to be considered adequate should include the following five components:

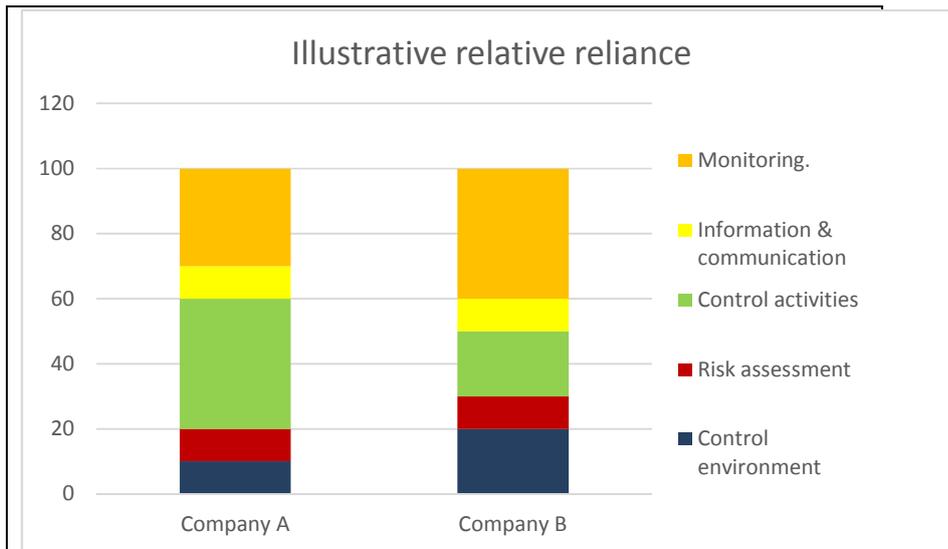
- Control environment
- Risk assessment
- Control activities
- Information system and communication
- Monitoring of controls

The five components work together to reduce risk to reliable financial reporting to an acceptable level commensurate with the size of the company and nature of its business. Because controls can serve different purposes and may differ in the degree to which they address a particular risk, a combination of more than one control, each with limited effect, can lead to satisfactory results.

Example: Company A may rely more on control activities relative to other components of internal controls and Company B may rely more on effectiveness of control environment to reduce risk and monitoring / personal involvement by senior management. Diagram below depicts such relative reliance on difference components of internal controls both leading to satisfactory results i.e. in the example below Company A has more reliance on control

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activities while in Company B more reliance is on monitoring activities. However, in combination with other components of internal controls the same results are achieved in terms of effectiveness of internal controls.



Question 8: Control environment may not be available in documented form. How should an auditor deal with this situation?

Response - Audit evidence for elements of the control environment in smaller companies may not be available in documented form, in particular where communication between management and other personnel may be informal, yet effective.

For example, smaller companies may not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by examples set by management.

Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller

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company's control environment. The nature of the control environment may also influence the significance of other controls, or their absence.

For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in smaller companies. However, it may increase other risks, for example, the risk of management override of controls.

Question 9: What is the importance of evaluating Control Environment in audit of ICFR?

Response - A favorable assessment of the company's control environment can be a positive factor in assessing risk of material misstatement due to error or fraud. On the other hand, an unfavorable assessment of the company's control environment may have a negative impact on the overall effectiveness of the company's internal financial controls over financial reporting and may lead auditor to conclude that there is a need to obtain more evidence as to the effectiveness of the other components of internal control, such as control activities at the process/transaction levels.

Question 10: Is it always necessary to evaluate and test IT General Controls?

Response – IT General Controls shall be evaluated only where the IT system is being relied by the management to operate controls relevant for financial reporting. In case, where controls are largely manual in nature or limited dependency is placed on the IT system, evaluation and testing of IT General Controls may not be necessary.

Question 11: What are the Entity Level Controls, which the auditor should consider for evaluation of internal controls?

Response - The way in which internal control is designed, implemented and maintained varies with a company's size and complexity. Smaller, less complex companies may use

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less structured means and simpler processes and procedures to achieve their objectives.

An illustrative list of questions to evaluate Entity Level Controls in smaller, less complex companies considering nature of business, size of operation and organisational structure of the entity is given in **Appendix 1**. This list is not exhaustive and does not seek to replace the auditor's judgment

Question 12: What type of process level controls need to be considered by an auditor?

Response - Based on the scoping, the auditor may identify the processes to be considered for a more detailed understanding of controls. Typically, process level control activities relevant to the audit of a smaller company are likely to relate to:

- The financial reporting process; and
- Main transaction cycles of revenues, purchases, inventory and payroll.

Each company needs to determine the right set of controls considering nature of business, size of operation and organisational structure of the entity. An illustrative list of process level controls and how these could be evaluated for smaller, less complex companies is provided in **Appendix 2**. This list is not exhaustive and does not seek to replace the auditor's judgment.

2.2 Obtaining sufficient appropriate audit evidence with limited documentation

Question 13: If the company does not have formal documentation of its processes and controls, how can the auditor obtain sufficient understanding from other related documentation?

Response - If the company does not have formal documentation of its processes and controls, the auditor may

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consider whether other related documentation is available for obtaining sufficient understanding. A practical way to identify such other documentation is to look for the information that the company uses to run its business.

Examples of other documentation (if any) that may be considered for obtaining understanding of the company's process level control environment:

- Circulars/Memorandum relating to practices followed for an efficient conduct of business.
- Period closure accounting adjustments circulars/guidelines may specify the period end activities carried out by a company covering some of the aspects e.g. period-end accruals/provisions, period end adjustments for exchange differences, assumptions of estimates including provisions for employee benefits, doubtful debts, warranty, reconciliation of key accounts (inter-company accounts, bank, sub-ledgers and general ledger etc.)
- Internal departmental documents prepared by a department for its functioning.
- Checklists used may provide factors or points to be considered while carrying out an activity/ process so as to ensure accuracy and consistency in processing of the documents.
- Relevant extracts of Management/Internal Audit and key improvement areas and actions to be taken by the senior management/board on periodic basis may provide an insight into the areas covered in the reports to gain understanding of relevant processes.
- Other information available with the company which can be used to supplement process understanding and risk assessment e.g. minutes of Board/Committees meetings, Business Plan, and information prepared for the purpose of obtaining loans from Banks/institutions, rating reports issued by various authorities etc.

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Question 14: Whether absence of formal documentation of operation of control means the control is ineffective? If no, what are the examples of alternative sources of evidence?

Response - The absence of documentation evidencing the operation of a control does not by itself create the presumption of ineffectiveness of the control. Rather, the auditor must be satisfied that the control actually operated through other corroborating evidence that is sufficiently persuasive. In this regard, the following examples of evidence can be considered by an auditor:

- Memorandum that outlines the considerations, rationale and conclusions reached;
- Email correspondence from the control operator demonstrating follow up and resolution of items that meet the criteria/thresholds;
- Corroborating inquiry via discussions with others that interact with the control operator in the performance of the review;
- Detailed meeting minutes, that include the considerations, rationale, conclusions, as well as how those were arrived at;
- Notations on forms, documents or analysis that demonstrate the substance of the execution of the review;
- Recalculations and agreement to underlying data and support when the control is designed to achieve those objectives;
- Obtain an appropriate management representation.

Based on the assessment of evidence collectively, considering circumstances, including the nature, size and complexity of the company, the auditor in judgement may be able to conclude that the control actually operated.

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Question 15: Can effectiveness of a control be inferred from the absence of misstatement detected by substantive procedures performed for financial statements audit?

Response - No. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures performed for financial statements audit. However, the absence of misstatements detected by substantive procedures, should guide the auditor's risk assessments, and in determining the testing necessary to conclude on the effectiveness of a control.

2.3 Evaluating the risk of management override of controls and compensating controls

Question 16: What should be the auditor's approach towards evaluation of risk of management override of controls?

Response - Some of the controls that may address the risk of management override of controls are:

- Maintaining integrity and ethical values;
- Active oversight by the owner manager, senior manager, or board of directors;
- Maintaining a compliant mechanism;
- Controls that prevent or detect unauthorised journal entries e.g. restricted access, dual authorisation of manual entries, periodic review etc.

Example

The owner/manager/senior manager of a small manufacturing unit, performs the following procedures to address the risk of management override of controls:

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- (a) Review of the reasonableness of management's assumptions and judgements used to develop significant estimates at least on an annual basis; and
- (b) Review of the functioning of the company's complaint mechanism.

Also refer to **Appendix 3** for illustrative list of compensating controls to be evaluated considering nature of business, size of operation and organisational structure of the entity.

2.4 Evaluating controls implemented in lieu of segregation of duties

Question 18: What are the examples of alternative controls in lieu of segregation of duties?

Response - Segregation of duties (SOD) refers to dividing incompatible functions among different people to reduce the risk that a potential material misstatement of the financial statements would occur without being prevented or detected. In smaller companies, the following examples demonstrate alternative controls in lieu of SOD:

- Examples of alternative controls:
1. For controls such as cash receipts handling, payroll processing, or securities recordkeeping, the company may use an external party to perform an entire function.
 2. Management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts etc.
 3. The person responsible for stores also updates related accounting records. As an alternative control the purchase manager periodically performs physical verification and reconciles inventory to the general ledger.

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2.5 Evaluating financial reporting competencies

Question 19: What factors may be considered while evaluating financial reporting competence as the companies may not have staff with experience in certain accounting matters?

Response – Few companies may not have experienced staff in certain accounting matters. In these circumstances, a company may engage outside professionals to provide the necessary expertise (i.e., an individual or firm possessing special skill or knowledge in the particular accounting and financial reporting matter such as deferred tax calculation, capitalisation of fixed assets and computation of depreciation etc.).

When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may together consider the competence of company's personnel and other professionals that may assist the company with functions related to financial reporting.

2.6 Testing

Question 20: Guidance Note emphasizes on testing of relevant controls closer to the year end. Does this mean that the controls needs to be tested again towards the year end, even if the same have been tested earlier during the interim phase of testing during the year?

Response – 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, the auditor should determine the need for additional evidence for operation of the controls for the remaining period ('Roll forward procedures'). Extent and nature of such roll forward procedures depends on various factors such as, the time period of interim testing, results of interim period testing, changes in the control, the risk

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associated with the control, etc. considering nature of business, size of operation and organisational structure of the entity.

Example:

1. In a case where the risk associated with the controls is assessed as not higher and the roll forward period is sufficiently short (typically no more than three to four months), the auditor may determine that inquiry and observation alone may be sufficient.
2. In case of control assessed as higher risk, there can be typically two alternative approaches—
 - (a) Spread the total number of selections throughout the year. For example, for a test of a relevant control using a sample size of 25, the auditor may choose to perform a portion of the test at interim date by selecting 20 items over the first nine months and then selecting the 5 remaining items in the fourth quarter, or alternatively;
 - (b) Perform a complete test of the control at an interim date. Under this approach, additional procedures are required to be performed to assess the operating effectiveness of the control during the roll forward period or the balance-sheet date. Additional procedures can be testing of a few update samples during the roll forward period or at the balance sheet date.

Question 21: How can reliance be placed on reports generated from IT Systems where an auditor is unable to get comfort on IT General Controls?

Response - Reliance may be placed on such reports if management has assessed reliability of reports by performing testing of completeness and accuracy of reports

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generated from IT systems (for example performing input/output tests).

Example: Following procedures may be performed by the company management in case of trade receivables ageing report:

- Select testing of the date and amount to support documents (e.g., sales invoices) of individual transactions to ensure the appropriateness/ accuracy of the report;
- Test mathematical accuracy of the report by performing crossing and footing of the report to ensure that the sum-up of each row and column are accurate;
- Agree total balance in report to amount in general ledger to ensure that there are no missing items, else perform the testing on reconciliation between report and account ledger.

Question 22: Is the auditor required to test all Entity Level Controls (ELCs) put in place by management? What types of ELCs are required to be tested by the auditors for IFCFR?

Response –The auditor is not required to test all the ELCs put into place by the management. As stated in the Guidance Note the auditor must test those entity-level controls that are important to the auditor’s professional judgement about whether the company has effective internal financial controls also considering nature of business, size of operation and organisational structure of the entity. The auditor’s evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

The effectiveness (or ineffectiveness) of the ELCs is a relevant factor for determining the audit plan for a company as a whole for combined audit i.e. audit of the financial

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statements and the audit of internal financial controls over financial reporting.

For sample size of testing of ELC, refer the Guidance Note.

Question 23: How should the auditor approach an audit of IFCFR in situations where certain business processes are outsourced to a third party or group's shared service centre?

Response –The auditor may consider following options, considering nature, size and complexities of such outsourced business processes, to obtain evidence that the relevant controls are operating effectively:

- Obtain the service auditor's report; if any
- Perform tests of the company's controls over the activities of the service organization (input–output controls);
- Perform test of controls at the third party location or the shared service centre directly.

2.7 Deficiency

Question 24: In case deficiencies in controls are remediated by the management before the year end, can reliance be placed on such controls to reduce substantive testing for opining on the financial statements?

Response - In such cases, although the audit opinion on controls may be unmodified, but in respect of the financial statements, auditor will need to perform additional substantive audit procedures to mitigate the risk of those controls which were not designed or operating effectively during the major part of the financial year.

Question 25: Whether the use of an inherently weak IT system directly result in a controls deficiency?

Response – It may not directly result in a control deficiency.

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In cases where inherently weak application systems are in use, the auditor first needs to identify whether there is significant dependency on use of IT.

In case, there are adequate manual controls which ensure completeness and accuracy of financial data and address the relevant assertions and financial reporting risks, may compensate weakness in such IT Systems.

In case of IT dependent manual control, auditor may consider obtaining evidence of management's review of reliability and appropriateness of exception report used for operation of control.

For example, following procedures may be performed in case of Trial Balance:

- Test mathematical accuracy by testing the sum up of all debits and credits side. These should be balanced (net to zero).
- Track to source of document – trial balance to general ledger amount to ensure that all accounts have been accurately transferred from general ledger account to trial balance.
- Test completeness – to ensure that all account balances have been posted to trial balance by comparing the account name and code from chart of account to general ledger.

SECTION 3

REPORTING CONSIDERATIONS

Question 26: What could be the reporting considerations as per the Guidance Note where it is concluded that there are number of control deficiencies?

Response: Based on results of audit procedures which may include testing effectiveness of alternative controls established by the management, the auditor should evaluate severity of identified control deficiencies and accordingly may consider the following scenarios for reporting:

Scenario 1: Unmodified Opinion

In view of compensating controls (**Refer Appendix 3**), auditor concludes that such identified control deficiencies, individually or in aggregate, do not result in a material weakness, the auditor may be able to issue an unmodified opinion on internal financial controls over financial reporting.

Scenario 2: Modified opinion

If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor should evaluate the need to express a modified opinion – qualified or adverse on the company's internal financial controls over financial reporting.

Scenario 3: Limitation in scope / disclaimer of opinion

Based on the assessment of the internal financial controls over financial reporting, if the auditor concludes the following then disclaimer of opinion may be issued:

- a. Company has not established its system of internal financial controls over financial reporting considering the

Reporting Considerations

essential components of internal control as stated in the Guidance Note.

- b. Lack of available evidence constitutes a scope limitation that will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.

The auditor's report should disclaim an opinion on internal financial controls over financial reporting and disclose the substantive reasons for the disclaimer. The report should also disclose the material weaknesses of which the auditor is aware.

Question 27: How will prior period errors although corrected in current year will impact opinion on IFCFR?

Response – The auditor should evaluate root cause of prior period's error. In case prior period error was result of deficiency in a control's design or its operation, the auditor may need to assess whether such deficiency in control is continuing in the current year and accordingly deal with the same in the audit report.

Question 28: Under the Companies Act 2013, can the auditor issue single audit report for audit of financial statements and IFCFR?

Response –Yes, the auditor can issue single audit report for both financial statements and IFCFR under section 143(3) of the Companies Act 2013. Refer **Appendix 4** for illustrative formats of the audit reports.

Question 29: Whether it is mandatory to obtain separate engagement letter and management representation letter in respect of audit of IFCFR?

Response - As required by Standard on Auditing (SA) 210, "Agreeing the Terms of Audit Engagements" and Standard on Auditing (SA) 580, "Written Representations", auditor obtains engagement letter and letter of representation respectively for purpose of financial statements audit.

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The Guidance Note does not mandate obtaining a separate engagement letter and written representation letter for audit of IFCFR and thus an auditor may obtain a combined engagement letter and written representation letter.

However, the combined engagement letter and written representation letter should include all necessary elements in respect of audit of internal financial controls over financial reporting and audit of financial statements.

Question 30: Does inability to obtain written representation from management necessarily imply disclaimer of audit opinion?

Response - In accordance with Standard on Auditing (SA) 580, "Written Representations", inability to obtain written representation from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit.

When the scope of the audit is limited, the auditor should disclaim the audit opinion under the circumstances mentioned in SA 580.

Appendix 1

Illustrative list of Questions to evaluate Entity Level Controls considering nature of business, size of operation and organisational structure of the entity

Control Environment Component

| |
|--|
| Ethics and Integrity |
| <ul style="list-style-type: none">• Is there a code of conduct and/or other policies?• What are the documents to evidence that the company's code of conduct and/or other policies is communicated and acknowledged?• Is there a whistle blowing system (e.g., ethics hotline)?• If response to above is 'yes' what are the details of follow-up of matters raised.• Where formal programs/documents are not maintained, has it been observed that management at all levels of the company, and the board of directors, demonstrate the importance of integrity and ethical values through their directives, actions and behaviours? |
| Participation by those charged with governance |
| <ul style="list-style-type: none">• Are there documents supporting the appointment of experienced, competent and independent members?• Does the board of directors meet regularly to discuss objectives and issues faced by the company?• Does the company maintains proper minutes of these meetings/attendance register?• What is normally discussed in these meetings? (Observations from meetings that they are experienced, competent and independent. |

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|---|
| <ul style="list-style-type: none">• Do you have access to the system and records if you need to review any of the information, etc.? |
| Management philosophy and operating style |
| <ul style="list-style-type: none">• Does the company has certain parameters in terms of the type of business contracts/ventures to be accepted?• Are there safeguards to ensure compliance with accounting standards?• How does the company determine/select the accounting policies adopted by the organisation?• How does the company ensure that its financial reporting system captures correct and accurate information?• What is the trend of personnel turnover in the key financial reporting functions?• Has the board or management in the past overridden any established policies & procedures? In what circumstances and how often do these occur?• How frequently do senior management (Accounts Head/MD/CEO) and operating management (key managers) meet to discuss the company's operations, issues, etc.? |
| Organizational structure / assignment of authority and responsibility |
| <ul style="list-style-type: none">• Have reporting relationships been established which effectively provide managers with the information they need to carry out their responsibilities and perform their jobs?• Are employees aware of the established reporting relationships?• Does management periodically evaluate the organisational structure and make changes as necessary in response to changing conditions? |

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- Are authority and responsibility clearly assigned throughout the organisation and is this clearly communicated to all employees?
- Is responsibility for decision-making clearly linked to the assignment of authority? Are individuals held accountable accordingly?
- Along with increased delegation of authority and responsibility, does management have effective procedures to monitor results?
- Do job descriptions and performance evaluations contain specific references to internal control-related duties, responsibilities, and accountability?
- Does the company have an adequate workforce (in numbers and experience), given the nature of its operation, to carry out its objective?
- Are there policies for approval of significant, unusual and related party transactions?

Human resources / commitment to competence

- Does job descriptions mention the required knowledge, qualification and skills which needs to be in line with roles and responsibilities?
- Are there policies and procedures for hiring, training, promoting and compensating employees to determine that knowledge, qualification and skills are important factors?
- There exists a structure of remuneration packages of management to determine that no factors place undue or significant pressure on management to achieve financial results?
- Does the minutes of meetings evidence that no factors place undue or significant pressure on management to achieve financial results?

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Risk Assessment Component

- Is the management's assessment of business risks that are relevant to the company's financial reporting objectives?
- Are there documents to determine that management estimated risks significance, assessed the likelihood of their occurrence and decided the actions to be taken to address them?
- Where formal documentation of management's risk assessment does not exist, has it been observed that management has:
 - (i) identified changes in the company and its environment (such as changes in business transactions, events and conditions; accounting standards; and processes, information systems, and controls),
 - (ii) assessed likelihood of occurrence and significance of these changes in preparing the financial statements, and
 - (iii) taken necessary action(s) to design and implement control activities to address assessed risks of misstatement.
- Does the company consider compliance with laws and regulations as part of their risk assessment objectives?
- What is the management's current assessment of financial reporting objectives and related risks?
- Has the minutes of meetings obtained to determine that financial reporting objectives and related risks are presented to those charged with governance for review and approval?
- What documents are available to determine that management has established a formal process for managing changes?

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Information System & Communication Component

| |
|---|
| Information |
| <ul style="list-style-type: none">• Are there processes and information systems in place for gathering key financial information to support the financial reporting objectives and the financial statements preparation for example flowchart and/or narrative description to determine that business processes and information systems by which transactions are initiated recorded, processed, reported and corrected in the financial statements?• Are there documents to determine that the controls over the reliability of the internal information are performed?• Does the IT function has appropriate numbers of people, particularly with respect to data processing and information technology, with the requisite skill levels for the size and complexity of the company?• Are there documents to evidence that there were timely responses to deficiencies in internal control relevant to IT? |
| Communication |
| <ul style="list-style-type: none">• Are there policy/processes for reviewing and reporting on the financial position and performance of the company which needs to be communicated timely and clearly throughout the company and to external stakeholders and regulatory parties?• Have you evidenced minutes of meetings to determine nature of questions asked and issues raised on the information by users outside the financial reporting function and responses to those?• What are the documents to determine that appropriate information is received on a timely basis by the external stakeholders? |

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| Complexity of IT system |
|---|
| <ul style="list-style-type: none">• Is the IT system in use non-complex? Illustrative factors to determine complexity of IT system:<ul style="list-style-type: none">○ IT system(s) to be an off-the-shelf package.○ System has automated complex calculations (e.g., calculation of insurance premium).○ System is an older technology that is no longer or poorly supported by vendors.○ System is a new and emerging technology not yet widely used.○ System is company-developed or a highly modified off-the-shelf software.○ System is an Enterprise Resource Planning (ERP) system.○ There are extensive customized interfaces between systems.○ System processes a high volume of transactions (e.g., bank and retail operations).○ System processes for a complex or sophisticated business entity (e.g., multinational operations).○ System is part of a complex information technology infrastructure (e.g., multiple sites, multiple systems). |

Monitoring of Controls Component

| |
|--|
| <ul style="list-style-type: none">• Does the management have an ongoing process for monitoring internal controls built into recurring business processes including management and supervisory activities for instance management performs key/significant reconciliations to detect a control that is not operating as designed for example business performance |
|--|

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reviews, bank, accounts receivable, accounts payable, payroll, fixed assets depreciation?

- Does the management review management accounts on a monthly basis (by appropriate company officials) and unusual fluctuations are investigated?
- Does the management perform periodic asset counts to check proper recording?
- Are there additional supervisory reviews performed as part of a separate evaluation?
- Is there a Board / Audit Committee Charter to determine that the internal audit's role is supported in monitoring of internal controls?
- Are there documents to determine that the internal audit has a plan for reviewing the internal controls during the year?
- Have you observed that the organizational structure of the internal audit is made of sufficient qualified and experienced individuals given the size and complexity of the company?
- Were there inquiries about the lines of reporting and authority between internal audit and those charged with governance to determine if internal audit has sufficient and direct access to those charged with governance?

Appendix 2

Illustrative list of process level controls that an auditor may consider for evaluation considering nature of business, size of operation and organisational structure of the entity

| Risks | Nature of controls/activities | Tests of control |
|---|--|---|
| <p>Misstatement of the financial statements Completeness, Existence/Occurrence and Accuracy of:</p> <ul style="list-style-type: none"> • Bank • Accounts receivable • Accounts payable • Payroll • Fixed assets depreciation | <p>Control accounts are regularly reconciled.</p> | <ul style="list-style-type: none"> • Through inspection, evidence that control accounts have been reconciled for [*] months: <ul style="list-style-type: none"> - bank - accounts receivable - accounts payable - payroll - fixed assets depreciation • Through inquiry and inspection or performance, confirm that reviews performed over the control account reconciliations include obtaining an understanding of the process surrounding the investigation and resolution over all reconciling items |
| <p>Lack of responsibility and segregation of duties</p> | <p>Formal authorisation policies are in place (e.g. the finance director must approve all purchases over x amount)</p> | <p>Through inquiry and inspection, confirm that the authorisation policy is kept up-to-date and has been clearly communicated (e.g. if the authorisation process is electronic, the authorisation limits may be built into the system)</p> |
| <p>Sales and receipts*</p> | | |
| <p>All goods shipped are not invoiced, therefore</p> | <p>• The client raises a shipping document</p> | <p>• Through examination, confirm whether shipping</p> |

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| Risks | Nature of controls/activities | Tests of control |
|--|--|---|
| <p>revenue is not complete (completeness)</p> <p>Invoices are raised, but the data used (either quantities or price) is inaccurate, therefore revenue is not accurate (accuracy)</p> <p>Revenue is recorded for transactions that had not taken place (occurrence)</p> | <p>for all goods supplied. These shipping documents form the basis for the sales invoice;</p> <ul style="list-style-type: none"> • A monthly review is undertaken to confirm that a sales invoice has been raised for each shipping document. • there may also be a daily or weekly review of sales numbers by management to ensure that the sales recorded are the ones that they were expecting to be shipped in that period, given their understanding of the order book and schedule • gross margin review may pick up stock shipped but not invoiced | <p>documents are “controlled”, e.g. sequential pre-numbering, i.e. uniquely identifiable and can be easily matched to the subsequent invoice raised.</p> <ul style="list-style-type: none"> • Re-perform controls document sequence to check that all documents are accounted for in raising invoices. • Inspect [*] monthly exception report(s) which list un-invoiced shipping documents and obtain explanations from management for any omissions and / or delays in processing. • Inspect [*] shipping documents to ensure that the correct quantity and stock description has been entered onto the invoice and that the invoice is raised without delay after the despatch date [only relevant where not automated process] • Select [*] sales invoices and confirm through inspection of the shipping documents that a sale had taken place • [Alternative approach may be to obtain a download of invoices processed on an excel spreadsheet and “sort” in despatch number order to identify un-invoiced despatches] |

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| Risks | Nature of controls/activities | Tests of control |
|--|---|--|
| Under provision for bad debts (Completeness of provision for doubtful debts; Valuation of trade debtors; Completeness of expenses) | Aged accounts receivable ledger may be used by credit control staff to highlight aged debts, individual payment profiles (to highlight poor/slow payers) and to establish the correct level of bad debt write-offs and provision against bad debts. | <ul style="list-style-type: none"> • Through inquiry and inspection, obtain evidence for [*] months that the aged accounts receivable ledger is used by credit control clerks(s) to highlight any errors, establish the correct level of provisioning and to chase aged debts • Discuss any errors identified by the above control, such as missing credit notes, overpayments/credit balances, unallocated cash balances and obtain explanations for each of the errors identified. • Review report to ensure all of the following items identified in the aged accounts receivable report have been examined, investigated and satisfactorily resolved/in the process of being resolved: <ul style="list-style-type: none"> - overdue/long-outstanding debts - unallocated cash balances - credit balances |
| Expenses and payments* | | |
| Unauthorized expenses are incurred (occurrence) | Expenses are authorized by appropriate company officials, who approve all invoices and payments. Where | <ul style="list-style-type: none"> • Inspect documentation for [*] months for evidence of appropriate authorisation of expenses. |

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| Risks | Nature of controls/activities | Tests of control |
|--|--|--|
| | dual-signatories are not in place, there is appropriate segregation of duties between incompatible tasks | |
| <p>Goods not received are recorded and paid (occurrence)</p> <p>Goods received are not recorded (completeness)</p> | Invoices received are matched with purchase orders and goods receipt notes before they are recorded | <ul style="list-style-type: none"> • Select [*] purchase transactions and reperform the 3-way match between the purchase order, goods receipt note and purchase invoice |
| All expenses incurred are not recorded | Reconciliations between supplier statements and the accounts payable sub ledger are performed | <ul style="list-style-type: none"> • Inspect or reperform reconciliations performed by the company between supplier statements and the accounts payable sub ledger and determine how reconciling items are investigated and resolved. <u>Note:</u> Consider performing dual-purpose testing, i.e. testing year end reconciliations that may also contribute towards substantive evidence. |
| Expenses are not classified appropriately and consistently (presentation & disclosure) | When expenses are authorized, approvers check the allocation and classification to ensure it is accurate | <ul style="list-style-type: none"> • When inspecting for appropriate authorisation, consider whether the allocation and classification is appropriate • Determine whether business reviews are performed at a granular enough level to detect misclassifications |

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| Risks | Nature of controls/activities | Tests of control |
|---|--|---|
| Payroll* | | |
| <p>Invalid payroll expenses are incurred (occurrence); Completeness and accuracy of payroll expense</p> | <p>Payroll data is reviewed and authorised by senior manager. Senior manager review variation analysis (e.g. head count movement, fluctuation analysis) Senior manager verifies supporting documents where fluctuation varies significantly from his expectations. Use of external party for processing of data where inputs sent and output received are reviewed and approved.</p> | <ul style="list-style-type: none"> • For [*] months, confirm through inquiry and inspection that the payroll was reviewed and authorised by senior management prior to payment. • Through inquiry, determine the process management uses to determine any variances/analysis and what variance (monetary value) would prompt further investigation; inspect any supporting documentation provided to management to justify the payroll charge for the month, for instance where this differs significantly from that budgeted such as bonus payments/redundancy payments • Where the payroll function has been outsourced to a service organisation, obtain an understanding of the controls in place to ensure management is satisfied that the payroll payments are correct. For instance, management controls in place to check data inputs/outputs to the service organisation |
| Inventory* | | |
| <p>Inventory received not authorised or not recorded in the inventory system</p> | <p>All purchase orders are approved by an authorised</p> | <ul style="list-style-type: none"> • Verify purchase orders, goods receipt notes and invoices for selected transactions for |

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| Risks | Nature of controls/activities | Tests of control |
|--|---|--|
| <p>(completeness);</p> <p>Inventory does not exist or belong to the company (Existence, rights/obligation)</p> <p>Inventory recorded in the general ledger does not reconcile to the inventory records (Completeness, Existence, Rights and Obligations, Valuation and Allocation)</p> <p>Inventory may not be valued properly (Valuation)</p> | <p>personnel.</p> <p>Goods receipt note is prepared for quantities received and is verified for an approved purchase order.</p> <p>Physical inventory is counted periodically and discrepancies are investigated and corrected in the inventory records.</p> <p>Inventory records based on the physical inventory are reconciled to the general ledger with any differences being recorded as a book-to-physical inventory adjustment.</p> <p>Management reviews and approves the reconciliation of the inventory records to the general ledger and any reconciling items are reviewed and addressed on a timely basis.</p> <p>Management reviews inventory valuation is appropriate considering obsolescence, NRV, condition, method used for valuation.</p> | <p>management reviews and approvals</p> <ul style="list-style-type: none"> • Observation management's physical verification of inventory at the year-end • Verify that management has reconciled physical verification to inventory records and necessary adjustments have been made in the books to reconcile the books with physical verification results after appropriate approvals. • Verify that management has reviewed valuation of inventory considering obsolescence, NRV, condition, method used for valuation |

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| Risks | Nature of controls/activities | Tests of control |
|--|---|---|
| Period end financial reporting process* | | |
| <p>There is no basis for significant estimates and judgments associated with non-routine event or transaction.</p> <p>Relent assertions -</p> <ul style="list-style-type: none"> • Completeness • Occurrence and rights and obligations • presentation & disclosure • Accuracy and valuation | <p>A review of significant judgments and estimates included in the financial records is performed at the end of every accounting period by knowledgeable personnel.</p> <p>Significant estimates and judgments and changes thereto are reported to the senior management / board of directors/ audit committee on a regular basis</p> | <ul style="list-style-type: none"> • Through inquiry and inspection, obtain evidence for [*] months that the review is performed by competent personnel which includes a comparison with subsequent outcomes and an evaluation to determine degree of accuracy, fairness of information, and evidence of bias |
| <p>Misstatement of the financial statements</p> <p>Completeness, Existence/Occurrence and Accuracy of:</p> <ul style="list-style-type: none"> • Bank • Accounts receivable • Accounts payable • Payroll • Fixed assets depreciation | <p>Control accounts are regularly reconciled.</p> | <ul style="list-style-type: none"> • Through inspection, evidence that control accounts have been reconciled for [*] months: <ul style="list-style-type: none"> - bank - accounts receivable - accounts payable - payroll - fixed assets depreciation • Through inquiry and inspection or performance, confirm that reviews performed over the control account reconciliations include obtaining an |

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| Risks | Nature of controls/activities | Tests of control |
|--|--|---|
| | | understanding of the process surrounding the investigation and resolution over all reconciling items |
| <p>There is no review of disclosures to ensure compliance with GAAP</p> <ul style="list-style-type: none"> • Completeness • Occurrence and rights and obligations • presentation & disclosure • Accuracy and valuation | <p>A review of significant disclosures made in the financial statements is performed by knowledgeable personnel.</p> <p>The company uses up-to-date disclosure checklists (or other suitable mechanisms) to ensure that all relevant financial information is disclosed (1) appropriately in accordance with generally accepted accounting principles and the company's accounting and disclosure policies and (2) in the appropriate accounting period. Management ensures that all personnel preparing and reviewing disclosures receive the relevant checklists and instructions to perform their</p> | <ul style="list-style-type: none"> • Through inquiry and inspection, obtain evidence for [*] months that the review is performed by competent personnel which includes an evaluation to determine degree of accuracy, fairness of information, and evidence of bias |

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| Risks | Nature of controls/activities | Tests of control |
|--------------|---|-------------------------|
| | assigned duties in accordance with the company's disclosure policies. | |

*** Tailor these controls and the extent of testing to reflect client circumstances and the level of assurance sought to be obtained from controls.**

Appendix 3

Illustrative list of compensating controls which the auditor should evaluate considering nature of business, size of operation and organisational structure of the entity

| Deficiency in Internal Control | Compensating control |
|---|--|
| <ul style="list-style-type: none"> Invoices could be introduced into the accounting systems which had not been approved. | <p>Management authorizes all cheques. Documentation is inspected if the nature of the transaction is unknown to the cheque signatory.</p> <p>Obtain an understanding of the process surrounding electronic payments and test any controls identified</p> <p>The risk is increased on uncompleted transactions but audit approach to the balance sheet (e.g. Review of Accounts Payable and Accruals) address this risk.</p> |
| <ul style="list-style-type: none"> Invoices are not evidenced/ cancelled to confirm payment and therefore could be paid twice. | <p>If over-payments were made which were material then they would be identified in the purchase ledger. For instance by scanning the aged creditors report for debit balances.</p> <p>In addition (also if invoices were to be processed twice), material duplicate transactions would be highlighted by a review of the income statement performed as part of the management accounts review.</p> <p>The risk is increased on uncompleted transactions but audit approach to the balance sheet (e.g. Review of Accounts</p> |

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| Deficiency in Internal Control | Compensating control |
|---|--|
| | Payable and Accruals) address this risk. |
| <ul style="list-style-type: none"> The person responsible for raising cheques is also responsible for entering them in the accounting records. As a result, fraudulent payments could be made. | Over-payments would be identified (if material) in a review of the accounts and review by cheque signatories. |
| <ul style="list-style-type: none"> The person responsible for processing the payroll is also responsible for updating the standing data. | <p>The payroll is reviewed to ensure:</p> <ul style="list-style-type: none"> - totals appear reasonable - individual amounts paid look reasonable <p>The charge in the management accounts is reviewed to ensure it is reasonable.</p> <p>Any significant misstatements arising as a result of fraud would be detected by management, given the size and complexity of the organisation.</p> |
| <ul style="list-style-type: none"> Credit notes can be introduced which are not authorised, e.g. introduced after authorisation and prior to processing. | <p>Any significant fluctuations would be identified in a review of gross margins.</p> <p>Review credit notes during the year as part of review of trade debtors.</p> |
| <ul style="list-style-type: none"> Journals are not authorised by persons independent of their preparation. | Monthly review of Journals by senior management. |

Appendix 4

Illustrative format of Independent Auditor's Report (SA 700¹)

Scenario1: Circumstances include the following:

- Audit of a complete set of standalone general purpose financial statements of a company prepared under the Companies Act, 2013 financial reporting framework and internal financial controls over financial reporting.
- The terms of audit engagement reflect description of management's responsibility for the financial statements and internal financial controls over financial reporting in SA 210, 'Agreeing the Terms of Audit Engagements'.
- The independent auditor:
 - Has given an Unmodified Opinion in respect of true and fair view of the financial statements; and
 - Has given an Unmodified Opinion in respect of operating effectiveness of internal financial controls over financial reporting

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Standalone² Financial Statements

We have audited the accompanying standalone financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at 31st March, 20XX, the Statement of Profit and Loss, the Cash Flow Statement for

¹ Illustrative format included in the Standard on Auditing (SA) 700, Forming An Opinion and Reporting on Financial Statements.

² Where the Company does not have any requirement to prepare consolidated financial statements under the Companies Act 2013, in the auditor's report, the term "Standalone financial statements", wherever appearing, would be replaced by the term "financial statements".

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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)]³.

Management's Responsibility for the Standalone Financial Statements and for Internal Financial Controls over Financial Reporting

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) Rules, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of 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.

The Company's management is responsible for establishing and maintaining internal financial controls based on the[for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the

³ Where applicable.

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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 Act.

Auditor’s Responsibility

Our responsibility is to express an opinion on these standalone financial statements based on our audit and to express an opinion on the Company’s internal financial controls over financial reporting 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 and the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. 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 the financial statements are free from material misstatement and whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

An audit involves performing procedures to obtain audit evidence about the amounts, the disclosures in the financial statements and adequacy of the internal financial controls system over financial reporting and their operating

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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 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 controls 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. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the 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 Company's internal financial controls system over financial reporting and the standalone financial statements.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial controls 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

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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 authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised 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

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. 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

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, 20XX, 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 Section 143(3) of the Act, we report that:
 - (a) We have sought and obtained all the information

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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.⁴)
- (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 report⁵.
- (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 us⁶].
- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 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, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (g) In our opinion considering nature of business, size of operation and organisational structure of the entity,

⁴ Where applicable.

⁵ Where applicable.

⁶ Where applicable.

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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 31st March 20XX, 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.

- (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 has disclosed the impact of pending litigations on its financial position in its financial statements - Refer Note XX to the financial statements; (or the Company does not have any pending litigations which would impact its financial position⁷]
 - ii. 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 Note XX to the financial statements; (or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.⁸]
 - iii. There has been no delay in transferring amounts, required to be transferred, to the

⁷ As may be applicable.

⁸ As may be applicable.

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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 or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company⁹}.

2. As required by the Companies (Auditor's Report) Order, 2016 ("the order") issued by the Central Government in terms of Section 143(11) of the Act, we give in "Annexure" a statement on the matters specified in paragraphs 3 & 4 of the Order.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Designation¹⁰)
(Membership No. XXXXX)

Place of Signature:

Date:

⁹ As may be applicable.

¹⁰ Partner or Proprietor, as the case may be.

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Scenario 2: Circumstances include the following:

- Audit of a complete set of standalone general purpose financial statements of a company prepared under the Companies Act, 2013 financial reporting framework and internal financial controls over financial reporting.
- The terms of audit engagement reflect description of management's responsibility for the financial statements and internal financial controls over financial reporting in SA 210, 'Agreeing the Terms of Audit Engagements'.
- The independent auditor:
 - Has given an Unmodified Opinion in respect of true and fair view of the financial statements; and
 - Has given a Qualified Opinion^{*} on adequacy (and therefore operating effectiveness) of internal financial controls over financial reporting.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Standalone¹ Financial Statements

We have audited the accompanying standalone financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at 31st 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

* For other examples of modified auditor's report reference should be made to the Guidance Note.

¹ Where the Company does not have any requirement to prepare consolidated financial statements under the Companies Act 2013, in the auditor's report, the term "Standalone financial statements", wherever appearing, would be replaced by the term "financial statements".

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that date audited by the branch auditors of the Company's branches at (location of the branches)]².

Management's Responsibility for the Standalone Financial Statements and for Internal Financial Controls over Financial Reporting

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) Rules, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of 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.

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,

² Where applicable.

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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 Act.

Auditor's Responsibility

Our responsibility is to express an opinion on these standalone financial statements based on our audit and to express an opinion on the Company's internal financial controls over financial reporting 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 and the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. 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 the financial statements are free from material misstatement and whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

An audit involves performing procedures to obtain audit evidence about the amounts, the disclosures in the financial statements and 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

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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 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 controls 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. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of the accounting estimates made by the 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 and qualified 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 controls 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 controls 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,

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and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised 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

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. 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

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, 20XX, 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 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.

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- (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.³)
- (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 report⁴.
- (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 us⁵].
- (e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 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, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.
- (g) According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:
 - i. The Company did not have an appropriate internal control system for customer acceptance,

³ Where applicable.

⁴ Where applicable.

⁵ Where applicable.

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credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

ii. [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 considering nature of business, size of operation and organisational structure of the entity, 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, 20X1, 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"].

I / 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, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my /

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our opinion on the standalone financial statements of the Company.

- (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 has disclosed the impact of pending litigations on its financial position in its financial statements - Refer Note XX to the financial statements; (or the Company does not have any pending litigations which would impact its financial position^{6]}
 - ii. 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 Note XX to the financial statements; (or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.^{7]}
 - iii. 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 or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company^{8}}.

⁶ As may be applicable.

⁷ As may be applicable.

⁸ As may be applicable.

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2. As required by the Companies (Auditor's Report) Order, 2016 ("the order") issued by the Central Government in terms of Section 143(11) of the Act, we give in "Annexure" a statement on the matters specified in paragraphs 3 & 4 of the Order.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)

Signature
(Designation⁹)
(Membership No. XXXXX)

Place of Signature:

Date:

⁹ Partner or Proprietor, as the case may be.