Guidance Note on Audit of Internal Financial Controls Over Financial Reporting

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FOREWORD

The Companies Act, 2013 has introduced many new reporting requirements for the statutory auditors of companies. One of these requirements is given under the Section 143(3)(i) of the Act requiring the statutory auditor to state in his audit report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The section has cast onerous responsibilities on the statutory auditors because reporting on internal financial controls is not covered under the Standards on Auditing issued by the ICAI and also because of the fact that no framework has been prescribed under the Companies Act, 2013 and the Rules thereunder for the evaluation of internal financial controls. Therefore, a need was felt for providing appropriate guidance on this section so that the requirements and expectations of the section can be fulfilled in letter and spirit by the auditors.

I am happy that the Auditing and Assurance Standards Board has brought out this Guidance Note on Audit of Internal Financial Controls Over Financial Reporting for the benefit of the members. The Guidance Note has been developed in an easy to understand language and contains detailed guidance on various intricacies involved in reporting on Internal Financial Controls. I am also happy that the Guidance Note is comprehensive and self contained reference document for the members.

The efforts made by CA. Abhijit Bandyopadhyay, Chairman, CA. J. Venkateswarlu, Vice-Chairman and other members of Auditing and Assurance Standards Board in bringing out this guiding literature for the benefit of the members are highly commendable. I am sure that the members and other interested readers would find the Guidance Note immensely useful.

August 25, 2015
New Delhi

CA. Manoj Fadnis
President, ICAI

PREFACE

The Companies Act, 2013 has introduced some new requirements relating to audits and reporting by the statutory auditors of companies. One of these requirements is given under Section 143(3)(i) of the Act which requires the statutory auditor to state in his audit report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The section has cast onerous responsibilities on the statutory auditors because reporting on internal financial controls is not covered under the Standards on Auditing issued by the ICAI. Since the concept of reporting on internal financial controls is still new in India this new reporting requirement has thrown up many challenges for the members. To help the members properly understand and perform the various aspects of this reporting responsibility, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has brought out this Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. The Guidance Note covers aspects such as Scope of reporting on internal financial controls under Companies Act 2013, essential components of internal controls, Technical guidance on audit of Internal Financial Controls, Implementation guidance on audit of Internal Financial Controls. For the benefit of the members, the Appendices to the Guidance Note include Illustrative Engagement Letter, Illustrative Management Representation Letter, Illustrative Reports on Internal Financial Controls, Illustrative Risks of Material Misstatement, Related Control Objectives and Control Activities, Text of Standard on Internal Audit (SIA) 5 – Sampling, Examples of Control Deficiencies,. The illustrative formats of the report on internal financial controls also include an illustrative format in case of audit of consolidated financial statements.

At this juncture, I wish to place on record my sincere thanks to CA. K. Sai Ram, Chennai and CA. V. Balaji, Bangalore for taking time out of their other pressing preoccupations to develop this Guidance Note and to give it its present shape and form.

I also wish to express my deep gratitude to CA Manoj Fadnis, President, ICAI and CA. M Devaraja Reddy, Vice President, ICAI for their vision, guidance and support to the activities of the Board.

I also wish to thank all my colleagues at the Central Council for their cooperation and guidance in formulating and finalizing the various authoritative pronouncements of the Board. My sincere thanks are also due to the members of the Auditing and Assurance Standards Board, viz., CA. J Venkateswarlu, Vice Chairman, CA. Prafulla Premsukh Chhajed, CA. Pankaj I Jain, CA. Nihar N Jambusaria, CA. Shriniwas Y Joshi, CA. Dhinal A Shah, CA. Nilesh S. Vikamsey, CA. Babu A Kallivayalil, CA. K. Raghu, CA. G. Sekar, CA. Sumantra Guha, CA. Shyam Lal Agarwal, CA. Sanjiv Chaudhary, CA. Naveen N.D. Gupta, CA. Charanjot Singh Nanda, Shri A M Bajaj, Shri Salil Singhal, Shri R.K. Jain, CA. Sanjay Vasudeva, CA. Radha Krishna Agrawal, CA. Kamlesh

Amlani, CA. Aseem Trivedi, CA. Krishna Kumar T. and CA. Rajeevan M. for their support and guidance to the Board. I also wish to thank the special invitees to the Board, viz., Shri R Kesavan, Shri Narendra Rawat, CA Aniruddh Sankaran, CA. Vijay Sachdeva and Dr. Sanjeev Singhal for their support and guidance to the Board.

I am confident that this Guidance Note would be well received by members and other interested readers.

August 25, 2015
Kolkata

CA. Abhijit Bandyopadhyay
Chairman, Auditing & Assurance Standards Board

BRIEF CONTENTS

DETAILED CONTENTS

Contents of Accompanying CD

1. Text of Guidance Note on Audit of Internal Financial Controls Over Financial Reporting
2. Appendix IV: Illustrative Risks of Material Misstatement, Related Control Objectives and Control Activities
3. Illustrative Work Paper Templates for Testing Controls

PART - A

OVERVIEW

OVERVIEW

I. Scope of reporting on internal financial controls under clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013

Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013 ("the 2013 Act" or "the Act") requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

The scope for reporting on internal financial controls is significantly larger and wider than the reporting on internal controls under the Companies (Auditor's Report) Order, 2015 ("CARO"). Under CARO, the reporting on internal controls is limited to the adequacy of controls over purchase of inventory and fixed assets and sale of goods and services. As such, CARO does not require reporting on all controls relating to financial reporting and also does not require reporting on the "adequacy and operating effectiveness" of such controls.

Management's Responsibility

The 2013 Act has significantly expanded the scope of internal controls to be considered by the management of companies to cover all aspects of the operations of the company. Clause (e) of Sub-section 5 of Section 134 to the Act requires the directors' responsibility statement to state that the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Clause (e) of Sub-section 5 of Section 134 explains the meaning of the term, "internal financial controls" as "the policies and procedures adopted by the company 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."

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors' responsibility statement is in addition to the requirement for the directors to state that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

Auditors' Responsibility

The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting and the procedures in respect thereof are carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the date specified in management's assessment. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

Paragraph A1 of Standard on Auditing (SA) 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states, "The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. **The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity**. (Emphasis added)

Globally, auditor's reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate to only internal controls over financial reporting. For example, in USA, Section 404 of the Sarbanes Oxley Act of 2002, prescribes that the registered public accounting firm (auditor) of the specified class of issuers (companies) shall, in addition to the attestation of the financial statements, also attest the internal controls over financial reporting.

It may be noted that in India too, the Companies Act, 2013 specifies the auditor's reporting on internal financial controls only in the context of audit of financial statements. Consistent with the practice prevailing internationally, the term 'internal financial controls' stated in Clause (i) of Sub-section 3 of Section 143 would relate to 'internal financial controls over financial reporting' in accordance with the objectives of an audit stated in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"

Further, Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of all the companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements" only.

Considering the above, **the auditor needs to obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.**

Accordingly, **the term 'internal financial controls' wherever used in this Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the Act, *per se* implies and relates to internal financial controls over financial reporting.** For this purpose, "internal financial controls over financial reporting" shall mean *"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*

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

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

(iii) 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."[1]

II. Applicability of reporting in the case of unlisted companies

Clause (e) of Sub-section 5 of Section 134 of the 2013 Act has prescribed the Directors' Statement of Responsibility over establishing adequate internal financial controls and asserting operating effectiveness of such controls of the company only in case of listed companies. It may however be noted that Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of **all** companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements". Also, section 143(3) applies to the statutory auditors of all the companies. Hence, it appears that the auditors of even unlisted companies are required to report on the adequacy and operating effectiveness of the internal financial controls over financial reporting.

III. Criteria for Internal Financial Controls Over Financial Reporting

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the financial reporting framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework based on which companies prepare and present their financial statements and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and operations of the company in an audit of the financial statements carried out under the 2013 Act.

Similarly, a benchmark internal control system, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control.

In the Indian context, for example, Appendix 1 "Internal Control Components" of SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment"[2] provides the necessary criteria for internal financial controls over financial reporting for companies.

IV. Specified date for reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting and applicability in case of interim financial statements

The reporting by the auditor on internal financial controls under clause (i) of Sub-section 3 of Section 143 of the Act does not specify whether the auditor's report should state if such internal financial controls existed and operated effectively during the period under reporting of the financial statements or as at the balance sheet date up to which the financial statements are prepared.

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[1] This definition of the term "Internal Controls Over Financial Reporting" has been reproduced from the Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting that Is Integrated with An Audit of Financial Statements* issued by the Public Company Accounting Oversight Board (PCAOB), USA. The other text in this Guidance Note which has been reproduced from the aforesaid AS 5 of PCAOB has been identified in *italics* text in the relevant sections of the Guidance Note. The copyright of the so reproduced material rests with the PCAOB.

[2] Refer Section III of this Guidance Note.

Reporting on internal control systems is similar to reporting on the commercial operations of the company. Whilst the testing is carried out on the transactions recorded during the year, the reporting is as at the balance sheet date. For example, if the company's revenue recognition was erroneous through the year under audit but was corrected, including for matters relating to internal control that caused the error, as at the balance sheet date, the auditor is not required to report on the errors in revenue recognition during the year.

It should be noted that even when forming the opinion on internal controls, the auditor should test the internal controls during the financial year under audit and not just the internal controls as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher.

Attention is invited to Clause (k) of paragraph 57 of the Statement on the Companies (Auditor's Report) Order, 2003 issued by the ICAI on the auditor's responsibility for reporting on internal control and continuing failure in the internal control under CARO. The said paragraph states that, "The auditor, while commenting on the clause, makes an assessment whether the major weakness noted by him has been corrected by the management as at the balance sheet date. If the auditor is of the opinion that the weakness has not been corrected, then the auditor should report the fact while commenting upon the clause."

Accordingly, **the auditor should report if the company has adequate internal control systems in place and whether they were operating effectively as at the balance sheet date.**

It may also be noted that auditor's reporting on internal financial controls over financial reporting is a requirement specified in the Companies Act, 2013 and therefore will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, **reporting on internal financial controls over financial reporting will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.**

V. Auditors' responsibility for reporting on internal financial controls over financial reporting in case of consolidated financial statements

Section 129(4) of the 2013 Act states that the provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, *mutatis mutandis*, apply to the consolidated financial statements.

As such, on a strict reading of the aforesaid provision in the 2013 Act, it appears that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements. In the case of components included in the consolidated financial statements of the parent company, reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting would apply for the respective components only if it is a company under the 2013 Act. Accordingly, in line with the approach adopted in case of reporting on the consolidated financial statements on the clauses of section 143(3) and reporting on the Companies (Auditor's Report) Order, 2015 notified under section 143(11) of the 2013 Act, the reporting on adequacy of internal financial controls would also be on the basis on the reports on section 143(3)(i) as submitted by the statutory auditors of components that are Indian companies under the 2013 Act. The auditors of the parent company

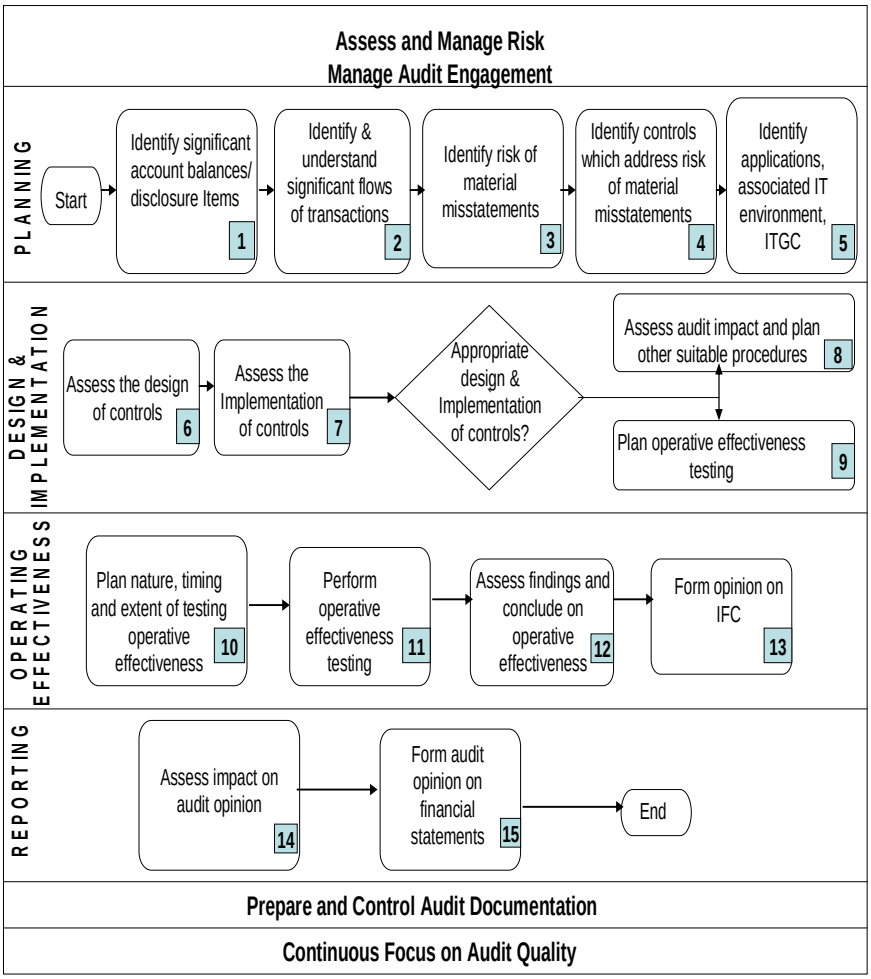
should apply the concept of materiality and professional judgment as provided in the Standards on Auditing and this Guidance Note while reporting under section 143(3)(i) on the matters relating to internal financial controls over financial reporting that are reported by the component auditors.

VI. Components of Internal Control and Guidance Provided

Internal Control Component	Guidance reference*
Control environment	Paragraphs 88–93 – Identifying entity-level controls Paragraph 84 – Using the work of others
Risk assessment	Paragraph 76-78 – Role of risk assessment Paragraph 80-81 – Addressing the risk of fraud Paragraph 105-107 – Selecting controls to test Paragraphs 113, 119,122 – Relationship of risk to the evidenced obtained Paragraph 124 and 127 – Special considerations for subsequent years' audit Paragraphs 144 and 145 – Subsequent events
Control activities	Paragraphs 100-104 – Understanding likely sources of misstatement Paragraphs 105 – 107 – Selecting controls to test IG 2.4 – Process flow diagrams IG 4 – Understanding IT Environment
Information system and communication	IG 2.4 – Process flow diagram IG 8 – Information Produced by the Entity (IPE) IG 2.9 to 2.13 – IPE Diagrams IG 9.3 and 9.4 - Situation in which service organisations are relevant for internal financial controls
Monitoring activities	Paragraphs 90, 91 and 93 – Identifying entity-level controls Paragraph 135 – Indicators of material weakness

* These references are not exhaustive. The purpose of these references is to help the reader understand the requirements of the components of internal control system in a better manner.

VII Flowchart Illustrating Typical Flow of Audit of Internal Financial Controls Over Financial Reporting



Internal financial controls over financial reporting - Flowchart legends

Legend	Technical guidance / Implementation guidance reference
1	Paragraph 94-99 & IG 2
2	IG 2
3	Paragraph 100-104 & IG 2
4	Paragraph 105-107 & IG 2
5	IG 2 & IG 4
6	Paragraph 108-109, IG 10, IG 11 & IG 12
7	Paragraph 108-109, IG 10, IG 11 & IG 12
8	Paragraph 128-136
9	Paragraph 110-111 & IG 13
10	Paragraph 110-111, IG 13
11	Paragraph 128-136
12	IG 13
13	Paragraph 153 - 164
14	Paragraph 157 - 164
15	Paragraph 163 & IG 20

PART - B

DETAILED GUIDANCE

SECTION I
BACKGROUND

Introduction

1. Internal control helps entities achieve important objectives and sustain and improve performance.

Paragraph 4(c) of the Standard on Auditing (SA) 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" defines the term 'internal control' as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

SA 315 requires the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement and help the auditor to reduce the risks of material misstatement to an acceptably low level.

2. Section 217(2AA) of the Companies Act, 1956 required the Directors of a company to specifically state in the Directors' responsibility statement that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the (1956) Act, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

The Act, 2013 has significantly expanded the scope of internal controls to be considered by the management of companies to cover all aspects of the operations of the company. Clause (e) of Sub-section 5 of Section 134 to the Act requires the directors responsibility statement to state that the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as "the policies and procedures adopted by the company 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."

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper

and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

3. The concept of internal financial controls is not new in India for listed companies. Clause 49 of the Equity Listing Agreement requires certification by the CEO / CFO stating that they accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the audit committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify those deficiencies.

Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India

4. Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Reporting on internal financial controls over financial reporting under the 2013 Act *vis-à-vis* reporting on internal controls under the Companies (Auditor's Report) Order, 2015 (CARO)

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

Reporting on internal financial controls over financial reporting – global scenario

6. In June 2003, the Securities and Exchange Commission (SEC) of the United States of America adopted Rules for the implementation of Sarbanes – Oxley Act, 2002 (SOX) that required certification of the Internal Controls over Financial Reporting (ICFR) by the management and by the auditors.

The Public Company Accounting Oversight Board (PCAOB) has issued its Auditing Standard (AS) 5 on "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements". This Standard establishes requirements and provides direction that applies when an auditor is engaged to also perform an audit of the internal controls over financial reporting in addition to the audit of the financial statements.

7. In June 2006, the Financial Instruments and Exchange Act (J-SOX) was passed by the Diet, the National Legislature of Japan. The requirements of this legislation are similar to the requirements of internal controls over financial reporting under SOX.

Reporting by the Auditors

8. Where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

Combined audit of internal financial controls over financial reporting and financial statements

9. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously. In a combined audit of internal controls over financial reporting and financial statements, the auditor expresses opinion on the following aspects:

a. Opinion on internal control over financial reporting, which requires:

   – Evaluating and opining on management's assessment of the effectiveness of internal financial controls (In Japan based on the requirements of the Financial Instruments and Exchange Act).

   – Evaluating and opining on the effectiveness of internal controls over financial reporting (In USA based on the requirements of Section 404 of the Sarbanes – Oxley Act).

b. Opinion on the financial statements.

10. While the objectives of the audit of internal controls over financial reporting and audit of financial statements are not identical, the auditor plans and performs 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 his or her testing of controls to accomplish the objectives of both audits simultaneously.

11. In such an audit, the auditor plans and conducts the audit:

- To obtain sufficient evidence to support the auditor's opinion on the internal financial controls as of the year-end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of the financial statements.

12. Obtaining sufficient evidence to support control risk assessments of "Low" for purposes of the financial statements audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

13. Unlike the requirements in Japan referred in paragraph 9 above, in India, auditors are not required to report on the management's assertion of effectiveness on internal financial controls. Reporting under the Act will be an independent assessment and assertion by the auditor on the adequacy and effectiveness of the entity's system of internal financial controls.

SECTION II
REPORTING ON INTERNAL FINANCIAL CONTROLS UNDER THE COMPANIES ACT, 2013

Criteria to be considered by companies for developing, establishing and reporting on internal financial controls over financial reporting

14. Internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

15. To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

16. Similarly, a benchmark system of internal control, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy and compliance of the system of internal control.

17. In the Indian context, for example, the Appendix 1 “Internal Control Components” of SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”[3], issued by ICAI, provides the necessary criteria for Internal financial controls over financial reporting for companies.

18. Internal control is a process/set of processes designed to facilitate and support the achievement of business objectives. Any system of internal control is based on a consideration of significant risks in operations, compliance and financial reporting. Objectives such as improving business effectiveness are included, as are compliance and reporting objectives.

19. The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

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[3] Refer Section III of this Guidance Note.

20. Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

21. **An internal control system:**

- Facilitates the effectiveness and efficiency of operations.
- Helps ensure the reliability of internal and external financial reporting.
- Assists compliance with laws and regulations.
- Helps safeguarding the assets of the entity.

22. 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.

The components of internal control are discussed in more detail in Section III of this Guidance Note.

23. Internal financial controls system needs to be dynamic to address the changes in entity's operating environment, including:

- Business developments, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Legal and regulatory developments such as changes in industry regulations and new regulatory reporting requirements.
- Changes in the financial reporting framework, such as changes in accounting standards.

24. Internal financial controls should not be confused with Enterprise Risk Management (ERM). Internal control is an integral part of enterprise risk management. The following are some of the key differences between internal controls over financial reporting and ERM:

- ERM is applied in strategy setting while internal financial controls operate more at the process level.
- ERM is applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk while internal financial controls are applied for the processes which contribute to financial reporting.

25. It may be noted that Clause (n) of Sub-section 3 of Section 134 of the Act requires the board report to include a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which in the opinion of the board may threaten the existence of the company. The existence of an appropriate system of internal financial control does not by itself provide an assurance to the board of directors that the company has developed and implemented an appropriate risk management policy.

Objective in an audit of internal financial controls over financial reporting and interpretation of the term 'internal financial controls' for auditor's reporting under Section 143(3)(i)

26. Meaning of internal financial controls under the Act

Clause (e) of Sub-section 5 of Section 134 which explains the meaning of internal financial controls specifically states that the meaning is for the purpose of that clause. The explanation provided in clause (e) of Sub-section 5 of Section 134, inter alia, states that the internal financial controls system includes policies and procedures for ensuring efficiency and effectiveness of business and ensuring accuracy of accounting records.

27. Meaning of internal control

Standard on Auditing 315 "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment" defines Internal Control as follows:

"The process **designed, implemented and maintained** by those charged with governance, management and other personnel **to provide reasonable assurance** about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control." (Emphasis added)

28. Objectives of an auditor in an audit of internal financial controls over financial reporting

The auditor's objective in an audit of internal financial controls over financial reporting is to express an opinion on the effectiveness of the company's internal financial controls over financial reporting. It is carried out along with an audit of the financial statements. Because a company's internal controls cannot be considered effective if one or more material weakness exists, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the balance sheet date. A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

29. Paragraph A1 of Standard on Auditing (SA) 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states "The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. **The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity**." (Emphasis added)

30. Paragraph A1 of the SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing further states that "in some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an

opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions." Thus, it may be noted that even if the auditor performs his or her audit in accordance with the Standards on Auditing, the auditor will not be able to express an opinion on the adequacy or effectiveness with which management has conducted the affairs (business) of the entity.

31. Reporting under Section 143(3)(i)

The reporting by the auditor is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

As discussed above, establishing an appropriate criteria and system of internal financial controls over financial reporting to, inter alia, ensure efficiency and effectiveness of business and accuracy of accounting records is the responsibility of the company's management.

32. Globally also, auditor's reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate only to internal controls over financial reporting. For example, in USA, Section 404 of the Sarbanes Oxley Act of 2002, prescribes that the registered public accounting firm (auditor) of the specified class of issuers (companies) shall, in addition to the attestation of the financial statements, attest the internal controls over financial reporting.

33. It may be noted that in India too, the Act specifies the auditor's reporting on internal financial controls only in the context of the audit of financial statements.

Further, **Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements" only**.

34. Consistent with the above requirements of the Act and the Rules thereunder as well as the practice prevalent globally, **the term 'internal financial controls' wherever used in this Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the Act, per se implies and relates to "internal financial controls over financial reporting".**

For this purpose, "internal financial controls over financial reporting" shall mean,

"A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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."[4]

The process may also be designed by, or under the supervision of a committee or group of the aforesaid persons.

35. Considering the above, the auditor should obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.

Applicability of standards on auditing for the audit of internal financial controls over financial reporting

36. Paragraph A1 of SA 200, *inter alia*, states "In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions."

Accordingly, the Standards on Auditing do not fully address the auditing requirements for reporting on the system of internal financial controls over financial reporting. However, relevant portions of the Standards on Auditing need to be considered by the auditor when performing an audit of internal financial controls over financial reporting. For example, the auditor should consider the requirements of SA 230, "Audit Documentation" when documenting the work performed on internal financial controls; the auditor should consider and apply the requirements of SA 315 when understating internal controls, etc.

37. This guidance aims to provide the supplementary procedures that would need to be considered by the auditor for planning, performing and reporting in an audit of internal financial controls over financial reporting under Clause (i) of Sub-section 3 of Section 143 of the 2013 Act. The applicable standards on auditing which, inter alia, need to be considered by the auditor when performing an audit of internal financial controls is given in the respective paragraphs of this guidance.

Specified date for reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting

38. The reporting by the auditor on internal financial controls under clause (i) of Sub-section 3 of Section 143 of the Act does not specify whether the auditor's report should state if such internal financial controls existed and operated effectively during the period under reporting of the financial statements or as at the balance sheet date up to which the financial statements are prepared.

[4] This definition of the term "Internal Controls Over Financial Reporting" has been reproduced from the Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting that Is Integrated with An Audit of Financial Statements* issued by the Public Company Accounting Oversight Board (PCAOB), USA. The other text in this Guidance Note which has been reproduced from the aforesaid AS 5 of PCAOB has been identified in *italics* text in the relevant sections of the Guidance Note. The copyright of the so reproduced material rests with the PCAOB.

39. Reporting on internal financial controls system is similar to reporting on operations of the company. Whilst the testing is carried out on the transactions recorded during the year, the reporting is as at the balance sheet date. For example, if the company's revenue recognition was erroneous through the year under audit but was corrected, including for matters relating to internal control that caused the error, as at the balance sheet date, the auditor is not required to report on the errors in revenue recognition during the year.

40. Attention is invited to paragraph (k) of Clause 57 of the Statement on the Companies (Auditor's Report) Order, 2003 issued by the Institute of Chartered Accountants of India on the auditor's responsibility for reporting on internal control and continuing failure in the internal control under CARO. The said paragraph states that "The auditor, while commenting on the clause, makes an assessment whether the major weakness noted by him has been corrected by the management as at the balance sheet date. If the auditor is of the opinion that the weakness has not been corrected, then the auditor should report the fact while commenting upon the clause."

41. Accordingly, the auditor should report if the company has an adequate internal financial controls system in place and whether the same was operating effectively as at the balance sheet date. It should be noted that when forming the opinion on internal financial controls, the auditor should test the same during the financial year under audit and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher.

42. It may also be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Auditors' responsibility for reporting on internal financial controls over financial reporting in the case of unlisted companies

43. Under the Act, the directors statement of responsibility over establishing adequate internal financial controls and asserting operating effectiveness of such controls of the company is required only in case of listed companies. However, it appears that the auditor is required to report on adequacy and operating effectiveness of such internal financial controls even in the case of unlisted companies since Clause (i) of Sub-section 3 of Section 143 of the 2013 Act does not specifically state that it is applicable only in the case of listed companies.

44. It may be noted that the management has the primary responsibility for the design, implementation and maintenance of internal control 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. Consequently, the responsibility of designing, implementing and maintaining appropriate internal financial controls also rests with the management. It may also be noted that Clause (vii) of Sub-section 4 of Section 177 of the Act states that every audit committee shall act in accordance with the terms of reference specified in writing by the board which shall, inter alia, include, "evaluation of internal financial controls and risk management systems". Further, Sub-section 5 of Section 177 provides that the audit committee may call for

the comments of the auditors about internal control systems including the observations of the auditors and may also discuss any related issues with the internal and auditors and the management of the company.

In addition, **Rule 8(5)viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.**

Consequently, even if a specific statement of responsibility of the directors over internal financial controls is not made in the board's report to the members of unlisted companies, ensuring adequacy and operating effectiveness of the internal financial controls system still remains with the management and the persons charged with governance in the company.

45. Therefore, this guidance also applies for reporting on internal financial controls in respect of unlisted companies and small companies and one person companies as defined in the Companies Act, 2013. Further, a small or a one person company typically possesses qualitative characteristics such as:

a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

b) One or more of the following:

   i. Straightforward or uncomplicated transactions;

   ii. Simple record-keeping;

   iii. Few lines of business and few products within business lines;

   iv. Few internal controls;

   v. Few levels of management with responsibility for a broad range of controls; or

   vi. Few personnel, many having a wide range of duties.

It may, however, also be noted that these qualitative characteristics are not exhaustive, nor are they exclusive to small or one person companies. Also, all small and one person companies need not necessarily display all of these characteristics.[5]

Auditors' responsibility for reporting on internal financial controls over financial reporting in case of consolidated financial statements

46. Section 129(4) of the 2013 Act states that the provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, *mutatis mutandis*, apply to the consolidated financial statements.

As such, on a strict reading of the aforesaid provision in the 2013 Act, it appears that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements. .

[5] Attention of the readers is also drawn to Section IG 19 of the Guidance Note.

47. In the case of components included in the consolidated financial statements of the parent company, reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting would apply for the respective components only if it is a company under the 2013 Act. Accordingly, in line with the approach adopted in case of reporting on the consolidated financial statements on the clauses of section 143(3) and reporting on the Companies (Auditor's Report) Order, 2015 notified under section 143(11) of the 2013 Act, the reporting on adequacy and operating effectiveness of internal financial controls would also be on the basis on the reports on section 143(3)(i) as submitted by the statutory auditors of components that are Indian companies under the Act. The auditors of the parent company should apply the concept of materiality and professional judgment as provided in the Standards on Auditing and this Guidance Note while reporting under section 143(3)(i) on the matters relating to internal financial controls over financial reporting that are reported by the component auditors.

SECTION III
OVERVIEW OF INTERNAL CONTROLS AS PER SA 315

48. Components of Internal Control

Appendix I to SA 315 explains the five components of any internal control as they relate to a financial statement audit. The five components are:

i. Control environment
ii. Entity's risk assessment process
iii. Control activities
iv. Information system and communication
v. Monitoring of controls

I. Control environment

49. The control environment encompasses the following elements:

(a) **Communication and enforcement of integrity and ethical values.** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

(b) **Commitment to competence***.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

(c) **Participation by those charged with governance***.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

(d) **Management's philosophy and operating style***.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

(e) **Organisational structure***.* Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.

The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.

(f) **Assignment of authority and responsibility**. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

(g) **Human resource policies and practices.** Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

II. Entity's risk assessment process

50. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

51. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

a) Changes in operating environment. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

b) New personnel. New personnel may have a different focus on or understanding of internal control.

c) New or revamped information systems. Significant and rapid changes in information systems can change the risk relating to internal control.

d) Rapid growth. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

e) New technology. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

f) New business models, products, or activities. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

g) Corporate restructurings. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.

h) Expanded foreign operations. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.

i) New accounting pronouncements. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

III. Control activities

52. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

a) Performance reviews. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

b) Information processing. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

c) Physical controls. Controls that encompass:

- The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
- The authorisation for access to computer programs and data files.
- The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting

records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

d) Segregation of duties. Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

53. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

IV. Information system, including the related business processes, relevant to financial reporting, and communication

54. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

55. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

a) Identify and record all valid transactions.

b) Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.

c) Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.

d) Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.

e) Present properly the transactions and related disclosures in the financial statements.

56. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

57. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

V. Monitoring of controls

58. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions.

Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

59. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

60. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

61. Components of internal control and guidance provided

Refer Table below to see the mapping of internal control components with relevant references in this guidance:

Internal Control Component	Guidance reference*
Control environment	Paragraphs 88 – 93 – Identifying entity-level controls Paragraph 84 – Using the work of others
Risk assessment	Paragraph 76-78 – Role of risk assessment Paragraph 80-81 – Addressing the risk of fraud Paragraph 105-107 – Selecting controls to test Paragraphs 113, 119, 122 – Relationship of risk to the evidenced obtained Paragraph 124 and 127 – Special considerations for subsequent years' audit Paragraphs 144 and 145 – Subsequent events
Control activities	Paragraphs 100-104 – Understanding likely sources of misstatement Paragraphs 105 – 107 – Selecting controls to test IG 2.4 – Process flow diagrams

Internal Control Component	Guidance reference*
	IG 4 – Understanding IT Environment
Information system and communication	IG 2.4 – Process flow diagram IG 8 – Information Produced by the Entity (IPE) IG 2.9 to 2.13 – IPE Diagrams IG 9.3 and 9.4 - Situation in which service organisations are relevant for internal financial controls
Monitoring activities	Paragraphs 90, 91 and 93 – Identifying entity-level controls Paragraph 135 – Indicators of material weakness

* These references are not exhaustive. The purpose of these references is to help the reader understand the requirements of the components of internal control system in a better manner.

Effective Internal Control

62. The control environment sets the tone of an organization, influencing the control consciousness of its people. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

63. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a material weakness or significant deficiency in the entity's internal control.

64. An entity's system of internal control contains manual elements and often contains automated elements. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported. An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of information technology. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

65. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Limitations of internal control system

66. Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives. Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

SECTION IV
TECHNICAL GUIDANCE ON AUDIT OF INTERNAL FINANCIAL CONTROLS OVER FINANCIAL REPORTING[6]

Introduction

67. This guidance provides direction that applies when an auditor is required to report under Clause (i) of Sub-section 3 of Section 143 of the 2013 Act on whether the company has in place adequate internal financial controls over financial reporting and the operating effectiveness of such controls.

68. Effective internal financial *controls over financial reporting provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the company's internal* financial *controls cannot be considered effective.*

69. Because a company's internal financial *controls over financial reporting cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether the material weaknesses exist as of the balance sheet date. A significant deficiency or material weakness in internal* financial *controls over financial reporting may exist even when financial statements are not materially misstated.*

70. This guidance establishes the fieldwork and reporting requirements applicable for expressing an audit opinion to internal financial *controls over financial reporting.*

71. The auditor should use the same system of internal financial *controls over financial reporting to perform his or her audit of internal* financial *controls over financial reporting as management uses for its annual evaluation of the adequacy and effectiveness of the company's internal financial controls.*

Combining the audits

72. The audit of internal financial *controls over financial reporting should be combined with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.*

73. In a combined audit of internal financial *controls over financial reporting and financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously:*

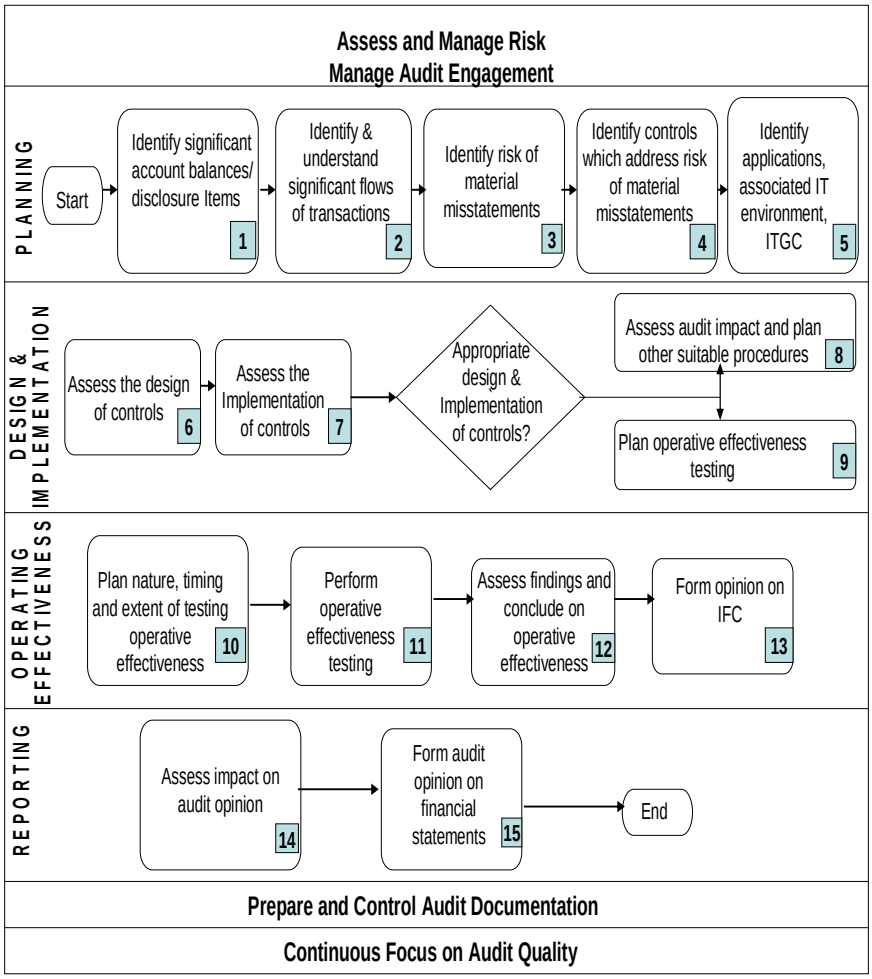
- *To obtain sufficient evidence to support the auditor's opinion on internal* financial *controls over financial reporting as of year-end, and*

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

- *To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.*

74. Obtaining sufficient evidence to support control risk assessments for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

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



Internal Financial Controls over Financial Reporting - Flowchart legends

Legend	Technical guidance / Implementation guidance reference
1	Paragraph 94-99 & IG 2
2	IG 2
3	Paragraph 100-104 & IG 2
4	Paragraph 105-107 & IG 2

5	IG 2 & IG 4
6	Paragraph 108-109, IG 10, IG 11 & IG 12
7	Paragraph 108-109, IG 10, IG 11 & IG 12
8	Paragraph 128-136
9	Paragraph 110-111 & IG 13
10	Paragraph 110-111, IG 13
11	Paragraph 128-136
12	IG 13
13	Paragraph 153 - 164
14	Paragraph 157 - 164
15	Paragraph 163 & IG 20

Planning the Audit

75. The auditor should properly plan the audit of internal financial *controls over financial reporting and properly supervise any assistants. The activities will include pre-engagement activities such as agreeing the terms of the engagement. (Refer* ***Appendix I*** *for illustrative format of the engagement letter). When planning a combined audit of internal* financial *controls over financial reporting and financial statements, the auditor should evaluate whether the following matters are important to the company's financial statements and internal* financial *controls over financial reporting and, if so, how they will affect the auditor's procedures:*

- *Knowledge of the company's internal* financial *controls over financial reporting obtained during other engagements performed by the auditor;*
- *Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;*
- *Matters relating to the company's business, including its organisation, operating characteristics, and capital structure;*
- *The extent of recent changes, if any, in the company, its operations, or its internal financial controls over financial reporting;*
- *The auditor's preliminary judgements about materiality, risk, and other factors relating to the determination of material weaknesses;*
- *Control deficiencies previously communicated to the audit committee or management by the auditor or the internal auditor;*
- *Legal or regulatory matters of which the company is aware;*
- *The type and extent of available evidence related to the effectiveness of the company's internal* financial *controls over financial reporting;*

- *Preliminary judgements about the effectiveness of internal* financial *controls over financial reporting;*
- *Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal* financial *controls over financial reporting;*
- *Knowledge about risks related to the company evaluated as part of the auditor's KYC guidelines; and*
- *The relative complexity of the company's operations.*

Note: *Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralised accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.*

Role of Risk Assessment

76. Risk assessment underlies the entire audit process described by this guidance, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

77. A direct relationship exists between the degree of risk that a significant deficiency or material weakness could exist in a particular area of the company's internal financial *controls over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal* financial *controls over financial reporting will fail to prevent or detect a misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.*

An illustrative list of risks of material misstatement, related control objectives and control activities is given in ***Appendix IV.***

78. The complexity of the organisation, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Further, the auditor needs to consider SA 315, for detailed procedures in connection with risk assessment.

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 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.

Addressing the Risk of Fraud

80. When planning and performing the audit of internal financial *controls, the auditor should take into account the results of his or her fraud risk assessment. As part of identifying and testing entity-level controls, as discussed beginning at paragraph 88 of this Section, and selecting other controls to test, as discussed beginning at paragraph 105 of this Section, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include:*

- *Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;*
- *Controls over journal entries and adjustments made in the period-end financial reporting process;*
- *Controls over related party transactions;*
- *Controls related to significant management estimates; and*
- *Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.*

81. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal financial *controls over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in* SA 240 “The Auditor’s Responsibilities Relating to Fraud in An Audit of Financial Statements”.

Further the auditor would also need to consider the requirements of other guidance issued by ICAI for the procedures to be performed in connection with fraud risk factors.

Using the Work of Others (Refer IG 18)

82. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. SA 610 “Using the Work of Internal Auditors” and SA 620 “Using the Work of an Auditor’s Expert” *apply in a combined audit of internal* financial *controls over financial reporting and financial statements.*

83. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the auditor when expressing an opinion on financial statements and internal financial *controls over financial reporting. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor’s use of the work of the internal auditors.*

84. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work.

Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess

objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

85. The extent to which the auditor may use the work of others in an audit of internal financial *controls over financial reporting also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.*

Materiality

86. In planning the audit of internal financial *controls over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements* as provided in SA 320 “Materiality in Planning and Performing an Audit”.

Note: Since the audit of internal financial controls is in connection with the financial reporting, the concept of materiality will be applicable even in such audit. The auditor may consider materiality when he or she makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement;

(c) Identifying classes of transactions, account balances and disclosures that need to be considered for testing; and

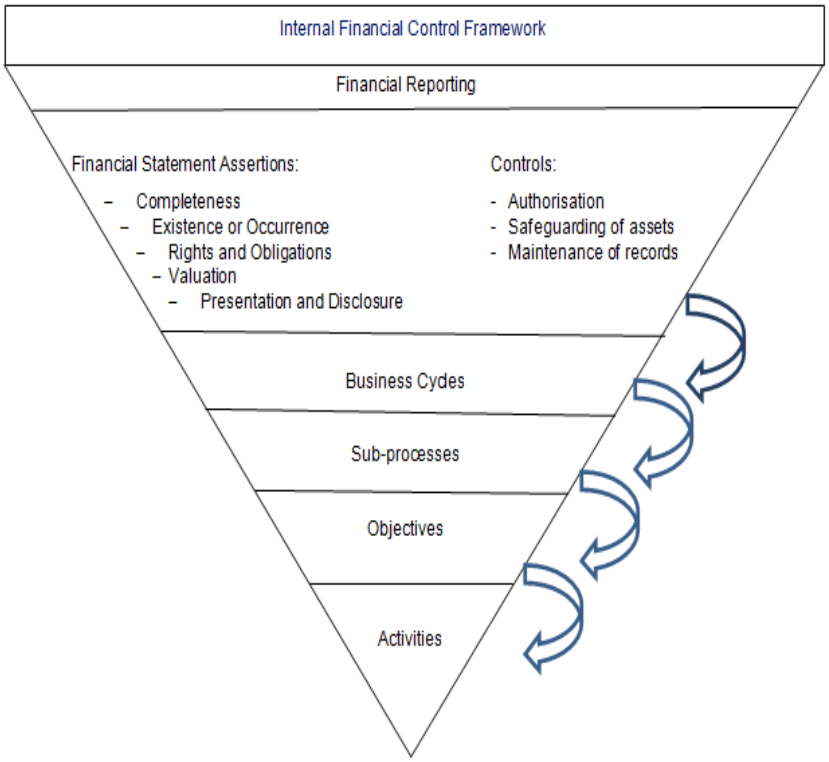
(d) Determining the nature, timing and extent of audit procedures.

Using a Top-down Approach

87. The auditor should 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. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.*

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Top-Down Approach to Internal Financial Controls Over Financial Reporting



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

88. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal financial *controls over financial reporting. 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.*

89. Entity-level controls vary in nature and precision:

- *Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.*
- *Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls when operating effectively, might allow the auditor to reduce the testing of other controls.*
- *Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more*

relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

90. Entity-level controls include:

- *Controls related to the control environment;*
- *Controls over management override;*

Note: *Controls over management override are important to effective internal* financial *controls over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.* Similarly, in case of a small company as defined in the 2013 Act, since there is no requirement for an Audit Committee, the Board of Directors could be providing such detailed oversight that focuses on the risk of management override.

- *The company's risk assessment process;*
- *Centralised processing and controls, including shared service environments; (Refer IG 9)*
- *Controls to monitor results of operations;*
- *Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;*
- *Controls over the period-end financial reporting process;*
- *Controls over recording of unusual transactions; and*
- *Policies that address significant business control and risk management practices.*

91. Control environment. Because of its importance to effective internal financial *controls over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess:*

- *Whether management's philosophy and operating style promote effective internal* financial *controls over financial reporting;*
- *Whether sound integrity and ethical values, particularly of top management, are developed and understood; and*
- *Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.*

92. Period-end financial reporting process. Because of its importance to the auditor's opinions on internal financial *controls over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following:*

- *Procedures used to enter transaction totals into the general ledger;*
- *Procedures related to the selection and application of accounting policies;*

- *Procedures used to initiate, authorise, record, and process journal entries in the general ledger;*
- *Procedures used to record recurring and non-recurring adjustments to the annual and quarterly / interim financial statements / results, if any;*
- *Procedures for preparing annual and quarterly financial statements and related disclosures.*

93. As part of evaluating the period-end financial reporting process, the auditor should assess:

- *Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and interim financial statements;*
- *The extent of information technology ("IT") involvement in the period-end financial reporting process;*
- *Who participates from management;*
- *The locations involved in the period-end financial reporting process;*
- *The types of adjusting and closing entries; and*
- *The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.*

Note: *Because the annual period-end financial reporting process normally occurs after the balance sheet date, management's assessment of those controls usually cannot be tested until after the balance sheet date.*

Note: *The auditor should obtain sufficient evidence of the effectiveness of those interim controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the interim balance sheet dates for the purpose of evaluating the annual period–end financial reporting process. However, the auditor is not required to obtain sufficient evidence for each interim period financial reporting process individually, since the auditor would be reporting on the adequacy and operating effectiveness of the internal* financial *controls over financial reporting as at the year-end balance sheet date.*

Identifying significant accounts and disclosures and their relevant assertions

94. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include:

- *Existence or occurrence;*
- *Completeness;*
- *Valuation or allocation;*
- *Rights and obligations;*

- *Assertions relating to presentation and disclosure*

95. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include:

- *Size and composition of the account;*
- *Susceptibility to misstatement due to errors or fraud;*
- *Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;*
- *Nature of the account or disclosure;*
- *Accounting and reporting complexities associated with the account or disclosure;*
- *Exposure to losses in the account;*
- *Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;*
- *Existence of related party transactions in the account; and*
- *Changes from the prior period in account or disclosure characteristics.*

96. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor should also determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account or disclosure.

97. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal financial *controls over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.*

Note: *In the financial statements audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are determined not to be significant accounts, disclosures and relevant assertions.*

98. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

99. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the financial statements of the company as a whole. Having made those determinations, the auditor should then apply the guidance provided in paragraph IG 1 for multiple locations scoping decisions.

Understanding likely sources of misstatement

100. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- *Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded; (Refer IG 2 and IG 3)*
- *Verify that he/she has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;*
- *Identify the controls that management has implemented to address these potential misstatements; and*
- *Identify the controls that management has implemented over the prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.*

An illustrative list of risks of material misstatement, related control objectives and control activities is given in ***Appendix IV****.*

101. Because of the degree of judgement required, the auditor should perform the procedures that achieve the objectives in paragraph 100 either by himself or herself or supervise the work of others who provide direct assistance to the auditor.

102. The auditor should also understand how Information Technology (IT) affects the company's flow of transactions. The auditor should apply the requirements of SA 315*, which discuss the effect of information technology on internal* financial *controls and the risks to assess. (Refer IG 4)*

Note: *The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this guidance.*

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

104. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting controls to test

105. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

106. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

107. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, detective control).

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

108. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements. This would also enable the auditor to conclude if the company has an adequate internal financial *controls system over financial reporting in place.*

***Note:** A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organisation. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.*

109. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing controls-testing operating effectiveness (Refer IG 13)

110. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

***Note:** In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.*

111. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

Relationship of risk to the evidence to be obtained

112. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a significant deficiency or material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

***Note:** Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's overall internal* financial *controls over financial reporting. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.*

113. Factors that affect the risk associated with a control include:

- *The nature and materiality of misstatements that the control is intended to prevent or detect;*
- *The inherent risk associated with the related account(s) and assertion(s);*
- *Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;*
- *Whether the account has a history of errors;*
- *The effectiveness of entity-level controls, especially controls that monitor other controls;*
- *The nature of the control and the frequency with which it operates;*
- *The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance; (Refer IG 6)*
- *The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls); (Refer IG 7 and IG 8)*
- *Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and*

***Note:** A less complex company or business unit with simple business processes and centralised accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.*

- *The complexity of the control and the significance of the judgements that must be made in connection with its operation.*

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

114. When the auditor identifies deviations from the company's controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: *Because effective internal* financial *controls over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives over the period-end financial reporting process, an individual control does not necessarily have to operate without any deviation to be considered effective.*

115. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Note: *Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.*

116. Nature of tests of controls. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation, and re-performance of a control. (Refer IG 10)

Note: *Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.*

117. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist.

Note: *A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.*

118. Timing of tests of controls. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the balance sheet date provides more evidence than testing performed earlier in the year. The auditor should balance performing the tests of controls closer

to the balance sheet date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness. (Refer IG 16)

119. Prior to the balance sheet date, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal financial *controls over financial reporting. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test the design and operating effectiveness of those superseded controls, as appropriate. (Refer IG 17)*

120. Extent of tests of controls. The more extensively a control is tested, the greater the evidence obtained from that test. (Refer IG 14)

121. Roll forward procedures. When the auditor reports on the effectiveness of controls as of the balance sheet date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence concerning the operation of the controls for the remaining period is necessary. (Refer IG 15)

122. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors:

- *The specific control tested prior to the balance sheet date, including the risks associated with the control and the nature of the control, and the results of those tests;*
- *The sufficiency of the evidence of effectiveness obtained at an interim date;*
- *The length of the remaining period; and*
- *The possibility that there have been any significant changes in internal* financial *controls subsequent to the interim date.*

***Note:** In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.*

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

123. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal financial *controls over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 112 to 122.*

124. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 113 and the following:

- *The nature, timing, and extent of procedures performed in previous audits,*
- *The results of the previous years' testing of the control, and*

- *Whether there have been changes in the control or the process in which it operates since the previous audit.*

125. After taking into account the risk factors identified in paragraphs 113 and 124, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

When planning the nature, timing and extent of testing for reporting on internal financial *controls over financial reporting in a subsequent year, the auditor is normally not expected to adopt a rotation / cyclical plan for testing controls i.e., the auditor cannot choose to defer testing of certain controls for the reason that they were tested in the immediate previous year. Rotation / cyclical plan for testing internal* financial *controls over financial reporting may be permitted in limited circumstances as more fully described in IG 16.*

126. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph IG 7.6.

127. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed or change the combination of procedures used.

Evaluating identified deficiencies

128. The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses as of the balance sheet date. In planning and performing the audit, however, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a significant deficiency.

Note: For purpose of this guidance,

- A ‘deficiency’ in internal financial control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- A ‘significant deficiency’ is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
  - A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.
  - A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

- 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.

129. The severity of a deficiency depends on:

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

130. The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.

131. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- *The nature of the financial statement accounts, disclosures, and assertions involved;*
- *The susceptibility of the related asset or liability to loss or fraud;*
- *The subjectivity, complexity, or extent of judgement required to determine the amount involved;*
- *The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;*
- *The interaction of the deficiencies; and*
- *The possible future consequences of the deficiency.*

***Note:** The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.*

***Note:** Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.*

132. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following:

- *The financial statement amounts or total of transactions exposed to the deficiency; and*
- *The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.*

133. In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount,

while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

134. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a significant deficiency or material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

Indicators of Material Weakness

135. Indicators of material weaknesses in internal financial *controls over financial reporting include:*

- *Identification of fraud, whether or not material, on the part of senior management;*
- *Errors observed in previously issued financial statements in the current financial year;*
- *Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal* financial *controls over financial reporting; and*
- *Ineffective oversight of the company's external financial reporting and internal* financial *controls over financial reporting by the company's audit committee.*

136. When evaluating the severity of a deficiency, or combination of deficiencies, the auditor should also determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that a deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weaknesses.

Communicating Certain Matters

137. The auditor must communicate, in writing, to management and those charged with governance all material weaknesses and any deficiencies, or combinations of deficiencies that are significant deficiencies identified during the audit. Where possible, the written communication should be made prior to the issuance of the auditor's report on internal financial *controls over financial reporting to provide an opportunity for the company to remediate the material weakness. If such remediation is done before or as at the balance sheet date, the auditor could test the same before forming his/her final opinion.*

138. Based on an evaluation of the implementation of the components of internal control which make up the system of internal financial *controls over financial reporting established by the company, if the auditor concludes that the oversight of the company's external financial reporting and internal* financial *controls over financial reporting by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors.*

139. The auditor should also communicate to management, in writing, all deficiencies in internal financial *controls over financial reporting (i.e., those deficiencies in internal* financial *controls over financial reporting that are of a lesser magnitude than significant deficiency)*

identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organisation.

140. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal financial *controls over financial reporting of which he or she is aware.*

141. Because the audit of internal financial *controls over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a significant deficiency, the auditor should not issue a report stating that no such deficiencies were noted during the audit.*

142. With respect to communications relating to the audit of internal financial controls over financial reporting , the auditor should also consider and suitably adapt the requirements and principles of SA 260 “Communication with Those Charged with Governance” and SA 265 “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”.

143. When auditing internal financial *controls over financial reporting, the auditor may become aware of fraud or possible illegal acts.* In such circumstances, the auditor must determine his or her responsibilities under the Companies Act, 2013 and SA 240 and SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”.

Subsequent Events

144. Changes in internal financial *controls over financial reporting or other factors that might significantly affect internal* financial *controls over financial reporting might occur subsequent to the date as of which internal* financial *controls over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors and obtain written representations from management relating to such matters, as described in paragraph 150.*

145. To obtain additional information about whether changes have occurred that might affect the effectiveness of the company's internal financial *controls over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:*

- *Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period,*
- *Regulatory agency reports on the company's internal* financial *controls over financial reporting, and*
- *Information about the effectiveness of the company's internal* financial *controls over financial reporting obtained through other engagements.*

146. The auditor might inquire about and examine other documents for the subsequent period. SA 560 “Subsequent Events”*, provides direction on subsequent events for a financial statement*

audit that may also be helpful to the auditor performing an audit of internal financial *controls over financial reporting.*

147. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal financial *controls over financial reporting as of the balance sheet date, the auditor should issue an adverse opinion on internal* financial *controls. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal* financial *controls over financial reporting, the auditor should disclaim an opinion.*

148. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date and before issuance of the auditor's report. If a subsequent event of this type has a material effect on the company's internal financial *controls reporting over financial reporting, the auditor should include in his or her report an explanatory paragraph describing the event and its effects.*

149. After the issuance of the report on internal financial *controls over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in SA 560.*

Obtaining Written Representations

150. In an audit of internal financial *controls over financial reporting, the auditor should obtain written representations from management:*

- *Acknowledging management's responsibility for establishing and maintaining adequate internal* financial *controls over financial reporting that were operating effectively;*
- *Stating that management has performed an evaluation and made an assessment of the adequacy and effectiveness of the company's internal* financial *controls over financial reporting and specifying the control criteria;*
- *Stating that management did not use the auditor's procedures performed during the audits of internal* financial *controls over financial reporting or the financial statements as part of the basis for management's assessment of the adequacy and effectiveness of internal* financial *controls over financial reporting;*
- *Stating management's conclusion, as set forth in its assessment, about the adequacy and effectiveness of the company's internal* financial *controls over financial reporting based on the control criteria as of the balance sheet date;*
- *Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal* financial *controls over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal* financial *controls over financial reporting;*
- *Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the*

company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal financial *controls over financial reporting;*

- *Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraphs 137 and 139 have been resolved, and specifically identifying any that have not; and*
- *Stating whether there were, subsequent to the date being reported on, any changes in internal* financial *controls over financial reporting or other factors that might significantly affect internal* financial *controls over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.*

SA 580 "Written Representations" *explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updated letter. (Refer* ***Appendix II*** *for illustrative format of the management representation letter)*

151. Inability *to obtain written representations 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 either disclaim the audit opinion or resign from the engagement.

152. Since the primary responsibility for establishing and maintaining an adequate internal financial controls system over financial reporting is that of the management and the board of directors of the company, the auditor should ensure that the board of directors approving the financial statements of the company also approve the management assertion and conclusion on the adequacy and operating effectiveness of internal financial controls over financial reporting and also take on record the deficiencies, significant deficiencies and material weaknesses identified by the management, internal auditors and the auditor.

Note: Since the board report under Section 134 of the Act, which would include the directors responsibility statement, inter alia, on internal financial controls, may be prepared after the date of the audit report, it is essential that the auditor obtains the assertion of the board of directors on the internal financial controls over financial reporting prior to issuance of the audit report.

Forming an Opinion (Refer IG 20)

153. *The auditor should form an opinion on the* adequacy and operating *effectiveness of internal* financial *controls over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.*

Note: *As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal* financial *controls over financial reporting and evaluate control deficiencies identified in those reports.*

154. After forming an opinion on the adequacy and operating *effectiveness of the company's internal* financial *controls over financial reporting, the auditor should evaluate the disclosures that the management and board of directors is required to make, under the Act on internal* financial *controls.* In this connection, the auditor should apply the requirements of SA 720 "The Auditor's Responsibility In Relation To Other Information In Documents Containing Audited Financial Statements" for matters relating to internal financial controls over financial reporting included in the documents of the Company.

155. If the auditor determines that any required elements of the board's report on internal financial *controls over financial reporting are incomplete or improperly presented, the auditor should follow the requirements of* SA 720*.*

156. The auditor may form an opinion on the adequacy and operating *effectiveness of internal* financial *controls over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement.*

Reporting on Internal Financial *Controls over Financial Reporting*

157. The auditor's report on the audit of internal financial *controls over financial reporting must include the following elements:*

a. A title that includes the word independent;

b. A statement that management is responsible for maintaining adequate and *effective internal* financial *controls over financial reporting and for assessing the adequacy and effectiveness of internal* financial *controls over financial reporting as per the meaning of internal* financial *controls provided in the Act;*

c. An identification of the benchmark criteria used by the management for establishing internal financial controls over financial reporting;

d. A statement that the auditor's responsibility is to express an opinion on the company's internal financial *controls over financial reporting based on his or her audit;*

e. A statement that the audit was conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and the Standards on Auditing, to the extent applicable to an audit of internal financial controls over financial reporting, both issued by the Institute of Chartered Accountants of India;

f. A statement that the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and Standards on Auditing *require that the auditor plan and perform the audit to obtain reasonable assurance about whether* adequate and *effective internal* financial *controls over financial reporting were maintained in all material respects;*

g. A statement that an audit includes obtaining an understanding of internal financial *controls over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the adequacy and operating effectiveness of internal control over financial reporting based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;*

h. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

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

Note: In an audit of financial statements, it is presumed that the going concern assumption for the company is appropriate and the auditor evaluates the appropriateness of such assumption. In case such assumption is not appropriate or a material uncertainty exists, the auditor is required to comply with the requirements of SA 570 “Going Concern”. Correspondingly, in an audit of internal financial controls over financial reporting, the auditor needs to make appropriate disclosures to state the inherent limitations on internal financial controls over financial reporting and the limitations in consideration of such controls operating as at the balance sheet date for the future operations of the company.

j. The auditor's opinion on whether the company maintained, in all material respects, adequate internal financial *controls over financial reporting and whether they were operating effectively as of the balance sheet date, based on the control criteria;*

k. The signature of the auditor with firm name, where applicable;

l. The place and date of the audit report.

Audit Report

158. The auditor may issue separate reports on the company's financial statements and on internal financial controls over financial reporting.

159. Examples of separate unmodified report on internal financial controls over financial reporting in the case of the standalone and consolidated financial statements are given in **Appendix III – Example 1 and 5,** respectively**.**

160. Examples of separate modified report on internal financial controls over financial reporting in the case of the standalone financial statements are given in **Appendix III – Examples 2 to 4.**

Modified Opinion

161. Paragraphs 128 to 136 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must evaluate the need to express a modified opinion – qualified or adverse on the company's internal financial controls over financial reporting, unless there is a restriction on the scope of the engagement.

162. When expressing a modified opinion on internal financial controls because of material weakness, the auditor's report must include:

- The definition of a material weakness as provided in this Guidance Note.
- A statement that a material weakness has been identified.
- A description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness.

163. The auditor should determine the effect his or her modified opinion on internal financial *controls over financial reporting has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements*

was affected by the modified opinion on internal financial *controls over financial reporting. (Refer IG 20)*

Note: *When the auditor issues a separate report on internal* financial *controls over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 160 and 162. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.*

Report Date

164. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the auditor's reporting on internal financial controls over financial reporting is specified in the same Section as that of the opinion on financial statements viz. Section 143(3) of the Act, the date of the audit report on internal financial controls over financial reporting should be the same as that of the date of the audit report on the financial statements.

Audit Documentation

165. The auditor should document the work performed on internal financial controls over financial reporting such that it provides:

(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was planned and performed in accordance with this guidance, applicable Standards on Auditing and applicable legal and regulatory requirements.

In this regard, the auditor should comply with the requirements of SA 230 "Audit Documentation" to the extent applicable.

Considerations for Joint Audits and Branch Audits

166. Where applicable, the auditor should comply with the requirements of SA 299 "Responsibility of Joint Auditors" to the extent applicable when performing an audit of internal financial control over financial reporting. The following may be considered in case of both joint audits and branch audits, as applicable:

(a) Division of work

(b) Coordination

(c) Relationship among joint auditor / branch auditor

(d) Reporting responsibilities

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

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

SECTION V
IMPLEMENTATION GUIDANCE[7]

IG 1 Multiple Locations Scoping Decisions (Refer Paragraph 99)

IG 1.1 In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

***Note:** The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a reasonable possibility of material misstatement to the company's financial statements.*

IG 1.2 In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's financial statements. In lower-risk locations or business units, the auditor might first evaluate whether testing entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organisation, provides the auditor with sufficient evidence.

IG 1.3 In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include relevant audit work at various locations, the auditor may coordinate work with the internal auditors and plan the number of locations or business units at which the auditor would otherwise need to perform auditing procedures, subject to compliance with the requirements of SA 610 "Using the Work of Internal Auditors".

IG 1.4 The direction regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

IG 1.5 Special Situations: The scope of the audit should include businesses that are acquired on or before the balance sheet date and operations that are accounted for as discontinued operations on the balance sheet date.

IG 2 Process Flow Diagrams (Refer Paragraph 100)

Understanding process flows

IG 2.1 To enhance the understanding of the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded;

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[7] The text shown in *italics* in this Section of the Guidance Note has been reproduced from the following documents issued by the Staff of the Public Company Accounting Oversight Board (PCAOB):

- Staff Views - An Audit Of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements: Guidance For Auditors Of Smaller Public Companies *(January 2009)*
- Staff Audit Practice Alert No. 11, Considerations for Audits of Internal Control Over Financial Reporting *(October 2013)*

- Verify that he/she has identified the points within the company's processes at which a misstatement—including a misstatement due to fraud—could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

Information system relevant to financial reporting

IG 2.2 The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

- *The classes of transactions in the company's operations that are significant to the financial statements;*
- *The procedures, within both automated and manual systems, by which those transactions are initiated, authorised, processed, recorded, and reported;*
- *The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorise, process, and record transactions;*
- *How the information system captures events and conditions, other than transactions, that are significant to the financial statements; and*
- *The period-end financial reporting process.*

Process flow diagrams

IG 2.3 Process flow diagrams may be a helpful form of documentation for auditors to depict the process to initiate, authorise, process, record and report transactions; the points within the process at which misstatements could occur; and control activities that are designed to prevent or detect such misstatements, including providing greater transparency to segregation of duties. These diagrams also depict the relevant systems and Information Produced by the Entity (IPE).

Refer figure below on sources and linkage of information for internal financial controls purposes:

IG 2.4 When considering and reviewing the relevant information to developing process flow diagrams, the following questions may be helpful:

- Who is involved in the process (e.g., departments, roles, and people)?
- Are there segregations of duties that are relevant to the process?
- What is the general objective of the processes and what are the related sub-processes?
- When does the process occur?
- Does the process involve, or impact, multiple locations?
- What are the tasks within the process and in what sequence do they occur?
- What are the points in the process at which a misstatement, including a misstatement due to fraud, could arise?
- What control activities address the risks?
- What IPE is involved?
- How are application systems involved within the process?

Audit-specific Elements to be Added to the Process Flow Diagram

IG 2.5 Additional detail may be added to represent the audit-specific elements. The following are the general steps for consideration:

1. Insertion of risks of material misstatement
    a. The auditor may insert symbols for risk of material misstatement at the point(s) in the process flow where the risk is present. It is possible that, due to the nature of the risk of material misstatement, it may appear at multiple points in the process flow diagram.
    b. The auditor may use different symbols for significant and normal risk of material misstatement as necessary.
2. Attaching control activity symbols

a. Symbols may be placed for control activity that address risks of material misstatement on the diagram.

b. Automated and manual control symbols may be used as necessary

3. Identification of applications in the process flow diagram

a. If a task relies on an application system when performing an action, the auditor may use a symbol for such applications on the diagram

b. If formatting and space allows, the auditor may attach the application symbol directly on the task which it relates

4. Associating the IPE symbol where appropriate

a. If IPE is used in the execution of a control activity or IPE that is produced as part of the process that is important to the audit (e.g., IPE that an auditor uses in his or her substantive procedures), the auditor may attach a separate symbol for the IPE as a document symbol.

System Overview Diagrams

IG 2.6 The information system relevant to financial reporting can be complex; a visual representation may assist the auditor in understanding how information flows between systems related to the financial transactions of the entity.

IG 2.7 For complex entities, several system overview diagrams may be useful to depict the different systems relevant for a particular process (or across processes). A system overview diagram may also be useful when system complexities and interrelationships demand more visual space to depict the systems that are relevant to the process.

IG 2.8 The following types of information may be useful in this process:

- Applications relevant to the audit;
- Service providers, or service provider systems, involved in entity processes that are determined to be relevant to the audit (e.g., a payroll service organisation and the outsourced systems relevant to the process).

IPE diagrams

IG 2.9 When a control activity is dependent upon IPE that is generated from systems or other sources, it is important that the auditor understands what could go wrong in the generation of the IPE. Illustrative diagrams that depict the auditor's understanding of the report logic, parameters, and source data may be helpful when trying to understand and articulate the risks related to IPE.

IG 2.10 It may be helpful to involve Information Technology (IT) specialists in the creation of IPE diagrams, especially if the IPE is system generated, as much of the information may be generated from the IT systems of the entity. It is important that IT specialists collaborate with the auditors who use the IPE for audit purposes so everyone gains an appropriate understanding of the purpose and intended use of the IPE.

IG 2.11 IPE may be relevant to the audit due to its relationship with the auditor's tests of controls or substantive procedures. The following are the general reasons that IPE is relevant to the audit:

- IPE is used by entity personnel to perform a relevant control.
- IPE is used by the auditor to test a relevant control.
- IPE is used by the auditor to perform substantive procedures.

IG 2.12 Regardless of the use of the IPE in the context of an audit, the auditor may consider creating IPE diagrams to document his or her understanding of the IPE and assist in determining appropriate procedures to test the accuracy and completeness of the information.

IG 2.13 The following general steps to be performed by auditors to build an IPE diagram assume that the auditor has already identified relevant IPE to the audit:

Step 1 — Identification of and Understanding Report Logic and Parameters

The auditor should begin by obtaining an understanding of the business purposes of the IPE. Before gaining a detailed understanding of the parameters and report logic, it may be helpful to understand what specific information in the IPE is relevant to the audit. Auditors may then proceed to identify inputs that could impact the IPE and determine how the IPE is used during the performance of the control activity.

IPE parameters — the criterion for selecting data, such as date ranges, company codes, or specified thresholds:

- If the IPE can be modified by the user to produce a desired or different result, then parameters most likely are used in the generation of the IPE.
- The auditor should determine what parameters are available and have a direct impact to the information that is produced.

IPE report logic — the computer code that contains the algorithms for creating the report:

- The auditor should have discussions with the business users and technical owners of the IPE. He should understand what information is generated and gain an understanding of how the logic was developed to create the output.
- The auditor should gain an understanding if the IPE is generated through custom or standard reporting capabilities of the system.

The auditor should identify if there are general IT controls that address the risks arising from IT relevant to the system that generates the IPE.

Step 2 — Identification and Understanding Source Data

After understanding the report logic associated with IPE, it is also necessary for the auditor to consider the accuracy and completeness of source data. As the engagement teams begin to understand the source data used in the generation of a report, it is important that they consider the accuracy of the data for their intended use. The overall goal of developing IPE diagrams is to help understand and evaluate how the IPE might be inaccurate or incomplete. If the source data

is not appropriate for its intended use, indicate the same in the IPE diagram and describe further details in annotation to inform others as to the challenges that might exist.

It is also important for the auditor to determine the origination of the IPE data source (e.g., tables), if applicable, and annotate such in the IPE diagram.

For example, while IPE information may be extracted from a single reporting table in a system, the reporting table may have been created by consolidating information from several other system tables. Depicting the relationships between the tables that ultimately generate the IPE is important when understanding and evaluating the risks that the IPE might be inaccurate or incomplete because of issues related to source data. Such interrelationship of the source data in the IPE diagram should be depicted by the auditor.

Step 3 — Building the IPE Diagrams

After the IPE parameters, report logic and source data have been understood, the auditor can develop the IPE diagram.

The following basic elements may be depicted in the diagram to represent the auditor's understanding of the IPE:

- IPE parameters
  - Identification of relevant parameters that impact the results of the IPE.
  - Common parameter combinations used to generate IPE (if there are recurring uses).
- IPE logic
  - Identification of standard or custom IPE logic.
  - Location information on where the source logic is maintained in the system.
  - If a benchmarking strategy is used to test logic, identification of the date that logic was last changed.
  - Information that indicates whether general IT controls are relevant.
- IPE source data
  - Relevant application systems.
  - Sources of information used to generate IPE (e.g., system tables).
  - Information that indicates whether general IT controls are relevant.
  - If general IT controls are not relevant, document alternative methods for validating the accuracy and completeness of the data.
- Reference to IPE on process flow diagram, if applicable.

Automated control diagrams

IG 2.14 When automated control activities exist, it may be relatively easy to describe broadly how they function; however, it can be difficult to describe the detailed attributes of the control that are relevant to the audit and how they operate in sufficient detail to facilitate designing effective tests of such controls. Pictorial diagrams may enhance the auditor's understanding of how automated control activities are designed to address risks of material misstatement, and may therefore better facilitate planning effective tests of such controls. The purpose of the automated control diagram is to demonstrate how the control operates logically to prevent or detect risks of material misstatement from occurring.

The following general steps are helpful into building an automated control diagram:

Step 1 — Understanding Relevant Automated Controls

The auditor should begin by obtaining an understanding of the purposes of the automated control; he may consider performing the following:

- Have discussions with the business process owners and technical owners who interact with the automated control.
- Understand what the system is evaluating to prevent or detect errors from occurring. Identify if the automated control logic can be applied differently across the entity based on changing the configurations.
- Identify if there are general IT controls that address the risks arising from IT relevant to the application system with automated controls.

Step 2 — Building the Automated Control Diagram

After the automated controls are understood, the automated control diagram can be developed. The following basic elements may be depicted on the diagram to represent the auditor's understanding of the automated control:

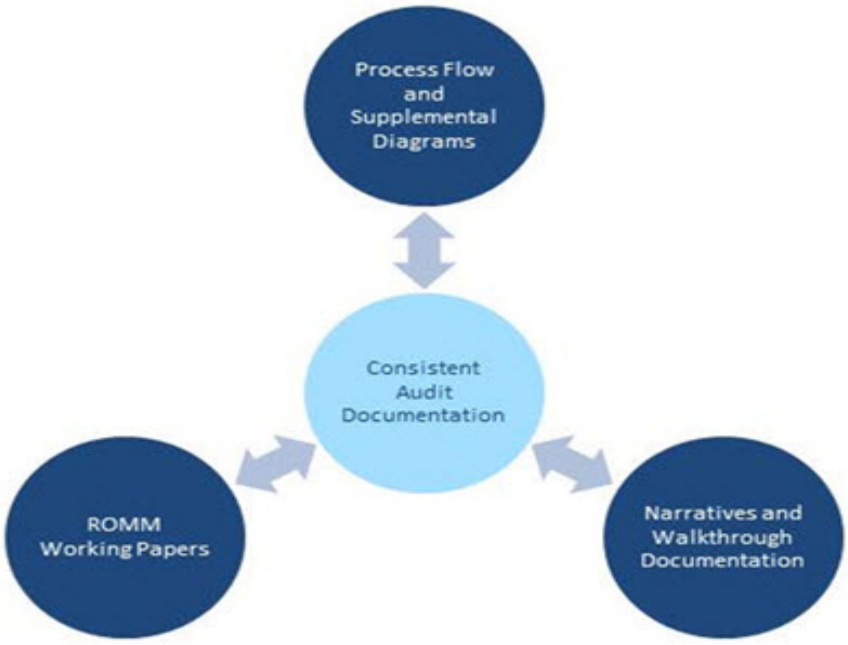
- Control activity reference
  - Depicting control activities in the form of task boxes with a description of the action enforced by the automated control.
  - Connecting the automated control symbol to the task box and use the same reference number that is depicted on the process flow diagram.
- System references
  - Depicting systems on the diagram when associated with a control activity task.
  - If data sources are shown in the diagram, depicting the source system.
- Automated control logic
  - The auditor should document what the automated control relies upon from a logic perspective to perform the desired action.

- The auditor should illustrate what happens as a result of the automated control; decision boxes show what the possible paths might be based on the conditions that could be met.

Validate understanding

IG 2.15 A final step in developing the process flow diagrams, as well as any other supplemental diagrams, is to validate the auditor's understanding and determine whether the diagrams are accurate and complete for their intended purpose. Because processes can be complex and multiple information sources may be used in the development of supporting diagrams, it is important to validate the consistency of the diagrams with other sources of information used during the audit to determine that the auditor's understanding is consistent with respect to the identified risks of material misstatement, control activities, and IPE.

Figure



The auditor's process flow diagrams may also be reviewed with the entity personnel to validate that they accurately represent the entity's processes. Discussions with the entity using graphical representations of their process flows may lead to further enhancement of the auditor's understanding of the entity, their flow of transactions, and the likely sources of misstatement (for a combined audit of internal financial controls over financial reporting and financial statements), and in some cases might necessitate revisions to the auditor's first drafts of the process flow diagrams.

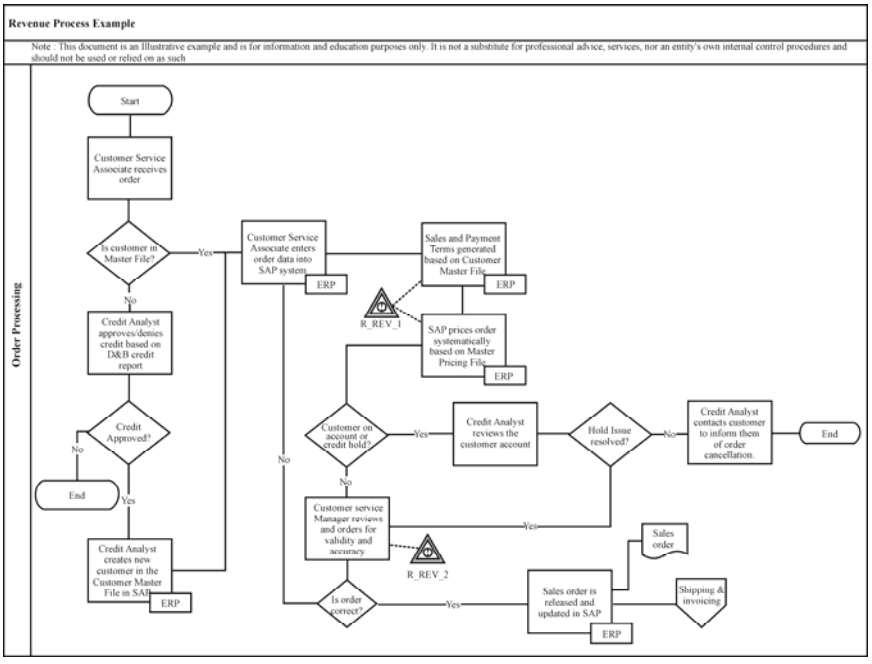
As part of the risk assessment procedures, evaluate process flow diagrams, and other supplemental diagrams, on an on-going basis and update as necessary. As the entity evolves and changes its systems, controls, and business processes, the risks of material misstatement might change, thereby leading to an update of the auditor's process flow diagrams.

Illustrative example of process flow documentation for revenue business cycle

IG 2.16 Below is the detailed illustrative example of process flow diagrams for the Revenue process (which assumes an automated application system (ERP) used by the entity). The Revenue process covers the following sub-processes: Order Processing, Shipping and Invoicing, and Sales Returns. This illustrative example consists of three process flow diagrams and related narratives:

- Diagram 1 — Order Processing
- Diagram 2 — Shipping and Invoicing
- Diagram 3 — Sales Returns
- Revenue Narrative 1 — Order Processing
- Revenue Narrative 2 — Shipping and Invoicing
- Revenue Narrative 3 — Sales Returns

Diagram 1 — Order Processing



Revenue Narrative 1 — Order Processing

Orders can be received via fax, mail, email, or phone. Customer Service Associates are responsible for monitoring incoming orders that arrive at the Business Centre. All faxes and postal mail are electronically converted by Customer Service Associates. Phone-based orders

are directed to a central call number which rings the next available Customer Service Associate to take order information.

All orders must be created with reference to a customer that is established in the customer master file within SAP. If an order is received for a non-existent account, the new account procedure is followed, whereby a Credit Analyst reviews credit worthiness based on a Dun & Bradstreet credit report. In the event that a decision is taken to not extend credit, the processing of the order ends and the customer is contacted to inform them of the credit decision. If credit is extended to the customer, the Credit Analyst creates a new customer in the customer master file and notifies the Customer Service Associates to process the order.

When entering an order, "Sold to" and "Ship to" fields must be populated with a valid customer number that matches an existing customer number established in the customer master file. Sales and payment terms are automatically populated through the information contained in the customer master file in SAP (R_REV_1). All line items on the sales order are systematically populated based on the information in the master pricing file (R_REV_1).

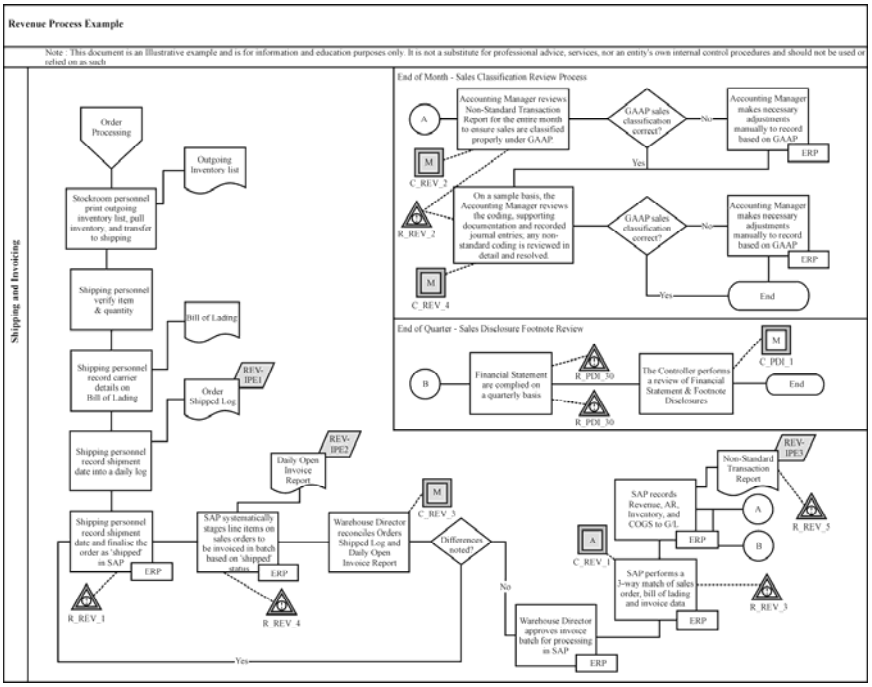
Sales orders are configured with the following key mandatory fields: Sales Order Type (Rush Order or Stock Order), Order Source (fax, mail, email, phone), Sales Organisation, Sold to/Ship to account numbers, item quantities, material numbers, and purchase order number. The balance of the information is automatically extracted from the customer master or pricing master file records. Sales to customers with non-standard payment or shipping terms are automatically flagged in SAP; the flags are used in the shipping and invoicing process to generate exception reports for management to review. Pricing for each customer may be different based on negotiated contracts which are configured against the master pricing file with customer-specific discounts applied.

For orders on hold due to an account or credit hold, the credit department is notified. A Credit Analyst will review the hold and make a determination if the hold can be resolved. If the hold cannot be resolved, the Credit Analyst will contact the customer and notify them of order cancellation, ending the order entry process. If the hold can be resolved after investigation, the Credit Analyst will release the hold and submit the order to the Customer Service Manager to review. All processed orders must be reviewed and approved by the Customer Service Manager prior to being submitted to the shipping and invoicing process. If any errors are noted, they are resolved by the Customer Service Associates and resubmitted through the process. After the order is approved, the sales order is released and updated in SAP (R_REV_1).

The following is the IPE identified in the process flow:

- Orders Shipped Log (**REV-IPE1**)

Diagram 2 — Shipping and Invoicing



Revenue narrative 2 — Shipping and Invoicing

After the sales order is approved, the data is transferred automatically from the order entry system to the shipping and invoicing modules in SAP. Outgoing inventory lists are printed by the stockroom personnel. Outgoing inventory list quantities are populated systematically based on information defined in the approved sales orders.

The product is pulled from the warehouse by shipping personnel based on the information defined on the outgoing inventory lists. Shipping personnel will verify the information, such as item and quantity, and then package the items in preparation of shipment.

After the order is prepared for shipment, the bill of lading is printed with the carrier information recorded on the document; a carbon copy is forwarded on to shipping data entry personnel where the order is confirmed as shipped, completing the shipping process within the system (R_REV_1). Shipments of goods to customers are logged just prior to marking the orders as shipped in SAP; this is completed by taking carbon copies of the bill of lading documents and manually logging them in a spreadsheet that is maintained by the shipping clerks. The spreadsheet is referred to as the "Orders Shipped Log."

Once marked as shipped, line items in the sales order will change automatically in the system, which will result in closing the shipped lines and staging of the line items to be invoiced (R_REV_4). Only the lines on the sales order that ship will be invoiced. Open lines are back-ordered and will remain open until those items are shipped. The only other way to close a line on an order is to reject the line(s), which requires approval by a Customer Service Manager.

The SAP system compiles the staged invoices on a daily basis in a "Daily Open Invoice Report." The Orders Shipped Log and the Daily Open Invoice Report are both reviewed by the Warehouse Director on a daily basis to validate that all orders shipped have also been included in the invoicing batch. The Warehouse Director matches the shipments recorded in the Daily Open Invoice Report to the shipments logged in the manual Orders Shipped Log as being shipped to a customer (C_REV_3). If differences are noted, the Warehouse Director works with shipping personnel to ensure shipments are recorded in the system accurately. If no differences are noted, the batch is approved in SAP for invoice processing.

Invoicing is performed nightly in SAP through a systematic batch process. The SAP system performs a 3-way match; invoices can only be processed when there is a systematic matching of the purchase order, bill of lading/shipped status, and completing a 3-way match to generate the invoice (C_REV_1 | R_REV_3). The invoice generation process updates the general ledger, records the sale (recognises the revenue) and the receivable, relieves the inventory, and records cost of goods sold. As part of the nightly batch process, the SAP system generates a report that lists every flagged transaction that contained non-standard sales or shipping terms. This report is called the "Non-standard Transaction Report" (R_REV_5).

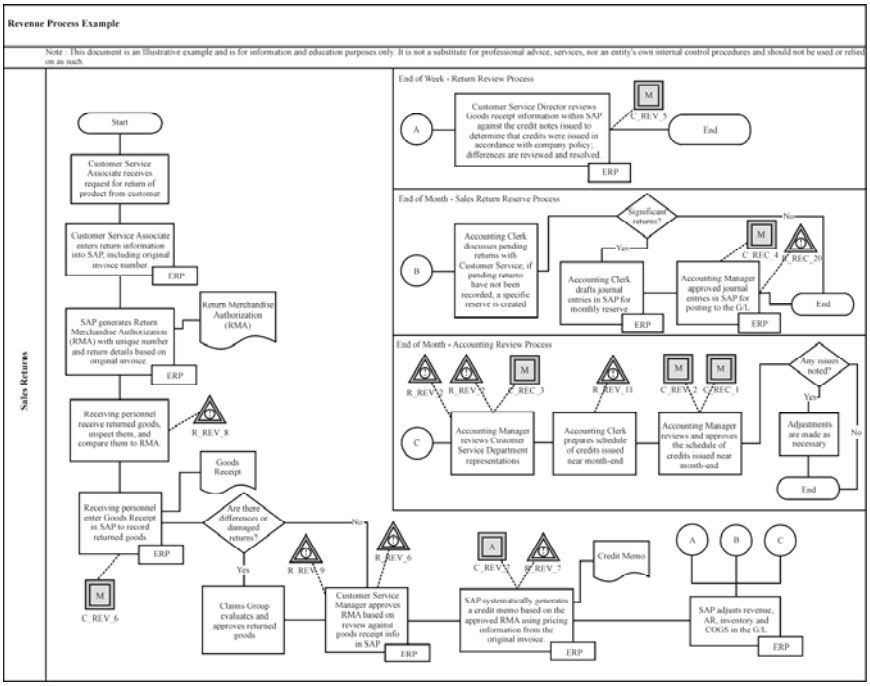
Revenue is recognised at the time of invoicing because the Company’s standard sales terms are defined as free on board (FOB) shipping point. At the end of the month, the Accounting Manager reviews all non-standard transaction reports on a daily basis that were generated during the month; any non-standard sales terms (e.g., FOB destination) are reviewed in detail to ensure sales are classified properly under GAAP (C_REV_2 | R_REV_1). If corrections are necessary, the Accounting Manager makes manual adjustments to reflect proper GAAP classification of the transaction. After non-standard terms are reviewed, the Accounting Manager samples 50 sales transactions to evaluate the coding, supporting documentation, and journal entries made to the general ledger for all sales that are booked; any non-standard coding is reviewed in detail and resolved to ensure sales are classified properly under GAAP (C_REV_4 | R_REV_1). If corrections are necessary, the Accounting Manager makes manual adjustments necessary to reflect proper GAAP classification of the transaction.

On quarterly basis, once the financial statements have been compiled, the Controller performs a review of the financial statements, including all footnote disclosures. Included in this review are the sales-related disclosures in the footnotes of the financial statements. As part of this review, the Controller checks references to supporting documents (R_PDI_38 | R_PDI_39 | C_PDI_1).

The following is the IPE identified in the process flow:

- Daily Open Invoice Report (**REV-IPE2**)

Diagram 3 — Sales Returns



Revenue narrative 3 — Sales returns

Customer Service Associates receive requests for return of product. Customer Service Associates enter information into SAP at the time of request and use the original invoice number as a unique lookup code to generate base information for the return. SAP generates the Return Merchandise Authorisation (RMA) with unique number and listing of material(s) requested to be returned, with pricing obtained from original invoice data.

Upon receipt of the returned items, receiving personnel inspect the items and compare them to the RMA (R_REV_8). Receiving personnel enter goods receipts within SAP to record the quantity received for the sales return associated with the RMA (C_REV_6). If there are differences or damaged returns, the RMA is forwarded to the Claims Group for review and approval. All RMAs are submitted to the Customer Service Manager for final review and approval of the return based on review against goods receipt information in SAP (R_REV_6) (R_REV_9). Upon approval of the RMA in the SAP system, a credit memo is generated systematically based on pricing information obtained from the original invoice that was recorded on the RMA (R_REV_7 | C_REV_7). Based on the credit memo that is issued, SAP automatically adjusts the general ledger to reverse the sales transaction; accounts receivable, sales, inventory, and cost of goods sold are reversed for the returned goods.

On a weekly basis, the Customer Service Director reviews the return details on the Goods Receipt information within SAP against the credit notes issued to determine that credits were issued in accordance with company policy. Any differences are resolved and corrective actions are taken (C_REV_5).

On a monthly basis, the Accounting Clerk evaluates the end-of-month position on returns through discussions with Customer Service Associates. If any significant pending returns are known but not recorded, a specific reserve is created to cover the anticipated exposure. The Accounting Clerk creates the journal entries in SAP to book the monthly return reserve; the Accounting Manager must post/approve the journal entry to record the reserve (R_REV_10 | C_REC_4).

On a monthly basis, the Accounting Manager obtains representations from the Customer Service Director who handles sales orders and credit notes. The representations are obtained to indicate that no verbal or unrecorded credit memos exist that have not been reported to finance management (R_REV_2, R_REV_7 | C_REC_3). After receiving the representations on unrecorded credit memos, the Accounting Clerk prepares a schedule of credit memos issued 3 days before and after the end of the month for analysis and review to make certain the sales and returns are recorded in the appropriate accounting period (R_REV_11). The Accounting Manager reviews and approves the schedule to ensure that sales returns are recorded in the correct period (C_REV_8) (C_REC_1). If any issues are noted regarding the cut-off or completeness of the sales returns, necessary adjustments are made by the Accounting department and support documentation is maintained.

The following is the IPE identified in the process flow:

- Non-standard Transaction Report (**REV-IPE3**)

IG 3 Difference between Process and Control (Refer Paragraph 100)

IG 3.1 Process and controls are two very different aspects. Often they are used interchangeably; hence it is important to understand the difference between them.

A **Process** describes the action of taking a transaction or an event through an established and usually a routine set of procedures or steps.

A **Control** is an action or activity taken to prevent or detect misstatements within the process.

The following examples distinguish a process from a control:

Example 1:

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

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

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

Example 2:

Control description: The Financial Controller prepares a memo documenting the basis for the entity's conclusions regarding impairment.

Pitfall: Preparing an analysis is typically a process step and not a control; the control is the activities performed to verify that the analysis is appropriate.

Improved control description: The CFO reviews the Impairment Analysis Memo and supporting documentation prepared by the Controller to assess the appropriateness of the conclusions reached.

Example 3:

Control description: The billed revenue file is summarised at the month end and the total is recorded into revenue.

Pitfall: Recording an event or transaction is a process step; the control is the activity that is performed to verify that the recording was appropriately performed.

Improved control description: The Accounting Manager verifies that the billed revenue was properly recorded to revenue by comparing the billed revenue file to the revenue recorded in the general ledger.

Example 4:

Control description: When new contracts are entered into or existing contracts are modified, the accounting manager determines and documents in a memo, the applicable revenue recognition model to be used for the contract.

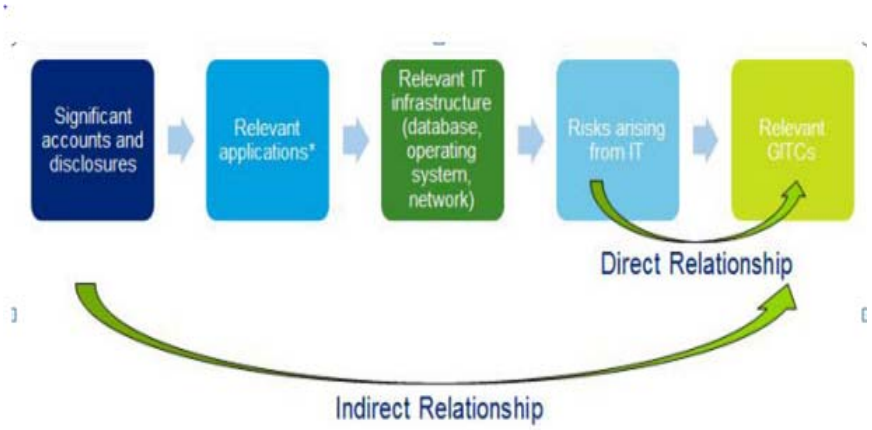
Pitfall: Determining the revenue recognition model and documenting the same are process steps. They do not have any preventive or detective action steps.

Improved control description: The controller reviews and approves the revenue recognition memo prepared by the accounting manager. As part of the review process, the controller reads all the relevant excerpts from the contract and applicable professional standards as well as reviews and challenges, as appropriate, the conclusions documented in the memo.

IG 4 Understanding IT Environment (Refer Paragraph 102)

IG 4.1 Based on the identification of the relevant flows of transactions or processes, the auditor also identifies the relevant IT environment related to those flows or processes to understand the effect of IT and the risks arising from IT. The term IT environment includes both the application systems and the IT infrastructure supporting those applications systems, including the database, operating system and network.

IG 4.2 The auditor identifies the relevant applications and IT infrastructure to identify the relevant risks arising from IT (IT risks) that need to be addressed for purposes of opining on internal financial controls and for purposes of being able to use a control reliance strategy for those accounts that are impacted by the IT risks (i.e., those accounts where the risks of material misstatement are addressed by controls that are dependent upon the relevant application systems and IT infrastructure.) He or she then identifies and tests the relevant general IT controls that address those IT risks. The relationship between risks of material misstatement, IT risks and relevant GITCs is depicted in figure below.



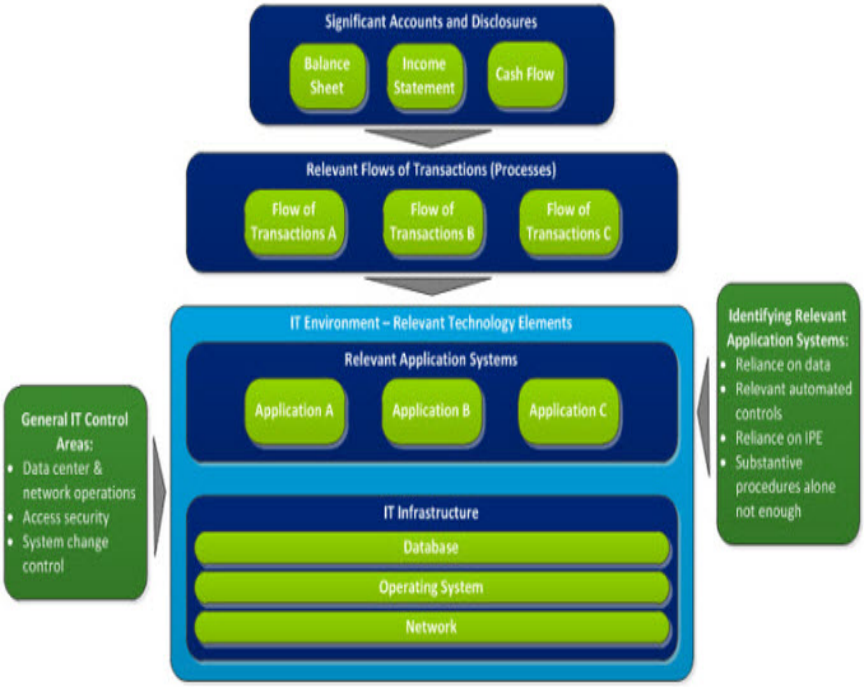
IG 4.3 The auditor's procedures related to IT risks and controls are performed in the context of the relevant flows of transactions related to significant accounts and disclosures. In other words, the auditor is not required to obtain an understanding of all the entity's IT systems; instead, he or she focuses on those aspects of the entity's IT environment that may pose risks to the entity's financial statements. Even when a control-reliance strategy is not planned, the auditor's understanding of IT's role in the entity's processes is important to the identification and assessment of risks of material misstatement and to plan further substantive procedures.

IG 4.4 The auditor should obtain an understanding of the information system, including the related business processes relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures within both IT and manual systems by which those transactions are initiated, authorised, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.
- The related accounting records supporting information and specific accounts in the financial statements that are used to initiate, authorise, record, process, and report transactions. This includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions, or adjustments.

IG 4.5 The diagram below depicts a typical IT environment, including the relationship between the significant accounts and disclosures, the related flow of transactions, the related application systems, the IT infrastructure supporting those applications, and the relevant GITCs, modified to

align with the auditor's terminology. Notably, the diagram illustrates that the identification of the relevant aspects of the IT environment follows the auditor's identification of significant accounts and disclosures, further emphasising that the relevant aspects of the IT environment are identified based on the effect they may have on the entity's internal control, and ultimately on the financial statements.



IG 4.6 In understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. IT also poses specific risks to an entity's internal control, including, for example:

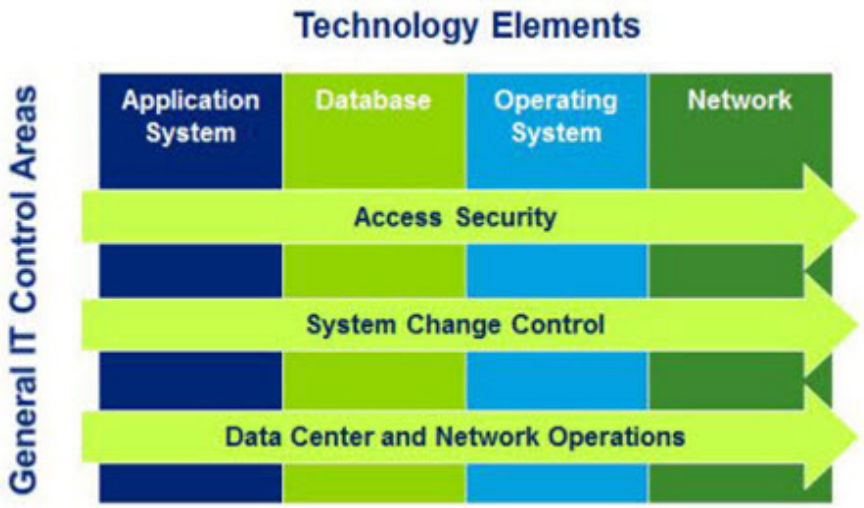
- *Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.*
- *Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions or inaccurate recording of transactions. Particular risks may arise when multiple users access a common database.*
- *The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby breaking down segregation of duties.*
- *Unauthorised changes to data in master files.*
- *Unauthorised changes to systems or programs.*
- *Failure to make necessary changes to systems or programs.*
- *Inappropriate manual intervention.*
- *Potential loss of data or inability to access data as required.*

Understanding general information technology controls (GITCs)

IG 4.7 General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations.
- System software acquisition, change, and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

IG 4.8 GITCs include controls in the three areas of access security, system change control, and data centre and network operations. GITCs also include controls over each of the relevant technology elements within the entity's IT environment, including the application systems, databases, operating systems, and networks. As depicted in Figure below, GITCs are typically structured such that there are similar controls in place for each of the GITC areas across each of the technology elements.



Access security

IG 4.9 GITCs related to access security include logical access controls to prevent or detect unauthorised use of, and changes to, data, systems, or programs, including the establishment of system-based segregation of duties.

IG 4.10 An entity will typically have numerous controls in place to address logical access security, such as implementing user authentication to its systems through the use of unique user IDs and passwords; controlling the process for assigning, modifying, and terminating user access; monitoring the use of privileged-level access; and periodically reviewing user access privileges for appropriateness.

IG 4.11 Entities also control access to their systems through establishing segregation of duties controls. From an IT perspective, the auditor typically considers segregation of duties as it relates to each of the following types of users:

- End user system access — End users may be defined as entity personnel outside of the IT department who use the entity's application system (e.g., to process transactions or perform controls related to significant accounts and disclosures).

For example, a control over end-user access that prevents a single user from having access to both enter and approve journal entries may address risks of material misstatement related to the recording of fictitious or fraudulent journal entries for various significant accounts and disclosures.

- IT personnel system access — IT personnel may be defined as entity personnel responsible for administering the entity's IT systems (e.g., system administrators, security administrators). Segregation of duties controls over IT personnel system access are typically controls that address IT risks. It is typically appropriate for the auditor to test segregation of duties whenever testing user access to the entity's IT systems.

For example, a control over IT personnel system access that prevents a single IT system administrator from having access to both make changes to systems and promote those changes to the production environment may address an IT risk related to the promotion of unauthorised changes into the production environment, resulting in inappropriate modifications to systems or data.

System change control

IG 4.12 GITCs related to system change control include controls within the following categories:

- Program change: Controls to provide assurance that changes to the application systems and database management systems are implemented in a controlled manner.
- System software acquisition, change and maintenance: Controls to provide that network and communication software, systems software, and hardware are effectively acquired, changed, and maintained.
- Application system acquisition, development, and maintenance: Controls to provide that application systems and database management systems are effectively acquired, developed, implemented, and maintained. System change controls address implementation and integration of programs or systems within the IT environment to verify the integrity of processing, performance, and controls over the computerised application systems that it supports.

Data centre and network operations

IG 4.13 GITCs related to data centre and network operations include controls to provide for the integrity of information as it is processed, stored, or communicated by the relevant aspects of the IT infrastructure.

IG 5 Entity-level Controls (ELCs) (Refer Paragraph 88-93)

IG 5.1 ELCs may be categorised into three “buckets”. These “buckets” align with the distinction of direct controls and indirect controls and are described as follows:

- Indirect entity-level controls — Those ELCs that do not themselves directly address risks of material misstatement at the account/assertion level but are important to effective internal control and therefore relevant in an audit of internal financial controls. These include controls that typically fall within the control environment, risk assessment, monitoring, and information and communication components of internal control system, including the general IT controls.
- Direct entity-level controls that are not precise enough — Those ELCs that directly address a risk of material misstatement but are not precise enough *on their own* to fully address a risk of material misstatement at the account/assertion level. While the auditor may identify these as relevant controls and test them, the auditor should also identify and test the effectiveness of other controls that in combination with the entity-level control address the risk of material misstatement.
- Direct entity-level controls that *are precise enough* — Those ELCs that directly address a risk of material misstatement at the account/assertion level and are precise enough on their own to fully address the risks of material misstatements.

IG 5.2 Entity-level controls vary in nature and precision:

- *Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.*
- *Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.*
- *Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.*

IG 5.3 An auditor makes inquiries and applies his or her knowledge of the business and organisational structure to understand and identify ELCs across all three “buckets,” as the nature and effectiveness of ELCs affects the audit plan in three important respects, as follows:

- In terms of their impact on the scope of testing in case of multi-location or multi-business entities.

For example, the effectiveness (or ineffectiveness) of the ELCs is a relevant factor for determining the audit plan for an entity as a whole for both the audit of the financial statements and the audit of internal financial controls.

- In terms of their impact on the scope of testing of other controls.

For example, the effectiveness (or ineffectiveness) of the ELCs is a relevant factor for assessing risk associated with the control and the auditor's determination of the nature, timing and extent of testing of the operating effectiveness of such controls, including roll forward procedures to the balance-sheet date.

IG 5.4 The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal financial controls. 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.

- In terms of whether the ELCs are sufficiently direct and precise to address one or more assessed risks of material misstatement.

Direct and precise entity-level controls (D&P ELCs)

IG 5.5 D&P ELCs are typically review-type (detective) controls that can exist at any level in an organisation (and often exist in multiple layers). To identify those D&P ELCs that may be relevant, the auditor should make inquiries, beginning at the top of the organisation (e.g., Corporate Financial Reporting Department), regarding how the entity determines that its financial statements are prepared in accordance with the applicable financial reporting framework and are free of material misstatement and then work down through the various layers in the organisation. In larger organisations, ELCs that operate at the segment/division or location level are generally more direct and precise than those that operate at the group level.

D&P ELCs at multiple levels within an entity often have different purposes or focus, and therefore may be relevant in addressing different risks of material misstatement.

For example, in an entity with more than 300 components, the balance sheet and income statement of each component are reviewed in detail at the segment level by segment controllers, while the monthly financial reporting package, which includes key performance indicators and trend lines, is analysed at the group level by a financial analysis team. Since the focus of the reviews is different, both ELCs may be relevant controls in the context of an audit.

IG 5.6 The form of an ELC may be very narrow in scope such as the review of a specific analysis related to a specific account/assertion (e.g., an analysis supporting a material accounting estimate) or may be broad in scope such as the review of a financial reporting package that may depict actual trends lines, actual to budget/forecast, and key performance measures for the balance sheet and income statement (including analyses of certain accounts and commentary about unusual transactions or variances).

When a review is broader in scope, it may not be precise enough to address all the risks of material misstatement related to the accounts subject to the review but may be precise enough to address the risks of material misstatement related to some accounts.

For example, a direct and precise ELC that consists of a monthly review of the monthly financial reporting package may be sufficiently precise for some of the accounts where more detailed

analyses are performed but may not be precise enough for others where the review activities are more high-level.

IG 5.7 Examples of "direct but not precise enough" ELCs may include:

- Variance analysis of actual to budget, where budget is a "target" established at the beginning of the year but not a valid expectation against which to measure actual results in order to conclude positively that there is no material misstatements in the actual balance or amounts recorded. Budget versus actual analyses are often intended to be used for the primary purpose of explaining variances from budget for operational purposes, not to detect misstatements; therefore, these analyses are generally not effective in detecting misstatements when actual approximates budget. For a budget versus actual analysis to be an effective D&P ELC, the budget needs to represent a sufficiently precise expectation of the actual balance or amount.
- Trend-line analyses (e.g., current-year to prior-year comparisons) of an account balance, as this kind of analysis typically would not identify misstatements if there were no significant fluctuations between amounts recorded in the current and prior year.

IG 5.8 Examples of direct and precise ELCs may include:

- A variance analysis of rent expense to budget where budget is a valid expectation (e.g., based on the actual lease provisions) that is not expected to materially change during the applicable reporting period.
- Detailed analysis of prepaid expenses such that the reviewer, with sufficient knowledge of the accounts and related transactions and therefore a basis for an independent expectation, would reasonably be expected to identify a material misstatement in the recorded amount.

IG 6 Segregation of Duties (Refer Paragraph 113)

IG 6.1 Segregation of duties means assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

IG 6.2 Business case of implementing segregation of duties:

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

IG 6.3 The following are the typical set of tasks / activities that need to be segregated from a generic perspective:

- *Initiating a transaction (including developing appropriate documentation).*
- *Authorising the transaction.*

- *Recording the transaction.*
- *Monitoring custody of the physical asset.*
- *Reconciling subsidiary ledgers with the general ledger.*
- *Processing master file transactions.*
- *Authorising master file transactions.*
- *Following up on issues or discrepancies.*
- *Controlling systems development and daily operations in computer-based accounting systems.*

IG 7 Automated Controls (Refer Paragraph 113)

Application controls defined

IG 7.1 Application controls are a subset of internal controls that relate to an application system and the information managed by that application. Timely, accurate and reliable information is critical to enable informed decision making. The timeliness, accuracy and reliability of the information are dependent on the underlying application systems that are used to generate, process, store and report the information. Application controls are those controls that achieve the business objectives of timely, accurate and reliable information. They consist of the manual and automated activities that ensure that information conforms to certain criteria that is referred to as business requirements for information. Those criteria are effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability.

Automated control in a way is technology used to automate control activities

IG 7.2 Many control activities in an entity are partially or wholly automated using technology. These procedures are also known as automated control activities or automated controls. Automated controls include financial process-related automated transaction controls, such as a three-way match performed within an ERP system supporting the procurement and payables sub-processes, and computerised controls in operational or compliance processes, such as checking the proper functioning of a power plant. Sometimes the control activity is purely automated, such as when a system detects an error in the transmission of data, rejects the transmission, and automatically requests a new transmission. Other times there is a combination of automated and manual procedures. For example, the system automatically detects the error in transmission, but someone has to manually initiate the re-transmission. In other cases, a manual control depends on information from a system, such as computer-generated reports supporting a budget-to-actual analysis.

IG 7.3 Most business processes have a mix of manual and automated controls, depending on the availability of technology in the entity. Automated controls tend to be more reliable, subject to whether technology general controls, discussed later in this Section, are implemented and operating, since they are less susceptible to human judgement and error, and are typically more efficient.

Assurance on automated controls

IG 7.4 Application controls relate to the transactions and master file, or standing data pertaining to each automated application system, and are specific to each application. They ensure the

accuracy, integrity, reliability and confidentiality of the information and the validity of the entries made in the transactions and standing data resulting from both manual and automated processing.

IG 7.5 The objectives relevant for application controls generally involve ensuring that:

- Data prepared for entry are authorised, complete, valid and reliable.
- Data are converted to an automated form and entered into the application accurately, completely and on time.
- Data are processed by the application accurately, completely and on time, and in accordance with established requirements.
- Data are protected throughout processing to maintain integrity and validity.
- Output is protected from unauthorised modification or damage and distributed in accordance with prescribed policies.

Benchmarking of automated controls

IG 7.6 Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

IG 7.7 If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

IG 7.8 The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

IG 7.9 To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less suited for benchmarking. These factors are –

- *The extent to which the application control can be matched to a defined program within an application.*
- *The extent to which the application is stable (i.e., there are few changes from period to period).*
- *The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)*

IG 7.10 Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote – e.g., when the vendor does not allow access or modification to the source code.

IG 7.11 After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be re-established.

IG 7.12 To determine when to re-establish a baseline, the auditor should evaluate the following factors –

- *The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations.*
- *The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls.*
- *The nature and timing of other related tests.*
- *The consequences of errors associated with the application control that was benchmarked.*
- *Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.*

IG 8 Information Produced by the Entity (Refer Paragraph 113)

IG 8.1 The auditing standards do not provide a definition of information produced by the entity (IPE) or describe what constitutes IPE. IPE is typically in the form of a "report" which may be either system-generated, manually-prepared, or a combination of both (e.g., a download of system accumulated data that is then manipulated in an Excel spreadsheet). Examples of different forms of reports include:

- Standard "out of the box" or default reports or templates that either:
  - May not be modified and therefore don’t allow for customisation of inputs/outputs (e.g., a system generated standard Debtors aging report with no configurable settings or user optionality, that in today’s IT environment of ERP systems is fairly rare), or
  - May be configurable upon installation (e.g., by adding custom fields to a report design or removing fields on a report that are not required to be displayed) and can be modified thereafter through established program change processes (e.g., a system generated standard Debtors aging report with configurable settings such as user defined aging categories and user options for specifying the logic, such as the manner in which the aging is computed, that is more typical in today’s IT environments).
- Custom-developed reports that are not standard to the application and that are defined and generated by user-operated tools such as scripts, report writers,

programming language and query tools (e.g., a monthly user-initiated extract of inventory sales by SKU).

- Output from end-user applications such as automated spreadsheets or other similar applications that house and extract relevant information (i.e., data).
- Entity-prepared analyses, schedules and spreadsheets that are manually prepared by entity personnel either from information generated from the entity's system or from other internal or external sources.

IG 8.2 As there may be a large amount of information that is generated by an entity for use in managing the business and to analyse and prepare financial information, the auditor is only required to test the accuracy and completeness of IPE that is relevant to the audit and used as audit evidence, not all information that is produced by the entity.

IG 8.3 IPE that is relevant to the audit and used as audit evidence generally falls into one of three "buckets" as depicted in below:

IPE that the entity uses	When performing relevant controls
IPE that the auditor uses as an audit evidence	When performing tests of operative effectiveness of relevant controls
IPE that the auditor uses as an audit evidence	When performing substantive procedures

Understanding IPEs

IG 8.4 In order to design appropriate procedures to test the accuracy and completeness of IPE, it is important to first obtain an appropriately detailed understanding of the IPE. The auditor begins with a thorough understanding of what the IPE is, how the IPE is generated, and how the auditor intends to use it as audit evidence. This allows the auditor to design the most appropriate testing approach to determine whether the IPE is sufficient and appropriate for purposes of the audit.

IG 8.5 IPE typically consists of three elements: (1) source data, (2) report logic, and (3) parameters.

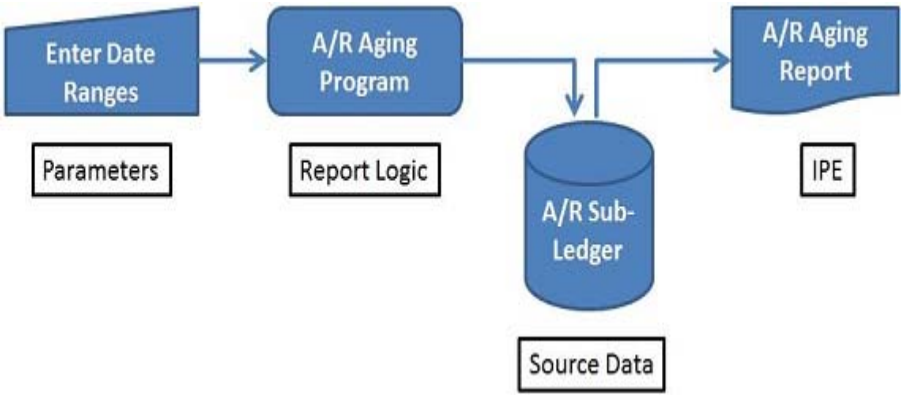
Accordingly, it is important that the auditor obtains an understanding of each of these three elements to determine the testing strategy for IPE. These three elements are further described as follows:

Element	Description
Source Data	The information from which the IPE is created. This may include data maintained in the IT system (e.g., within an application system or database) or external to the system (e.g., data maintained in an Excel spreadsheet or manually maintained), which may or may not be subject to general IT controls. **For example**, for a report of all sales greater than Rs. 1,000,000, the source data is the database of all sales transactions.
Report Logic	The computer code, algorithms, or formulas for transforming, extracting or loading the relevant source data and creating the report. Report logic may

Element	Description
	include standardised report programs, user-operated tools (e.g., query tools and report writers) or Excel spreadsheets, which may or may not be subject to the general IT controls. **For example**, for the Debtors Aging report, the report logic is typically a program in the Debtors application that contains the code and algorithms for creating the Debtors Aging (report) from the Debtors sub-ledger detail (source data).
Report Parameters	Report parameters allow the user to look at only the information that is of interest to them. Common uses of report parameters including defining the report structure, specifying or filtering data used in a report or connecting related reports (data or output) together. Depending on the report structure, report parameters may be created manually by the user (user-entered parameters) or they may be pre-set (there is significant flexibility in the configuration of parameters, depending on the application system), and they may or may not be subject to the general IT controls. **For example**, for a monthly report of slow moving inventory by warehouse location, the user enters the month and location code parameters to generate the reports.

IG 8.6 Figure below portrays the process and the three elements of IPE to generate a typical Debtors aging report: (1) the user-entered parameters (i.e., date ranges), (2) the source data (i.e., the Debtors sub-ledger), and (3) the report logic that generates the Debtors aging report (which includes both the extraction of the source data from the Debtors sub-ledger and the aging of the items).

Figure



IG 8.7 The auditor's objective when performing procedures on IPE is to determine if these three elements, when applicable, produce IPE that is accurate and complete. As IPE is generated in many different forms and through many different methods, the testing strategy may vary depending on the intended purpose of the IPE, the nature of the IPE (e.g., a standard pre-coded report versus a custom ad-hoc report) and how it is created (e.g., the degree of automation which typically increases reliability when subject to effective general IT controls).

For example, Entity A and Entity B both use the same ERP system; however, Entity A uses an Debtors aging report from the system to determine its allowance for doubtful accounts, and Entity B takes the same Debtors aging report, downloads it into Excel, and then manually manipulates the report. The downloading and manipulation of Entity B's report likely introduces additional possibilities that the IPE may be inaccurate or incomplete compared to the Debtors aging report used by Entity A and therefore, it would likely be necessary to perform additional procedures on Entity B's report to determine its accuracy and completeness as compared to Entity A's report.

IG 8.8 The following considerations related to accuracy and completeness of IPE may assist the auditor in obtaining an appropriate understanding to plan the testing approach to IPE:

- Not all data is captured.
  - For example, if all revenue transactions are not captured in the system, a report of revenue data that is derived from the system would likely be incomplete.
- The data is input incorrectly.
  - For example, data entry errors (e.g., a number that is transposed or entered incorrectly) into an Excel spreadsheet may result in incorrect totals in the spreadsheet.
  - For example, SAP maintains a central exchange rate table which is used to translate foreign currency transactions into the local reporting currency. The table is manually updated and therefore subject to human error (e.g., incorrect exchange rates may be input). Therefore, the system-generated report identifying the exchange rates may be incorrect.
- The report logic is incorrect.
  - For example, a report is designed to include sales transactions for which the variation between the actual selling price of an item and the price of that same item in the entity's standard price list is in excess of 15 percent; however, the report was incorrectly configured to only include transactions for which the variance is in excess of 20 percent.
  - For example, the system performs a consolidation of the various reporting entities based on company codes. If a new entity is not initially coded correctly, the manner in which it is consolidated into the overall results of all the reporting entities may not be correct.
  - For example, the entity relies on a report of average selling prices to monitor compliance with its pricing policies; however, the algorithm that calculates the average selling prices was inadvertently applied to sales occurring at only certain business units (i.e., the calculation was not applied to the entire population).
- The report logic or source data could be changed inappropriately or without authorisation.
  - For example, IT management runs a report of all changes to the entity's ERP application as part of a control to determine whether all changes were properly

tested and approved prior to implementation. In order to conceal an error that he had made, an employee in the IT department, who had administrator access to the system, manipulated the report to exclude an unauthorised change he made.

- For example, the report is an Excel spreadsheet that is not subject to general IT controls or otherwise protected and, therefore, may be subject to unauthorised changes.

- The user-entered parameters entered are incorrect.

  - For example, user-entered parameters related to the date range are required when generating a Debtors aging report. If the user-entered parameters are not entered correctly, the data on the report will not likely be correct (e.g., the report may not contain the expected or intended data).

  - For example, consider the circumstance in which a query tool is utilised by a user to extract receivables account detail related only to a particular customer. If the user-entered parameters are not set up to specifically and properly extract all the detail for the specified customer and only the specified customer, then the IPE may not be accurate and complete.

Evaluating IPE

IG 8.9 The auditor is required to "evaluate whether the IPE is sufficiently precise and detailed for purposes of the audit." This involves evaluating whether the IPE is appropriate for its intended purpose (e.g., the objectives of the specific control or substantive procedures for which it is being used).

IG 8.10 If the IPE is not sufficiently precise or detailed for the purpose, it is likely that the auditor cannot use it as audit evidence; however, the auditor may work with the entity to determine if the original IPE can be modified by the entity to meet his or her needs or identify other audit evidence to achieve the intended purpose. Typically, the auditor evaluates whether IPE is sufficiently precise and detailed for the stated purposes based on his or her understanding of IPE and the results of the procedures the auditor performs to address accuracy and completeness of the IPE.

For example, when the auditor is testing program change controls and the client provides a listing of application system changes in a Word document that does not provide sufficient information to identify the related changes made in the source code library for the application system (i.e., the listing is not sufficiently precise), the auditor may require management to either modify the report or to identify an alternative source or form of the information (e.g., a program change listing from the source code library management tool) that will be sufficiently precise and detailed for testing purposes.

IPE in the context of internal financial controls testing

IG 8.11 IPE in the context of internal control testing is IPE that the auditor uses as audit evidence to perform his or her tests of controls and, therefore, the auditor needs to perform procedures to determine that the IPE is accurate and complete.

For example, when testing the effectiveness of an entity's program change controls, the auditor may request the entity to provide a system-generated report that identifies the modifications made to a specific application during a specified time period and use such a report to identify and select items for testing of the entity's program change controls. The testing of change controls relies on the report being accurate and complete; therefore, the auditor needs to perform procedures to address the accuracy and completeness of the report.

IG 8.12 When the auditor uses a report (IPE) to identify the population of items of interest from which to draw the sample for testing, the tests of the items selected from the report typically address the accuracy of the report; however, such procedures often do not address the completeness of the report.

For example, when testing the effectiveness of an entity's program change controls, the auditor obtains a report listing the changes logged during the period of audit interest. When the auditor makes selections from that report and tests them to determine if the entity's controls over program changes are effective, the auditor is also obtaining evidence of the accuracy of the report. The auditor should design and perform other procedures to address the completeness of the report (e.g., the auditor may select program changes that the auditor identified from an independent population and trace them to the report of program changes or the auditor could test the effectiveness of the controls over the completeness of the report of program changes).

IG 8.13 The auditor may test IPE that he proposes to use to perform tests of controls by either:

- Performing "direct testing" procedures to address the accuracy and completeness of IPE. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor may directly test IPE that the auditor uses to perform tests of controls only when management is not using the IPE in the performance of its controls.
- Perform procedures to test controls that address the accuracy and completeness of the IPE.
- A combination of these approaches (i.e., performing direct testing and tests of controls to address the accuracy and completeness of IPE).

Testing accuracy and completeness of IPE that the entity's controls are dependent upon

IG 8.14 The auditor obtains evidence that such IPE is sufficiently reliable throughout the period of intended reliance. For a combined audit of internal financial controls over financial reporting and financial statements, the auditor is required to identify and test the effectiveness of controls addressing the accuracy and completeness of the information the controls are dependent upon.

IPE that the auditor uses in tests of operating effectiveness of relevant controls

IG 8.15 The auditor may obtain information to use in performing tests of certain controls, such as reports on system settings (e.g., access, profiles, passwords) or reports used to define the population of interest (e.g., a list of program changes). The auditor also performs procedures to test the accuracy and completeness of such IPE since the integrity of the tests of operating

effectiveness of the relevant controls depends on the accuracy and completeness of that information.

Direct testing of IPE

IG 8.16 The appropriate procedures and sample size for directly testing IPE is a matter of professional judgement based on the nature of the IPE and may vary depending upon the specific facts and circumstances.

IG 8.17 In order to determine whether "directly" testing IPE is the most effective and efficient testing method, the auditor considers whether and to what extent his tests of controls or substantive procedures address the accuracy or completeness of the IPE. For example:

1. Consider if the IPE is the starting point of the substantive procedures, and therefore, whether the substantive procedures for testing the relevant assertions for the class of transactions, account balance, or disclosure also address the accuracy and completeness of the three elements of the IPE. In such cases, additional procedures may not be necessary.

For example, the auditor may use a property roll forward schedule prepared by the entity as the starting point to perform the substantive testing of the property account balance. The substantive procedures of the property account balance (either tests of details or substantive analytical procedures) would likely include procedures that would address the accuracy and completeness of the information on the roll forward schedule, such as agreeing totals from the schedule to the beginning and ending general ledger balances, footing the schedule, and making selections from the various totals reflected on the schedule (e.g., additions, disposals, depreciation) to test by agreeing back to source documents or by recalculation. In this case, additional procedures to address the completeness and accuracy of the elements of the IPE are not likely necessary.

2. Consider if the IPE is extracted from data related to classes of transactions, account balances, or disclosures that is already being tested as part of the audit — either by testing the relevant controls or through substantive procedures. If so, the auditor may need to only plan additional testing of the remaining IPE elements (i.e., the report logic and, if applicable, the user-entered parameters).

For example, the auditor tests the relevant controls over sales, billing, and cash receipts, including the relevant general IT controls, for control reliance purposes and substantive procedures validate that the transaction data in the Debtors sub-ledger is accurate and complete and protected from unauthorised access or changes. Accordingly, when testing the Debtors aging report which is derived from the Debtors sub-ledger detail, the auditor does not need to trace selections back to source documents as the auditor has already determined through tests of relevant controls that the Debtors sub-ledger detail is accurate and complete.

IG 8.18 However, even when the auditor may have tested the controls related to the underlying source data or substantively tested the source data; he may still need to perform procedures to address the appropriateness of the report logic and user-entered parameters used in producing the IPE. In some cases, the auditor may be able to use the same items tested (or a subset thereof) for control tests or substantive procedures to perform procedures specifically directed at the accuracy and completeness of the process to extract the relevant data into the report.

For example, although the auditor has already determined through tests of relevant controls that the Debtors sub-ledger detail is complete and accurate, he still needs to perform procedures to address the appropriateness of the report logic. Therefore, to validate that the data in the Debtors aging report was properly extracted, the auditor may reconcile the Debtors aging report to the Debtors sub-ledger in the aggregate and then trace into the Debtors aging report the relevant information for the items (or subset thereof) that were selected for Debtors confirmations.

IG 8.19 Consider if the IPE consists of source data that may be tested for accuracy and completeness in conjunction with other tests of controls or substantive procedures for the relevant flows of transactions.

For example, when performing substantive test of sales transactions the auditor may also include testing that the product codes/SKUs were properly coded and input into the system in order to validate that the data at the sales by product code/SKU level is accurate and complete.

For example, when performing tests of controls, the auditor may also assess whether the identified controls specifically address the recording and reporting of revenue and expenses by location.

Example of IPE testing

Data/ Report Description	**Terminated Employee Listing**
Background	The Terminated Employee Listing is a standard parameter-driven report generated directly from the HR application and provided to auditors. The report pulls the names of employees terminated during a particular date range (i.e., the period under audit), as well as other pertinent information about the employees, such as their employee IDs and the effective dates of their separations from the entity. This report will be used by the auditor to determine whether there are active user accounts in the system for any of the terminated employees in order to test GITCs related to timely deactivation and/or removal of user accounts when employees terminate employment with the entity.
Example Testing Approach 1	The auditor compares the Terminated Employee Listing on a sample basis to relevant information in the system, and vice versa, to determine that: 1. The report was created from the appropriate production system during the period under audit. 2. The appropriate user-entered parameters were used to generate the report (e.g., date range). 3. The employee information in the system is consistent with that in the report. Additional audit evidence is obtained that the report accurately includes a complete population of terminations that occurred during the period under

	audit: • For example, inquiry is made of entity personnel to obtain the names of X individuals who were terminated in the period under audit and the timeframe during which these individuals were terminated (e.g., if the auditor knows the entity did layoffs at a certain time during the year). The Terminated Employee Listing is inspected to determine that the individuals identified during the auditor's inquiries appear on the list and the termination dates on the listing are consistent with those communicated to the auditor during his or her inquiries. • For example, a selection is made of terminated employees from the source where termination status is maintained and it is validated that the terminated employees appear on the Terminated Employee Listing.
Example Testing Approach 2	The auditor should test the relevant controls that provide audit evidence of the timely and accurate processing of terminations in the HR application, including the employment status of employees (e.g., active, terminated) and termination dates. As the report logic had been tested in the prior year, the auditor may apply a benchmarking strategy (e.g., carry forward a summary of direct testing of the report logic and user-entered parameters performed upon initial installation of the system, including describing the Terminated Employee Listing, how it was tested, and the conclusions reached. The auditor should also obtain evidence in the change management system that validates that the source code underlying the report has not been changed since it was originally tested in the prior year

IG 9 Use of Service Organisations (Refer Paragraph 90)

Service organisations

IG 9.1 The auditor's understanding of the flows of transactions includes an understanding of the entity's use of service organisations to perform processes relevant to financial reporting (e.g., payroll processing, processing of insurance or medical claims) and, from an IT perspective, the systems that are being used by the service organisations to perform those processes. In addition to outsourcing certain business processes to a service organisation, an entity may also outsource administration of one or more of its systems to a service organisation or use a service organisation to "host" its systems.

Identifying relevant service organisations

IG 9.2 Regardless of whether a service organisation is being used to perform business processes or IT functions, to the extent that these processes are relevant to the audit, the systems used by or administered by the service organisation (and the related general IT controls) may also be relevant to the audit. In determining whether these systems are relevant, the auditor considers the controls the user entity (i.e., an entity that uses a service organisation)

and the service organisation have in place to address the related risks of material misstatement or IT risks. These may include controls at the service organisation when the service organisation is performing processes relevant to financial reporting or when a service organisation is hosting systems for the user entity. However, to the extent that the entity has controls in place that are sufficiently precise to address the relevant risks and these controls do not rely on automated controls, data, or reports from the systems used by or administered by the service organisation, the auditor may determine that the service organisation controls are not relevant to the audit.

For example, an entity outsources the processing of its payroll transactions to a service organisation; however, the entity has the following controls in place that are sufficiently precise to address the relevant risks of material misstatement related to payroll and the entity does not rely on reports or other information it receives from the service organisation to perform these controls:

- Comparing the payroll data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
- Re-computing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

Situation in which service organisations are relevant for internal financial *controls*

IG 9.3 If the service organisation's services are part of a company's information system, then they are part of the information and communication component of the company's internal financial controls. When the service organisation's services are part of the company's internal financial controls, the auditor should include the activities of the service organisation when determining the evidence required to support his or her opinion.

IG 9.4 The following are the procedures that the auditor should perform with respect to the activities performed by the service organisation –

- *Obtaining an understanding of the controls at the service organisation that are relevant to the entity's internal control and the controls at the user organisation over the activities of the service organisation, and*
- *Obtaining evidence that the controls that are relevant to the auditor's opinion are operating effectively.*

IG 9.5 Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following:

- *Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed upon procedures that describes relevant tests of controls.*

***Note:** The service auditor's report referred to above means a report with the service auditor's opinion on the service organisation's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period. A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes*

from an agreed-upon procedures report rather than a service auditor's report, the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

- *Performing tests of the user organisation's controls over the activities of the service organisation (e.g., testing the user organisation's independent re-performance of selected items processed by the service organisation or testing the user organisation's reconciliation of output reports with source documents).*
- *Performing tests of controls at the service organisation.*

IG 9.6 If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- *The time period covered by the tests of controls and its relation to the as of date of management's assessment,*
- *The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and*
- *The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.*

***Note:** If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organisation, the auditor should evaluate whether the company is applying the necessary procedures.*

IG 9.7 In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence.

IG 9.8 When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organisation's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organisation, changes in personnel at the service organisation with whom management interacts, changes in reports or other data received from the service organisation, changes in contracts or service level agreements with the service organisation, or errors identified in the service organisation's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal financial controls. The auditor should also evaluate whether the results of other procedures performed indicate that there have been changes in the controls at the service organisation.

IG 9.9 The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organisation based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the

following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- *The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,*
- *The significance of the activities of the service organisation,*
- *Whether there are errors that have been identified in the service organisation's processing, and*
- *The nature and significance of any changes in the service organisation's controls identified by management or the auditor.*

IG 9.10 If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organisation is required, the auditor's additional procedures might include –

- *Evaluating procedures performed by management and the results of those procedures.*
- *Contacting the service organisation, through the user organisation, to obtain specific information.*
- *Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.*
- *Visiting the service organisation and performing such procedures.*

IG 9.11 The auditor should not refer to the service auditor's report when expressing an opinion on internal financial controls.

IG 10 Techniques of Control Testing (Refer Paragraph 116)

IG 10.1 Tests of controls are usually performed using the following techniques, often in combination:

Corroborative enquiry: This procedure, consisting of detailed interviews to obtain evidence about the effectiveness of controls, is performed in tandem with other procedures (e.g., examination of documentary evidence) to corroborate the information derived from the inquiry.

Observation: Observing the performance of a control activity often provides substantial evidence of its effectiveness. For example, the auditor may test controls over inventory by observing that employees who perform and record the counts follow management's written instructions. But observation of a control activity in action ordinarily does not, in itself, provide sufficient evidence of the effectiveness of the control activity, mainly because observations may not be representative of the usual performance of a control activity because management and staff may perform their tasks more diligently if they know they are being observed.

Examination of Documentation: If performance of a control activity is documented, the auditor can obtain evidence of its performance by examining the documentation, both electronic and written.

Re-performance: Re-performance may be effective for testing application controls, because the computer processes transactions systematically.

IG 11 Internal Financial Controls – Testing of Design (Refer Paragraph 108 -109)

IG 11.1 The objective of testing the design of a control is to determine if a deficiency in design exists. A deficiency in design exists when:

- A control necessary to meet the control objective (i.e., a control that mitigates the risk of material misstatement) is missing.
- An existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met (i.e., the risk of material misstatement would not be mitigated).

IG 11.2 Therefore, it is important to consider and to specifically conclude with respect to both aspects based on the auditor's procedures and evaluation. Professional judgement is necessary to evaluate the design of relevant controls

IG 11.3 The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organisation. For example, a smaller, less complex company might have fewer employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor should evaluate whether those alternative controls are effective.

IG 11.4 To appropriately evaluate the design of relevant controls, the auditor considers the following elements:

- The nature and significance of the risks of material misstatement addressed by the control.
- The characteristics or details of the control.
- Factors to determine whether the control is appropriately designed (i.e., the precision of a control) to address the identified risk.

Factors to consider when determining whether control is appropriately designed

The following factors will likely be a good starting point for evaluating the effectiveness of the design of many controls. (Note: these are not intended to be a complete list of considerations, nor is it intended that each of these is always relevant or needs to be considered for each control.)

IG 11.5 Appropriateness of the purpose of the control and its correlation to the risk/assertion

A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences. Additionally, a control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion

than a control that is directly related to an assertion. A control that identifies and explains differences may identify an unusual fluctuation but would not identify misstatements if there were no fluctuations.

For example, the purpose of a budget to actual revenue review is to typically identify and explain variances for operating purposes, not necessarily for the purpose of identifying misstatements.

It is important that this assessment be applied for each risk/assertion that a control addresses.

For example, if a control addresses six risks of material misstatement, then the purpose of the control and correlation to the risk/assertion is considered separately for each risk of material misstatement.

IG 11.6 Appropriateness of the control considering the nature and significance of the risk

The greater the inherent risk, the more precise the controls are expected to be.

For example, a higher-level D&P ELC may be appropriately precise for payroll expense, which is typically a normal risk of misstatement, but would likely not be sufficient by itself for a significant risk of material misstatement, such as a significant accounting estimate.

IG 11.7 Competence and authority of the person(s) performing the control

The experience level of the person performing the control and their organisational position affects the effectiveness of a control.

For example, if the assistant controller performs a review of a document prepared by the controller, the assistant controller's authority in performing such a review might be questioned, given the direct reporting relationship of the assistant controller to the controller.

For example, a junior clerk may not have the requisite knowledge of the business or stature within the organisation to perform an effective review control that requires an in-depth understanding of the business and the ability to raise challenges with superiors and others within the organisation.

For example, SAP security is administered by a Senior Analyst. The Senior Analyst is a Certified Information Systems Security Professional (CISSP), has ten years of IT experience and has been in his current position for two years. The auditor interacted with the Senior Analyst as he or she executed audit tests and found him to be knowledgeable of SAP security and controls. Based on these factors, it appears he has the competence and authority to operate SAP security controls.

For example, a control related to the review of user access privileges in a relevant application system is performed by a Manager, in the Information Compliance and Risk Management department of the entity. The auditor interacted with the Manager throughout the audit and noted she demonstrated sufficient knowledge of control processes related to the application system. The Manager has been responsible for overseeing the review of access and monitoring of the relevant application for the past three years. The auditor noted she appears to be competent to perform the controls for the relevant application system and has proper authority based upon her role, which was also confirmed by the auditor by reviewing an organisational chart.

Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

IG 11.8 Frequency and consistency with which the control is performed

A control that is performed routinely and consistently is generally more precise than one performed sporadically.

For example, a review control that has clearly defined procedures and which is designed to be performed each quarter would be more precise than a review control that has undefined process steps and which is performed infrequently or on an ad-hoc basis. Similarly, when general IT controls are effective, an automated control is expected to operate more consistently than a manual control.

IG 11.9 Level of aggregation and predictability

A control that is performed at a more detailed level generally is more precise than one performed at a higher level. The precision of those controls also depends on the predictability (i.e., the more predictable the expected result, the greater the precision to identify potential material misstatements).

For example, an analysis of revenue by location or product line is likely to be more precise than an analysis of total entity revenue.

IG 11.10 Criteria for investigation and process for follow-up

For review-type controls (unless the review is performed with regard to each transaction), the threshold for investigating deviations or differences and its relationship to materiality is an important but subjective determination of a control’s precision. It is equally important that there is an appropriate process to follow-up on any exceptions or unusual items noted from the review, including tracking open items for timely resolution and determining that responses are appropriate and supported as necessary.

For example, a control that investigates items that are near the selected materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control that investigates items that are smaller relative to materiality.

Review-type controls require the reviewer to make significant judgements when determining what requires further investigation. Accordingly, when evaluating the design of a review-type control the auditor considers the risk of implicit or explicit bias in the reviewer’s judgements in identifying a deviation or difference for investigation and follow-up. The auditor may also need to consider whether there are other controls that operate in conjunction with the review-type control that specifically address or mitigate the potential for bias (e.g., further review and challenge by others).

IG 11.11 Dependency on other controls or information

If the control is dependent upon other controls (e.g., the effective operation of general IT controls) or IPE, the design of the control cannot be concluded upon without also considering the effectiveness of the other control(s) or the accuracy and completeness of the IPE. When

evaluating the design of a control that is dependent on IPE, the auditor should identify and test the effectiveness of relevant controls that address the accuracy and completeness of the IPE that the controls is dependent upon.

Testing design effectiveness

IG 11.12 The purpose of a test of design of a relevant control is to obtain a sufficient understanding of each control (and the related risk that the control addresses) to:

- Conclude on the effectiveness of its design to address the risk.
- Plan the nature, timing, and extent of the tests of operating effectiveness of the control.

A “test of design” of a relevant control includes inquiry of personnel involved in the performance of the control, supplemented by a mix of observation of how the control is performed (e.g., demonstration by entity personnel to the auditor what they do) and inspection of the relevant documentation related to the performance of the control (which may include either IPE used in the performance of the control or documentation resulting from the performance of the control).The test of design of a relevant control confirms the auditor’s understanding of the controls (e.g., the detailed control description) and provides the basis to evaluate whether the controls are designed effectively (i.e., the auditor determines whether each risk is appropriately mitigated by the controls as designed).

IG 12 Internal Financial Controls–Walk Through(Refer Paragraph 103, 104, 108, 109)

Performing walkthroughs

IG 12.1 Walkthroughs are not required by the auditing standards; however, they are often an efficient means to:

- Obtain or update understanding of the entity’s flow of transactions.
- Identify controls that are relevant to the audit and gain an understanding (evaluate design and implementation) of those controls.

IG 12.2 In some instances, when the auditor is testing controls, the walkthrough procedures may be used to obtain evidence about the operating effectiveness of a control.

IG 12.3 The term “walkthrough,” while not specifically defined, refers to (1) the following of a transaction through the entity’s process and (2) the procedures the auditor might perform to validate the points in the process at which a material misstatement could occur and identify controls that may be relevant to the audit.

IG 12.4 In performing a walkthrough, the auditor generally follows a single transaction from its origination through the procedures or steps in the process to the transaction’s ultimate recording in the general ledger. Following the transaction through the procedures or steps in the process helps validate the auditor’s understanding of how transactions are initiated, authorised, recorded, processed, and recorded. The procedures or steps addressed in the walkthrough would correspond to those in the process narratives or the narratives combined with process flow diagrams.

IG 12.5 It is important to differentiate between a step in the process and a control. A process describes the action of taking a transaction or event through an established and usually routine set of procedures or steps. A control is an action or activity taken to prevent or detect misstatements within the process. The following is the description and examples of control activities:

IG 12.6 Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

- Authorisation;
- Performance reviews;
- Information processing;
- Physical controls;
- Segregation of duties.

IG 12.7 To perform a walkthrough, the auditor would generally:

- Select a single transaction and trace it through the procedures or steps in the process, and the relevant control activities, from initiation to recording in the general ledger. The walkthrough would generally begin with the original source document for a selected transaction (e.g., a revenue walkthrough might begin with a sales order, rather than the sales invoice).
- Make inquiries of the individuals who perform the procedures or steps in the process.

IG 12.8 As a result, for the relevant controls within the process, the auditor would corroborate his or her inquiries of individuals who perform the controls with additional procedures, such as inspection of relevant documents or accounting records used by entity personnel in performing the control and/or observation of individuals performing the control.

Extent of a walkthrough

IG 12.9 Just as the extent of the auditor's understanding of the entity's processes is a matter of professional judgement, so too is the extent of the walkthroughs.

IG 12.10 In a first year audit, the auditor might perform walkthroughs of all of the entity's processes related to significant accounts and disclosures. In subsequent years, the extent of walkthroughs may be again evaluated, especially for non-complex processes. However, in those situations, the auditor's understanding of the process still needs to be accurate and complete and reflect any significant changes since the prior audit, because those changes might result in changes to his or her identification and assessment of risks of material misstatement and identification of relevant controls.

For example, when performing a walkthrough in a continuing audit, rather than walk through every step in the process, the auditor may instead focus inquiries on identifying any significant changes in the process or on validating that no significant changes have occurred.

For example, the auditor might inquire as to whether there have been any changes to the information and reports used in the process, changes to IT applications, or changes in the way

entity personnel perform the steps in the process. [Note that inquiries are often used to obtain or update understanding of the steps in a process; however, for purposes of evaluating design and implementation of relevant controls in the process, inquiry alone is not appropriate and the auditor would corroborate his or her inquiries with other risk assessment procedures, such as inspection and observation.]

IG 12.11 Regardless of the approach the auditor takes to update his or her understanding of the process and relevant controls, he or she should evaluate the design and implementation of relevant controls in every audit by performing procedures in addition to inquiry.

Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

IG 13 Internal Financial Controls – Testing of Operative Effectiveness (Refer Paragraph 110 - 111)

IG 13.1 This Section provides an overview of testing the operating effectiveness of relevant controls. When testing the operating effectiveness of a control, the auditor obtains evidence about whether it is operating as designed.

IG 13.2 If a control is not designed properly, it cannot operate effectively; therefore, there is no need to test the operating effectiveness of controls that are improperly designed.

IG 13.3 The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

IG 13.4 If the control does not operate effectively (e.g., the auditor is unable to obtain sufficiently persuasive evidence that the control is operating as designed), then it is a “deficiency in operating effectiveness.”

IG 13.5 A deficiency in internal financial controls exists when the operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in operation exists when a properly designed control does not operate as designed, or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Process flow for testing operative effectiveness of controls

IG 13.6 This process flow illustrates the steps applicable to testing the operating effectiveness of a control. It is applied for each relevant control for which the auditor is required, or for which the auditor elects, to test operating effectiveness. Applying each of these steps requires professional judgement.

Assess the risks associated with the controls

IG 13.7 When the auditor has determined that it is necessary to test the operating effectiveness of a control, both for purposes of reporting on internal financial controls and when relying on the operating effectiveness of the control to reduce the extent of substantive procedures for purposes of the financial statement audit, he or she considers the risk associated with the control. The risk associated with the control is the risk that the control might not be effective. The assessment of risk associated with the control determines the persuasiveness of the evidence to be obtained about the effectiveness of the control. The auditor should assess the risk associated with the control as either “higher” or “not higher” and use this assessment to plan the nature, timing, and extent of the testing of each control.

IG 13.8 For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a significant deficiency or material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Factors considered when assessing the risk associated with the control

IG 13.9 Factors that affect the risk associated with a control include:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

Note: A less complex company or business unit with simple business processes and centralised accounting operations might have relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

- The complexity of the control and the significance of the judgements that must be made in connection with its operation.

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

Some of these factors relate to the risks of material misstatement that the control addresses, while others relate directly to the characteristics of the control itself. Therefore, it may be helpful to consider the factors in those two groups.

Factors related to the risks of material misstatement the control addresses

IG 13.10 The inherent risk associated with the risk of material misstatement

For example, controls that address risks of material misstatement that the auditor classifies as a significant risk have a higher risk associated with them, because determining the effective operation of such controls is more important due to the significance of the risks of material misstatement they address.

IG 13.11 The nature and materiality of misstatements that the control is intended to prevent or detect

For example, controls that address risks of material misstatement for accounts with smaller rupee values and routine transactions would typically have a lower risk associated with them than controls that address accounts with large transactions that occur on a non-routine basis.

IG 13.12 Whether there have been changes in the volume or nature of transactions that might adversely affect the controls design or operating effectiveness

For example, a significant increase in sales volume may stress the capacity of the manual controls that address the sales account, which likely increases the risk associated with such manual controls.

IG 13.13 Whether the account has a history of errors

For example, errors in an account are indicators that relevant controls that address the risks of material misstatement relating to such an account may not be operating effectively, which likely increases the risk associated with such controls.

Factors related to the characteristics of the control activity

IG 13.14 The complexity of the control and the significance of the judgements that must be made in connection with its operation

For example, controls that operate routinely, with little subjectivity, at the transaction level typically have lower risk associated with them as contrasted to highly subjective review-type controls that are complex because of the subject matter they address and the significant

judgements involved (including the possibility for implicit or explicit bias in the reviewer's judgements in identifying deviations or differences for investigation and follow-up.)

IG 13.15 The effectiveness of entity-level controls, especially controls that monitor other controls

For example, if an entity effectively monitors the periodic preparation of account reconciliations throughout the year, the risk associated with the control may be lower.

IG 13.16 The nature of the control and the frequency with which it operates

For example, the auditor may assess the risk associated with controls that operate more frequently as lower than those that operate only on an ad hoc basis (e.g., controls related to accounting for an acquisition or a divesture, when the entity enters into such transactions on an infrequent basis, may have a higher risk associated with them than other controls that operate more frequently and on a routine basis).

IG 13.17 The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or GITCs)

For example, automated controls depend upon the effectiveness of general IT Controls, and if such general IT controls are determined to be ineffective, the risk associated with the automated controls is likely to be higher.

IG 13.18 The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance

For example, if a new assistant controller is performing a control for the first time or if the person performing the control has not been trained either in how to perform the control or in the subject matter to which it pertains, there may be a higher risk associated with the control, as there is greater likelihood the control might not be performed appropriately, particularly as the complexity of the subject matter of the control increases (e.g., financial instruments).

IG 13.19 Whether the control relies on performance by an individual or is automated

For example, an automated control generally would be expected to have a lower risk associated with it when general IT controls (e.g., program change controls and security access controls) are effective.

IG 13.20 Although all of the factors listed above are potentially relevant when assessing the risk associated with a particular control, the auditor's consideration could begin with the inherent risk (i.e., whether or not the control addresses a significant risk of material misstatement) and the consideration of the complexity of the control and the significance of the judgements that must be made in connection with its operation will, in most cases, provide a sound foundation for consideration of the other factors.

For example, a control that comprises a three-way match (i.e., a control whereby invoices are matched to a valid purchase order and an approved packing slip or receiver) generally is not complex and requires minimal judgement in its operation, even if it is performed manually. Alternatively, a review-type control related to an asset impairment analysis performed by an impairment committee will be much more likely to have a higher risk associated with it, because much more can go wrong with the review of an asset impairment due to the complexity and

significant judgements that are likely to be involved in the operation of the review. Accordingly the nature, timing, and extent of operating effectiveness tests for the three-way match and the review-type control will likely be different in order to respond to each of these controls' assessment of the risk that the control might not be effective.

Plan the nature, timing, and extent of tests of operating effectiveness of controls

IG 13.21 When the auditor plans the nature, timing, and extent of substantive tests, he or she designs substantive tests that address the risks of material misstatement. When the auditor plans the nature, timing and extent of tests of operating effectiveness of a relevant control that addresses one or more risks of material misstatement, he or she should design tests to address the risk associated with the control.

IG 13.22 As the risk associated with the control increases, the auditor may do one or more of the following:

- Increase the persuasiveness of the nature of the audit evidence that will be obtained from the tests (e.g., utilise a combination of procedure types or perform more persuasive procedures),
- Increase the extent of testing,
- Perform procedures closer to the balance sheet or obtain more persuasive evidence of the operation of the control during the roll forward period,
- Identify and test other redundant controls, and
- Perform the procedures themselves rather than using the work of others.

IG 13.23 The planning for tests of operating effectiveness begins with the detailed description of the control procedure [i.e., the details of how the control is performed (e.g., who, what, and when)] to determine which characteristics of each control need to be tested.

IG 13.24 When the auditor tests the design effectiveness of the control, he or she concludes whether the control procedure as documented is designed effectively. Testing operating effectiveness simply means testing to determine whether the control procedure was performed properly (i.e., whether all of the important steps or characteristics identified in the detailed control description, in fact, operated as designed or intended, and for the period of intended reliance).

IG 13.25 The characteristics of the control that the auditor considers when planning and performing tests of operating effectiveness also include IPE. In the case of tests of operating effectiveness of controls, IPE may include:

- IPE that a control is dependent upon: The auditor obtains evidence that such IPE is sufficiently reliable throughout the period of intended reliance.
- IPE that the auditor uses in tests of operating effectiveness of relevant controls: The auditor may obtain information to use in performing tests of certain controls, such as

reports on system settings (e.g., access, profiles, passwords) or reports used to define the population of interest (e.g., a list of program changes). The auditor also performs procedures to test the accuracy and completeness of such IPE since the integrity of the tests of operating effectiveness of the relevant controls depends on the accuracy and completeness of that information.

IG 13.26 In addition to considering the risk associated with the control when planning the nature, timing, and extent of the operating effectiveness testing, the auditor also considers the requirement to introduce an element of unpredictability into the testing each year.

Nature of procedures

IG 13.27 Planning the nature of the operating effectiveness tests that the auditor is going to perform depends on two considerations:

(1) The risk associated with the control

The assessment of risk associated with the control influences the persuasiveness of the evidence that the auditor needs to obtain to support a conclusion that the control is operating effectively. Certain procedures will, by their nature, provide more persuasive evidence than other procedures. Inquiry alone will not provide sufficient appropriate audit evidence to conclude that a control is operating effectively. Depending on the auditor's assessment of the risk associated with the control and the nature of the control, auditor therefore performs other audit procedures in combination with inquiry, including observation, inspection of documentation, or re-performance of the control.

(2) The availability of evidence

When determining the nature of the procedures the auditor plans to perform, it is important to select procedures that will provide evidence that the control procedure operated as designed (i.e., address each of the important steps or characteristics of the control identified in the detailed control description). Obtaining evidence for only a portion of the control procedure (e.g., limiting tests of operating effectiveness to one step of the procedure, such as evidence of a sign-off) will often be insufficient evidence that the control operated as designed. Obtaining evidence of one step of the procedure (e.g., the sign-off) does not, in most cases, provide evidence of other relevant characteristics, including who performed the control and how it was performed (e.g., what the person performing the control analysed, reviewed, or did in support of his or her sign-off evidencing the completion of the control).

The reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. For example, in general:

- Evidence obtained from a knowledgeable source that is independent of the company is more reliable than evidence obtained only from internal company sources.
- The reliability of information generated internally by the company is increased when the company's controls over that information are effective.
- Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised, or otherwise

converted into electronic form, the reliability of which depends on the controls over the conversion and maintenance of those documents.

Because evidence of operating effectiveness may be obtained from various activities (e.g., performing walkthroughs, testing design, using the work of others, and the auditor's own operating effectiveness testing), it is also important to clearly identify the nature of the evidence that the auditor plans to obtain and the location of that evidence, or the description thereof, in the working papers on risk of material misstatement or other working papers.

Timing of tests of controls

IG 13.28 The timing of tests of controls is typically influenced by the following considerations:

(1) The period that is to be covered by the tests

This consideration includes balancing the need to obtain evidence throughout the period for control-reliance purposes with obtaining sufficiently persuasive evidence nearer to or at the balance-sheet date in support of the opinion on internal financial controls. These objectives may be summarised as follows.

- Evidence obtained to support the opinion on internal financial controls: The auditor obtains audit evidence of the operating effectiveness of relevant controls at the balance-sheet date. Testing performed closer to the balance sheet date provides more evidence than testing performed earlier in the year and testing controls over a greater period of time provides more evidence of the effectiveness of controls than would be provided by testing the controls over a shorter period of time.
- Evidence obtained to support a control reliance strategy: When relying on operating effectiveness of controls to reduce extent of substantive testing, the auditor obtains audit evidence of the operating effectiveness of the control for the period of intended reliance.

Prior to the period end, the entity might implement changes to their controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor may consider how such changes affect reliance on controls for specific relevant assertions and the period of time in which the control was operating effectively. The auditor need not test the design and implementation and operating effectiveness of the superseded control for purposes of expressing an opinion on internal financial controls, however, he or she may decide to test the superseded control for purposes of relying on that control for specific relevant assertions over the period of time in which the control was effective.

(2) The risk associated with the control

The assessment of the risk associated with the control influences the timing of when the auditor obtains evidence. As the risk associated with the control increases, it may be more likely that the auditor will plan to test operating effectiveness without using roll forward procedures. Alternatively, if the auditor plans to use roll forward procedures, such procedures need to provide more persuasive evidence as the risk associated with the control increases.

(3) When the auditor chooses to perform the tests

The testing of the operating effectiveness of controls generally is performed after the control has operated. However, for some controls, it may be necessary to obtain the evidence when the control operates (or soon thereafter) as the evidence the auditor needs to perform the testing may not be accessible at a later date.

For example, the evidence of certain IT controls may exist only in the system. If the system is updated on a daily basis, the evidence may not be accessible after the control has operated. Similarly, a relevant control may comprise a meeting; if the auditor plans to obtain evidence of the operation of the control by attending the meeting, the auditor will not be able to obtain such evidence after the meeting has occurred.

The timing of the tests may also be affected by the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously or many times a day (e.g., controls over sales transactions), while others operate only at certain times or at periodic intervals (e.g., controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts) or even only after the balance-sheet date (e.g., controls over the preparation of certain notes to financial statements disclosures). Evidence of the operation of a control that relates to a period subsequent to the balance-sheet or period-end date cannot be considered evidence of its operating effectiveness at the balance-sheet or period-end date unless the control is designed to operate only after the balance-sheet date or period-end.

For example, as controls over the March 31, 20X5 year-end financial close and reporting process only operate in April 20X5, the auditor may use the evidence of the controls operating in April 20X5 to conclude on operating effectiveness of such controls "as of" March 31, 20X5.

When the auditor chooses to test the operating effectiveness of controls as of an interim date, there are typically two alternative approaches he or she may consider:

- Apportion the control test over the year (i.e., spread the total number of selections throughout the year). Under this approach, the operating effectiveness result is determined only upon completion of the test at year-end. Performing testing in this manner provides the basis to support conclusions as to the effectiveness of the controls throughout the period of intended reliance and as of the balance-sheet date. As the testing is apportioned over the entire year, roll forward procedures are not necessary.

  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. The auditor cannot reach a conclusion on the operating effectiveness of the control at the interim date (September 30) since he or she did not test all 25 items; the auditor can only reach a conclusion on the operating effectiveness of the control when the testing of all sample selections is complete at year-end. Since the sample covered the entire period, the auditor is not required to perform separate roll forward procedures.

- Perform a complete test of the control (i.e., test all selections) at an interim date. This approach requires the auditor to perform sufficient testing to enable him or her to reach a preliminary conclusion regarding the operating effectiveness of the control

tested at the 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. The earlier in the year the interim tests are performed, the more persuasive the roll forward procedures will likely need to be, particularly when the risk associated with the control is higher.

For example, for a test of a relevant control using a sample size of 25, the auditor may choose to perform the entire test at interim date by selecting 25 items over the first nine months. Therefore, the auditor can reach a conclusion on the operating effectiveness of the control at the interim date (September 30) since the auditor tested all 25 items; however, the auditor needs to perform separate roll forward procedures to determine whether the control continues to be effective through the fourth quarter and near to or at the balance sheet date.

Extent of procedures

IG 13.29 Matters that may affect the necessary extent of testing of a control in relation to the degree of reliance on a control, in addition to the risk associated with the control, include the following factors:

- The frequency of the performance of the control by the entity during the audit period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control: Typically, for testing efficiency purposes, the auditor does not plan for deviations when designing the tests.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control: When the evidence the auditor plans to obtain is less persuasive (e.g., observing a control operate), the auditor may consider increasing the sample size.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion: This may relate to the evidence the auditor has about the effectiveness of other controls that monitor the control the auditor is testing, which may in turn provide a basis for lowering the assessment of risk associated with the control such that a lower extent of testing may be appropriate.
- The nature of the control, including, in particular, whether it is a manual control or an automated control: Automated controls are by nature more reliable than a manual control; however, their reliability depends on effective general IT controls — see next factor.
- For an automated control, the effectiveness of relevant general IT controls: A reduced level of testing of an automated control is appropriate when effective general IT controls operate throughout the period of reliance. General IT controls help ensure the continued proper operation of information systems and support the effective functioning of application controls, including the automated controls. If general IT controls are not effective, then it is generally necessary to test the automated control at or near the balance-sheet date in support of the opinion on internal financial controls. However, even when effective general IT controls exist, automated controls

are retested when changes are made to the control during the period in order to validate that the change was made appropriately and to test the control's effectiveness. Testing and relying solely on program change controls generally would not constitute direct evidence of the effectiveness of an automated control that had been changed.

- Higher risk associated with the control (including any control that addresses a significant risk).
- When one or more exceptions are identified that clearly indicate that the control is not operating effectively, it is generally not necessary to complete the test.

Dual-purpose tests

IG 13.30 In some situations, the auditor might perform a substantive test of a transaction concurrently with a test of a control relevant to that transaction (a "dual purpose test").

Typically, dual-purpose testing means that two tests, with different purposes and objectives, are planned to be performed concurrently and there may or may not be some level of "overlap."

For example, a substantive test of fixed-asset additions has the primary purpose of assessing whether the transaction selected for testing has been properly recorded in accordance with GAAP to validate occurrence, accuracy, and cut-off. The operating effectiveness test of relevant controls over fixed asset additions has the primary purpose of assessing whether the control(s) operated as designed which may include testing procedures or characteristics such as:

i) Evidence of authorisation.

ii) Review of the proper recording for occurrence, accuracy, and cut-off.

iii) Process for follow up on exceptions.

Performing the substantive test may also include reperforming the review control (ii) but would likely not address control characteristics (i) or (iii).

There are two main objectives when using dual-purpose tests for control purposes:

Objective 1: The test directly provides evidence that the control procedure operated (i.e., it addresses the important steps and characteristics identified in the detailed control description).

Objective 2: The test is contemplated and documented as a dual-purpose test when the work was planned and performed, not after the fact, such that the documentation clearly demonstrates how the combined test addresses both the substantive test and internal control test objectives.

Auditor's planning to use dual-purpose testing are advised to carefully consider whether a single test results in obtaining sufficient appropriate audit evidence for both the intended substantive test and the control test or whether it would be more appropriate to design and apply separate procedures to the same sample selections that more specifically meet the applicable objectives of the substantive test and the control test. Also, the performance of substantive tests that results in no misstatements being identified does not provide sufficient evidence of the effectiveness of related controls. However, the identification of misstatements during the performance of substantive tests may indicate that related controls are not effective.

In certain situations, the auditor should design the dual-purpose test to achieve the objectives of both the test of the control and the substantive test. Also, when performing a dual-purpose test, the auditor should evaluate the results of the test in forming conclusions about both the assertion and the effectiveness of the control being tested.

Perform tests of operating effectiveness of controls

IG 13.31 Considerations when performing tests of operating effectiveness include:

- Clearly defining the test objective, including establishing a clear understanding of what constitutes a deviation.
- Identifying the population to be sampled.
- Selecting the sample such that all items in the population have a chance of selection.
- Obtaining sufficient and appropriate audit evidence, including related to IPE upon which the control is dependent.
- Applying professional scepticism when evaluating the persuasiveness of the evidence obtained, including what constitutes a deviation or exception.

As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates the auditor should consider, with an attitude of professional scepticism, both the subjective and objective factors.

The auditor considers the risk associated with the control when assigning personnel to perform testing (e.g., generally more experienced personnel may be assigned to test the more complex controls with significant judgements, while less experienced personnel may assist with performance of tests of less complex controls). Review of tests of controls (i.e., detailed, primary, overriding) is performed by team members who have sufficient knowledge of the entity's controls and risks to properly assess the planning and performance of the tests of controls, as well as the sufficiency of audit evidence to support the conclusions reached.

Testing review-type controls

IG 13.32 The auditor should assess the risk associated with review-type controls, whether performed by individuals or groups, as higher due to the subjectivity and complexity of such controls. Usually, the level of aggregation and the criteria for investigation are important characteristics of these types of controls. In addition, these controls are often dependent upon other controls or IPE. Accordingly, the testing for review-type controls would typically include a combination of procedures, such as:

- Inquiry of the persons involved in the performance of the control, including persons to whom questions are directed.

- Inspection of the reports and documents used in performing the control.
- Inspection of documentary evidence of conclusions reached and follow-up actions taken.
- Observation of meetings in which the control is performed.
- Re-performance of the review.

IG 13.33 Documentation associated with these controls often includes items such as meeting preparation materials, invitations sent to attendees, correspondence about issues discussed, and documentation of follow-up actions. However, such documentation commonly does not include descriptions of the discussions that are sufficient for the auditor to obtain evidence about the substance and completeness of the discussions and thought processes that led to the conclusions reached in the meeting (e.g., inquiry of participants and examination of calendars indicating that a meeting was held will not be sufficient evidence about the nature and effectiveness of the activities performed in the meeting).

Accordingly, observation of these meetings may be an important means of testing the effectiveness of the actual activities undertaken in the meeting. When observation is not possible (e.g., a meeting involving management's discussion with counsel regarding the reserve for legal matters), inspection of documentation evidencing that the important characteristics of the control were performed, if available, or reperformance of the control often are necessary to obtain sufficient persuasive evidence.

For example, a review-type control whereby the monthly financial results are discussed and differences are investigated has been identified as a relevant control for certain accounts that are stable and predictable. Inspecting evidence that the meeting occurred is generally not sufficient evidence to determine to what extent the other important characteristics of the control operated at the meeting, such as evidence of (1) the purpose of the control (operationally focused versus financial-reporting focused), (2) the depth of the discussion at an appropriate level of disaggregation, and (3) the criteria for investigation and the nature of items questioned, including the follow-up process.

IG 13.34 Evidence of matters identified for follow-up and their resolution often provides additional evidence of the performance of the review control. Inquiry of the persons performing the control in addition to documentation of such findings and follow-up will increase the reliability of the audit evidence, while incomplete or altogether lacking documentation will diminish the reliability of audit evidence.

Accordingly, it may be useful to encourage management to retain documentation of reviews (e.g., notes, drafts, e-mails), including establishing a process for tracking matters identified for follow-up. In situations where there were no matters for follow-up, other procedures, such as observation, may be necessary to obtain sufficient evidence of effectiveness. It may be necessary to reconsider the effectiveness of a review-type control that seldom, if ever, identifies matters for follow-up, as this may be an indication that the control is not operating effectively or is not suitably designed to prevent or detect material misstatements.

IG 14 Sampling in Tests of Controls (Refer Paragraph 120)

IG 14.1 The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

IG 14.2 Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control.

IG 14.3 When planning a particular audit sample for a test of controls, the auditor should consider:

- The relationship of the sample to the objective of the test of controls.
- The maximum rate of deviations from prescribed controls that would support the planned assessed level of control risk.
- The auditor's allowable risk of assessing control risk too low.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

IG 14.4 For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of internal control sufficient to plan an audit do not involve sampling. Sampling generally is not applicable to tests of controls that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented controls. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system. For example, inquiry or observation of explanation of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control.

IG 14.5 When designing samples for tests of controls the auditor ordinarily should plan to evaluate operating effectiveness in terms of deviations from prescribed controls, as to either the rate of such deviations or the monetary amount of the related transactions. In this context, pertinent controls are ones that, had they not been included in the design of internal control would have adversely affected the auditor's planned assessed level of control risk. The auditor's overall assessment of control risk for a particular assertion involves combining judgements about the prescribed controls, the deviations from prescribed controls, and the degree of assurance provided by the sample and other tests of controls.

IG 14.6 The auditor should determine the maximum rate of deviations from the prescribed control that he or she would be willing to accept without altering his planned assessed level of control risk. This is the tolerable rate. In determining the tolerable rate, the auditor should consider (a) the planned assessed level of control risk, and (b) the degree of assurance desired

by the evidential matter in the sample. For example, if the auditor plans to assess control risk at a low level, and desires a high degree of assurance from the evidential matter provided by the sample for tests of controls (i.e., not perform other tests of controls for the assertion), he or she might decide that a tolerable rate of 5 percent or possibly less would be reasonable. If the auditor either plans to assess control risk at a higher level, or desires assurance from other tests of controls along with that provided by the sample (such as inquiries of appropriate entity personnel or observation of the application of the policy or procedure), the auditor might decide that a tolerable rate of 10 percent or more is reasonable.

IG 14.7 In assessing the tolerable rate of deviations, the auditor should consider that, while deviations from pertinent controls increase the risk of material misstatements in the accounting records, such deviations do not necessarily result in misstatements. For example, a recorded disbursement that does not show evidence of required approval may nevertheless be a transaction that is properly authorised and recorded. Deviations would result in misstatements in the accounting records only if the deviations and the misstatements occurred on the same transactions. Deviations from pertinent controls at a given rate ordinarily would be expected to result in misstatements at a lower rate.

IG 14.8 In some situations, the risk of material misstatement for an assertion may be related to a combination of controls. If a combination of two or more controls is necessary to affect the risk of material misstatement for an assertion, those controls should be regarded as a single procedure, and deviations from any controls in combination should be evaluated on that basis.

IG 14.9 Samples taken to test the operating effectiveness of controls are intended to provide a basis for the auditor to conclude whether the controls are being applied as prescribed. When the degree of assurance desired by the evidential matter in the sample is high, the auditor should allow for a low level of sampling risk (that is, the risk of assessing control risk too low).

IG 14.10 To determine the number of items to be selected for a particular sample for a test of controls, the auditor should consider the tolerable rate of deviation from the controls being tested, the likely rate of deviations, and the allowable risk of assessing control risk too low. When circumstances are similar, the effect on sample size of those factors should be similar regardless of whether a statistical or non-statistical approach is used. Thus, when a non-statistical sampling approach is applied properly, the resulting sample size ordinarily will be comparable to, or larger than, the sample size resulting from an efficient and effectively designed statistical sample.

The auditor may also apply the provisions of Standard on Internal Audit (SIA) 5 on “Sampling” and the sample sizes indicated in Appendix 4 of the above Standard. Refer the full text of SIA 5 in **Appendix VI** to this Guidance Note.

Sample selection

IG 14.11 Sample items should be selected from the appropriate population that is representative of the risk being tested. For example, a risk that sales may not be recorded for all goods despatched (relevant to the assertion ‘completeness’) should be tested based on the population of despatch documents and not from the population of recorded sales. Similarly for testing the risk of sales being recorded without corresponding despatch of goods (relevant to the assertions ‘existence’ and ’cut off’), the sample should be selected from the recorded population

of sales. Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. Random-based selection of items represents one means of obtaining such samples. Ideally, the auditor should use a selection method that has the potential for selecting items from the entire period under audit.

Assess findings and conclude on the operating effectiveness of controls

IG 14.12 Considerations when assessing findings and concluding on the operating effectiveness of controls include:

- Determining whether a deviation is identified.
- Determining the nature and cause of the deviation(s).
- Evaluating whether the deviation is a control deficiency.

IG 14.13 When the auditor identifies a deviation (or exception), he or she should consider the circumstances and reasons for the deviation and evaluate the effect of the deviation to determine whether:

- The tests of controls that have been performed provide an appropriate basis for reliance on the controls (e.g., the deviation is not a deficiency);
- To obtain additional evidence to obtain a better estimate of the projected deviation rate to determine if the deviation is a deficiency (e.g., the auditor may consider increasing sample sizes which, since a deviation was identified, would include considering whether to increase the risk associated with the control); or
- The deviation is a deficiency and in the absence of other redundant or compensating controls, the potential risks of misstatement need to be addressed using substantive procedures (e.g. the control is not effective and thus control reliance is not appropriate).

Determining whether a deviation exists

IG 14.14 In designing an audit sample to test controls, the auditor defines the objective of the audit procedure (i.e., the test objective) and the characteristics of the population from which the sample will be drawn. The determination of the objective of a test of a control includes a clear understanding of what constitutes a deviation so that all, and only, those deviations that are relevant to the purpose of the test are included in the evaluation of deviations.

IG 14.15 Generally, any failure in the operation of a control from (1) established policy and procedure, (2) a regulatory requirement or (3) the expectation of the operation based on peer or industry comparison is likely a deviation (which is then further evaluated as described below). Examples of instances in which a failure in the operation of a control may not be a deviation may include the following circumstances:

- When the control operates effectively in mitigating the risk, even though the control does not operate completely in accordance with the prescribed procedure (e.g., an authorisation form was not properly completed and signed off, but there is other evidence that clearly reflects the transaction was authorised).
- When the departure from policy or procedure is authorised by the appropriate level of management based on particular circumstances (e.g., in an employee's absence, the normal control process was not followed; however, management is aware of this and has compensated for it).
- If a document is selected that has been validly cancelled prior to operation of the control (i.e., the document does not constitute a deviation), it may be excluded from the sample and an appropriately chosen replacement may be examined. However, if the deviation relates to a document that cannot be located, the auditor makes every possible effort to locate it or to ascertain, using suitable alternative procedures that the control in this specific instance was operating properly. If evidence supporting operation of the control for the selected sampling unit is not available, another sampling unit cannot be substituted for the missing unit and it is generally necessary to treat this item as a deviation from the prescribed control.

Determining the nature and cause of the deviation

IG 14.16 When investigating the nature and cause of a deviation, the auditor may consider the following questions:

- Is the nature of the deviation limited to certain types of transactions (e.g., infrequent exceptions as opposed to the norm)? The auditor should consider the nature and volume of the exceptions that may be subject to other deviations.
- Has a change in roles or responsibilities of the person performing or monitoring the control contributed to the deviation? The auditor should consider the significance and breadth of the role and responsibility of the new person and the likelihood that other deviations in other controls operated by the new person could exist.
- Has a lack of competency of the person performing the control contributed to the deviation? The auditor should consider the significance and breadth of the role and responsibility of the person for which other deviations could exist.
- Was management aware of the circumstances causing the deviation? A deviation that management is not aware of and not monitoring may result in an increased likelihood that other deviations will occur.
- Have changes in volume of activity or transactions (e.g., significant seasonal fluctuations) contributed to the deviation? A deviation during a limited period of heavy volume may not be indicative of what might more typically occur during normal volume periods.

Evaluate whether the deviation is a control deficiency

IG 14.17 The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error. Accordingly, it is acknowledged that a

control could still be concluded to be effective, even when some level of deviation may exist. Because effective internal financial controls cannot, and does not, provide absolute assurance of achieving the company's control objectives, an individual control does not necessarily have to operate without any deviation to be considered effective.

IG 14.18 The following considerations are relevant when considering the level of "acceptable" deviations (i.e., such that a control deficiency does not exist):

- Risk associated with the control: The higher the risk, the more reliable the control needs to be.
- Extent of reliance on the control: When a risk of material misstatement is addressed solely by one control, the control generally needs to be more reliable, particularly when the risk being addressed is a significant risk.
- Testing approach: When the auditor tests the operating effectiveness of a control by sampling, the sample sizes are based on an acceptable tolerable deviation rate; therefore, when the auditor discovers more deviations than planned for, the test objective is generally not met. At this point the auditor cannot conclude the control is effective and therefore, the existence of deviations beyond what was planned for would generally represent a deficiency, in absence of performing additional testing. The auditor may then consider whether additional testing is necessary or appropriate. For controls that operate less frequently, given the small sample sizes, the auditor typically would not expand the sample size.

  For example, if a test of a control that operates many times a day is designed to not allow for any deviations and the actual number of deviations is one or more, the test objective is generally not met. The auditor may either conclude that the control is not effective or may decide to increase the sample sizes to obtain a better estimate of the projected deviation rate, in which case, the auditor should also reconsider whether to increase the risk associated with the control.
- If the auditor is able to test the entire population, he or she uses professional judgement to determine whether the actual deviation rate is indicative of a deficiency based on the risk associated with the control (e.g., an actual deviation rate up to 5 percent may be concluded to be acceptable).

  For example, the auditor assessed the appropriateness of access privileges for all 300 system users and noted 3 exceptions. The auditor evaluated the exceptions qualitatively and noted no significant concerns as the 3 users' inappropriate access was limited to one application. As it is not expected that the control would operate without deviation, and as the actual rate of deviation in the entire population is quantified or known (3 out of 300, or 1percent), the auditor may conclude that the deviation rate is acceptable and not indicative of a deficiency.
- Nature of the control: Relevant points when considering the nature of the control include:
  - The relative importance of the deviations to the overall performance of the control (i.e., the deviation is related to only one of many characteristics or attributes tested when assessing the related control).

For example, review controls typically have multiple characteristics that need to be tested; therefore, testing of such controls may result in deviations related to certain characteristics and not others. Determining whether such controls are nevertheless effective, even if some level of deviation has been identified, requires significant professional judgement.

- Whether misstatements have actually occurred.
- Whether the deviation has a potential effect on the effectiveness of other controls.

IG 14.19 Based on the above considerations, deviations are evaluated and concluded upon to be either:

- Only a deviation and not a deficiency: In this case, no further consideration is necessary (this is expected to be rare, particularly when the auditor is using a sampling approach); or
- A deficiency: In this case, the deficiency is further evaluated to assess its severity and implications on the financial statements audit (i.e., risk assessment and control reliance strategy).

IG 15 Roll Forward Testing (Refer Paragraph 121)

IG 15.1 This Section highlights considerations when the auditor rolls-forward the conclusions of the effectiveness of those relevant controls which were tested and concluded to be effectiveness as at an interim date. The roll forward procedures to be performed and evidence to be obtained are based on the auditor's assessment of certain factors related to the risk that controls that have been tested as of an interim date will not continue to operate effectively during the roll forward period. The roll forward period (also sometimes referred to as the "remaining" period) is the period from the date of the interim conclusion about the effectiveness of a control up to, and including, the balance sheet date for the report on internal financial controls.

IG 15.2 The auditor typically performs procedures to understand the likely sources of misstatements and conclude on design effectiveness at an interim date for many of the relevant controls. The roll forward procedures the auditor performs are focused on changes to the business or the entity's financial reporting that may give rise to a new risk or may affect an existing risk of material misstatement, which, in turn, would necessitate the entity's implementing new controls or modifying the design of existing controls.

IG 15.3 The auditor may also decide to perform tests of operating effectiveness of relevant controls at an interim date. Timing of tests of controls and the necessity of performing roll forward procedures to update conclusions about operating effectiveness of relevant controls depends on which testing approach the auditor applies:

- Apportion the test of operating effectiveness of a relevant control over the year, or
- Perform a complete test of the operating effectiveness of a relevant control (i.e., test all selections) at an interim date and conclude as to the effectiveness of the control as of the interim date.

IG 15.4 When the auditor apportions the control test over the year, he or she does not need to plan roll forward procedures because the testing plan will include selections up to or

near the balance sheet date. However, when the auditor performs a complete test at an interim date, he or she has to perform procedures to roll forward those conclusions to the balance sheet date to support the opinion on the effectiveness of internal financial controls and to support reliance on controls for substantive purposes (i.e., to reduce the evidence the auditor needs to obtain from the substantive procedures).

IG 15.5 There are factors to be considered when making such determination. Because controls have different characteristics and operate with differing levels of reliability, these factors are considered for each relevant control to determine the persuasiveness of the evidence the auditor needs to obtain to conclude that a control continues to operate effectively through the balance sheet date (i.e., to support the opinion on the effectiveness of internal financial controls and to support the reliance on controls for substantive purposes). The auditor plans the nature, timing, and extent of the roll forward procedures for each relevant control (or groups of controls that possess similar characteristics) tested as of an interim date based on the consideration of the factors.

Key activities in the process for planning and performing procedures to roll forward conclusions of design and operating effectiveness

IG 15.6 Key activities for planning procedures to roll forward interim conclusions of design and operating effectiveness:

- Identify relevant controls which were tested (i.e., both design and operating effectiveness were tested) and concluded at interim date and therefore subject to roll forward procedures.
- Consider management's ongoing monitoring processes and activities to identify changes that may give rise to new risks of material misstatement or modifications to existing risks, as well as new controls, or modifications to existing controls.
- Consider the evidence obtained by management during the roll forward period related to the controls that were tested at an interim date.
- Plan the nature, timing, and extent of the roll forward procedures.

IG 15.7 Key activities for performing procedures to roll forward interim conclusions of design and operating effectiveness:

- Perform procedures to determine whether there have been any significant changes to the business or the entity's financial reporting that would give rise to new or affect existing risks of material misstatement, which would necessitate the entity's implementing new controls or modifying the design of existing controls.
- Test the design and operating effectiveness of new or modified relevant controls.
- Obtain appropriate evidence of operating effectiveness that the controls tested at interim date continue to operate effectively for the roll forward period.
- Document the roll forward procedures performed, basis for professional judgements, and conclusions for each of the relevant controls.
- Log any deficiencies for classification as to severity and further evaluation of their impact on the risk assessment and audit of the financial statements.

Plan roll forward procedures

IG 15.8 Factors to consider when planning roll forward procedures:

The additional evidence that is necessary to roll forward the interim conclusion about the operating effectiveness of each relevant control tested as of an interim date is based on consideration of the factors as explained in more detail in the discussion that follows.

IG 15.9 The specific control tested prior to the balance sheet date, including the risk associated with the control and the nature of the control, and the results of the tests.

IG 15.10 The higher the risk associated with the control (which includes considerations related to the nature of the control and the results of tests of such control in prior years and the current year to date), the more persuasive the evidence the auditor needs to obtain from the roll forward procedures.

For example, the auditor would design more persuasive roll forward procedures for a control where he or she has assessed the risk associated with the control as “higher.”

IG 15.11 The auditor may also need to obtain more persuasive evidence from the roll forward procedures when the risk associated with a control is assessed as “not higher.”

For example, if the risk associated with a control related to a review-type control (or a more subjective control) in the revenue process has been assessed as “not higher,” the auditor may nonetheless conclude that more persuasive evidence is needed during the roll forward period due to the subjectivity of the operation of the control. In contrast, the auditor may decide that he or she needs less persuasive evidence for a routine control in the payroll process where the risk associated with the control is assessed as “not higher,” and the control has operated effectively in the past with no changes identified during the roll forward period that may affect the operation of the control.

IG 15.12 The sufficiency of the evidence of effectiveness obtained at an interim date

This factor means that the more persuasive the evidence that has been obtained to support conclusions reached at an interim date, the less persuasive the evidence that may be needed for the roll forward period.

For example, performing procedures such as inspection of documentation or reperformance may produce more persuasive evidence of the operating effectiveness of a relevant control at an interim date, and accordingly, the auditor may decide that procedures that produce less persuasive evidence (such as inquiry or observation) are appropriate for the roll forward period. However in certain circumstances (e.g., for controls where the risk associated with the control is higher), the auditor may decide that notwithstanding that more persuasive evidence was obtained as of the interim date, he or she would also need to obtain more persuasive evidence for the roll forward period.

IG 15.13 The length of the remaining period

As the length of the remaining period increases, the more persuasive the evidence that may be needed from the roll forward procedures (e.g., when the roll forward period exceeds three to four months) and the less likely that the auditor will be able to conclude that roll forward procedures that are comprised of inquiry alone are sufficient. Additionally, for certain controls (e.g., controls where the risk associated with the control is higher) for which the interim testing was completed

within three to four months prior to the balance sheet date, performing additional roll forward procedures (i.e., beyond inquiries) may, nonetheless, be necessary.

IG 15.14 The possibility that there have been any significant changes in internal financial controls subsequent to the interim date

This factor is in the context of whether there are significant changes in the business during the roll forward period that could impact the operating effectiveness of the relevant controls that the auditor tested as of an interim date (e.g., changes in the person performing the control); in this case, more persuasive evidence may be necessary to determine that the controls continued to operate effectively during the roll forward period.

For example, subsequent to the interim testing, a new Controller is hired who had no previous experience with the entity or its processes and controls; however, given the nature of the role and the related responsibilities, this new person is responsible for the operation of certain relevant controls. The auditor would consider the nature of each of the controls for which the Controller is responsible, and determine whether more persuasive evidence of continued operating effectiveness during the roll forward period is necessary, given the Controller's inexperience relative to the entity's business and the controls (which may require retesting the controls), as they are equivalent to the implementation of "new controls."

IG 15.15 The planned degree of reliance on the control

This factor means that more persuasive evidence may be necessary from the roll forward procedures when (1) a relevant control is the only control mitigating a risk of material misstatement (i.e., as opposed to one of a combination of controls that might collectively address the risk) or (2) the auditor is relying on the control to reduce the extent of the substantive procedures (i.e., take a control reliance approach).

Planning the approach to roll forward procedures

IG 15.16 The auditor should assess each of the factors identified in paragraphs IG 15.8 to IG 15.15 above for each relevant control tested as of an interim date (or groups of controls that possess similar characteristics) to determine:

- Whether inquiry alone is sufficient evidence of the continuing operating effectiveness; or
- Whether additional procedures beyond inquiry alone are necessary and, if so, the auditor considers the nature, extent, and timing of those procedures.

IG 15.17 After determining whether inquiry alone is sufficient or whether additional procedures need to be performed, the auditor should then plan the nature, extent, and timing of the roll forward procedures. The following two examples of approaches to planning roll forward procedures are discussed below:

- When inquiry alone is sufficient evidence of the continuing operating effectiveness of relevant controls tested as of an interim date.
- When additional procedures beyond inquiry are necessary.

IG 15.18 When inquiry alone is sufficient evidence of the continuing operating effectiveness of relevant controls tested as of an interim date

There may be a portion of the controls tested as of interim dates (and for which the auditor needs to update the interim conclusions) where (1) the risk associated with the controls is assessed as “not higher” (e.g., the controls are routine in nature, typically operating many times a day and with a history of operating effectively) and (2) the roll forward period is sufficiently short (e.g., typically no more than three to four months). In this case, the auditor may determine that there is a sufficiently low risk that these controls will be ineffective during the roll forward period such that inquiry alone may provide sufficiently persuasive evidence.

For example, the auditor tested within three months before the balance sheet date certain payroll controls that operate routinely many times a day (risk associated with the controls is “not higher”). The auditor concluded that inquiry alone will be sufficiently persuasive to update the interim conclusions through the remaining period. However, as the length of the roll forward period increases (e.g., extending beyond three to four months prior to the balance sheet date), the more likely it will be necessary for the roll forward procedures to include additional procedures beyond inquiry.

IG 15.19 When additional procedures beyond inquiry are necessary

For those controls tested as of an interim date where the auditor has concluded that additional procedures beyond inquiry are necessary to roll forward the interim conclusions, he or she may consider segregating the controls as follows:

a. For controls where the auditor has assessed risk associated with the control as “higher” (including controls that address significant risks), the auditor typically plans to perform more extensive additional procedures for each of these controls, given the higher risk associated with the control.

   For example, a manual control related to complex revenue transactions, where the risk associated with the control has been assessed as “higher”, (due to the complexity and subjectivity of the judgements involved), was tested through the third quarter and found to be effective. The roll forward procedures consist of performing inquiries combined with appropriately extensive additional procedures (e.g., observation, inspection of documentation or re-performance).

b. For controls where the auditor has assessed risk associated with the control as “not higher”, the auditor typically plans to perform less extensive additional procedures for each of these controls. It is generally not appropriate to only select a sample of these controls to test in the roll forward period and then extrapolate the results of that testing to the remaining population of controls not tested.

   For example, 30 relevant controls for which the risk associated with the control has been assessed as not higher are tested six months prior to the balance sheet date. Given the length of the remaining period, inquiry alone was determined to provide insufficient evidence. Accordingly, the auditor plans to perform additional procedures, in addition to inquiry, to obtain evidence that each of the 30 controls continue to operate effectively during the roll forward period.

Alternatively, when management has effective ongoing monitoring activities that directly monitor the controls for which the auditor is seeking to obtain evidence during the roll forward period, the auditor may test the design and operating effectiveness of the monitoring controls, which may

include selecting and testing a sample of the controls that he or she is rolling forward in order to provide evidence of the effectiveness of the monitoring controls.

Perform roll forward procedures

IG 15.20 The objective of the roll forward procedures is to identify whether (1) any changes to the business occurred that could give rise to new, or affect existing risks of material misstatement, which would necessitate implementing new controls or modifying the design of existing controls and (2) existing controls continue to operate effectively during the roll forward period. Accordingly, the procedures the auditor typically performs at this phase include a mix of inquiry, observation, inspection of documentation, and re-performance to obtain sufficient evidence to determine whether changes have occurred. The evidence the auditor seeks to gather generally consists of:

- Evidence from management's ongoing monitoring and risk assessment processes to identify and manage change. If there have been changes that affect the design or operating effectiveness of a control, either manual or automated controls, during the roll forward period, the auditor is required to obtain audit evidence about the effectiveness of the new or modified control without giving consideration to the evidence the auditor had obtained before the change occurred.
- Evidence from the planned roll forward tests of operating effectiveness.
- The determination of sample sizes for roll forward procedures is a matter of judgement considering the factors mentioned above. The auditor may also consider using the work of others, when applicable and appropriate.
- Evidence from the other auditing procedures.

Documentation considerations in roll forward procedures

IG 15.21 The purpose of this Section is to provide auditors with documentation considerations relative to planning and performing roll forward procedures.

Considerations include:

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

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

iii) The roll forward procedures performed and the evidence obtained, including:

  – A description of the procedures performed, including whether they were inquiry, observation, examination of documents, re-performance, or some combination. The documentation of inquiries includes (1) to whom the auditor made inquiries, (2) the specific inquiries made, and (3) the results of those inquiries.

- When the interim testing of the controls was performed (e.g., the month or quarter).
- Identification of and reference to testing of any IPE.
- A statement that there were no exceptions or a clear description of any deviations noted.

iv) The procedures, findings, and conclusions related to assessing findings and concluding on design and operating effectiveness, including:

- A clear statement about whether the control is effectively designed and operated.
- If auditor's conclusion is that the control is ineffective, consideration of the effect of the conclusion on tests of other controls that may depend on the control tested and the design of the substantive tests.
- The basis for the conclusions reached.

IG 16 Rotation Plan for Testing Internal Financial Controls (Refer Paragraph 118 and 125)

IG 16.1 Rotation plan for testing of internal controls may be relevant to efficiently perform an audit of internal financial controls. One of the important consideration in this regard is that control environment within a company is somewhat enduring in nature and hence in case there are no changes in the underlying controls the auditors may be able to leverage on the work carried out in the previous periods. The internal control testing work can broadly be categorised into following:

- Understanding the process flows.
- Testing design and implementation of controls.
- Testing operative effectiveness of controls.

IG 16.2 From the perspective of adopting a rotation plan for testing of internal controls, understanding the process flows and testing design and implementation of controls are required to be covered in every audit period. However, a rotation plan may be considered for testing operating effectiveness of controls subject to the criteria specified in paragraph IG 16.3 below.

IG 16.3 The following is the broad criteria to be met for adopting a rotation plan for testing operating effectiveness of controls:

- The auditor may be able to utilise the tests of controls performed in prior audits in the current audit. In determining the strategy for testing the operating effectiveness of controls upon which the auditor intends to rely, the auditor may plan an approach whereby he or she will use audit evidence about operating effectiveness of certain controls obtained in previous audits in combination with the evidence obtained from the understanding of controls in the current audit and tests of operating effectiveness of other controls performed in the current audit.
- In these circumstances, the auditor is required to establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

- The auditor is required to obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls.
- If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor is required to test the controls in the current audit.
- If there have not been such changes, it is recommended that the auditor tests the controls at least once in every third audit and need to test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

IG 17 Remediation Testing (Refer Paragraph 119)

IG 17.1 Auditors are required to express an opinion on the effectiveness of the entity's internal financial controls as of the balance sheet date.

IG 17.2 Accordingly, any issues or deficiencies either relating to design or operative effectiveness of controls if they are remediated before the period under consideration, then the auditor can still express an unqualified opinion. It would be important to note that the remediation has to happen within the financial period which is under consideration.

IG 17.3 Sufficient time should be allowed to evaluate and test controls. If deficiencies are discovered, management may have the opportunity to correct and address these deficiencies prior to the reporting date. However, once a new control is in place, management should allow enough time for its operations to validate the control's operating effectiveness. The amount of time that a control should be in place and operating effectively depends on the nature of the control and how frequently it operates. The amount of time a remediation control should be in existence for placing reliance on the control by the auditor is a matter of professional judgement. Under ordinary circumstances, control remediation that occurs after year-end will not mitigate an identified deficiency for reporting purposes. Auditor should not express an opinion on management's disclosure about corrective actions taken by the company after the balance sheet date.

IG 18 Using the Work of Internal Auditors and an Auditor's Expert (Refer Paragraph 82 - 85)

IG 18.1 The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the auditor are different insofar as it relates to financial statements, the ways in which the internal audit function and the auditor achieve their respective objectives in an audit of internal financial controls may be similar.

IG 18.2 The auditor's consideration of the internal audit function in an audit of internal financial controls, applies in a combined audit of internal financial controls over financial reporting and financial statements.

IG 18.3 The objectives of the auditor, where the entity has an internal audit function that the auditor has determined is likely to be relevant to the audit, are to determine:

(a) Whether, and to what extent, to use specific work of the internal auditors; and

(b) If so, whether such work is adequate for the purposes of the audit.

IG 18.4 In determining whether and to what extent to use the work of the internal auditors, the auditor shall determine:

(a) Whether the work of the internal auditors is likely to be adequate for purposes of the audit; and

(b) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the auditor's procedures.

IG 18.5 The auditor should apply the requirements of paragraphs 8, 9 and A4 of SA 610 "Using the Work of Internal Auditors" to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

IG 18.6 The auditor may also use the work of an auditor's expert in an audit of internal financial controls. In this regard the auditor should apply the requirements of SA 620 "Using the Work of an Auditor's Expert".

IG 18.7 Auditor's expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

IG 18.8 The key considerations for an auditor in using the work of an auditor's expert are:

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

IG 18.9 The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

IG 19 Additional Considerations for Auditing Internal Financial Controls Over Financial Reporting

IG 19.1 The complexity of a company is an important factor in the auditor's risk assessment and determination of the necessary audit procedures. Customising the audit is important for audits of internal control of all companies, especially smaller, less complex companies.

IG 19.2 The audit of internal financial controls should be integrated with the audit of the financial statements, so the auditor must plan and perform the work to achieve the objectives of

both audits. This direction applies to all aspects of the audit, and it is particularly relevant to tests of controls.

Customising the audit of internal financial controls

IG 19.3 Customising the audit of internal financial controls involves tailoring the audit approach to fit the individual facts and circumstances of the company. Many smaller companies have less complex operations, and they typically share many of the following attributes:

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

IG 19.4 The attributes of a smaller, less complex company can affect the particular risks that could result in material misstatement of the company's financial statements and the controls that a company might establish to address those risks. Consequently, these attributes have a pervasive effect on the audit of internal financial control, including assessing risk, determining significant accounts and disclosures and relevant assertions, selecting controls to test, and testing the design and operating effectiveness of controls. The following are examples of internal control-related matters that might be particularly affected by the attributes of a smaller, less complex company –

- Use of entity-level controls to achieve control objectives. In smaller, less complex companies, owners and / or senior management are often involved in many day-to-day business activities and perform duties that are important to effective internal financial controls. Consequently, the auditor's evaluation of entity-level controls can provide a substantial amount of evidence about the effectiveness of internal financial controls.
- Risk of management override. The extensive involvement of owners and/or senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls or intentionally misstate the financial statements in smaller, less complex companies. In a combined audit of internal financial controls over financial reporting and financial statements, the auditor should consider the risk of management override and company actions to address that risk in connection with assessing the risk of material misstatement due to fraud and evaluating entity-level controls.
- Implementation of segregation of duties and alternative controls. By their nature, smaller, less complex companies have fewer employees, which limit the opportunity to segregate incompatible duties. Smaller, less complex companies might use alternative approaches to achieve the objectives of segregation of duties, and the auditor should evaluate whether those alternative controls achieve the control objectives.
- Use of Information Technology (IT). A smaller, less complex company with less complex business processes and centralised accounting operations might have less complex information systems that make greater use of off the shelf packaged software

without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the testing of IT general controls might focus on those controls that are important to the effective operation of the selected application controls.

- Maintenance of financial reporting competencies. Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals. The auditor may take into consideration the use of those third parties when assessing financial reporting competencies of the company.
- Nature and extent of documentation. A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal financial controls. The auditor may take that into account when selecting controls to test and planning tests of controls.
- In some audits of internal control, auditors might encounter companies with numerous or pervasive control deficiencies. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls. The auditor's strategy can be influenced by the nature of the control deficiencies and factors such as the availability of audit evidence and the effect of the deficiencies on other controls.

Test of controls in a combined audit of internal financial controls over financial reporting and financial statements

IG 19.5 Selection of controls to test

Appropriate selection of controls helps focus the auditor's testing on those controls that are important to the auditor's conclusion about whether the company's internal financial controls are effective. The decision about whether to select a control for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement in a given relevant assertion rather than on how the control is labelled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control).

A practical starting point for identifying these controls, is to consider the controls that management relies on to achieve its objectives for reliable financial reporting. Besides the overriding consideration of whether a control addresses the risk of misstatement, as a practical matter, the auditor might also consider the following factors when selecting controls to test:

- Is the control likely to be effective?
- What evidence exists regarding operation of the control?

When selecting controls to test, the auditor could seek to select controls that are more likely to be effective in addressing the risk of misstatement in one or more relevant assertions. If none of the controls that are intended to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.

The auditor needs to be able to obtain enough evidence about a control's operation to conclude on its effectiveness. The auditor could take into account the nature and availability of audit evidence when selecting controls to test and determining the nature, timing, and extent of tests of controls. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor may select the control for which evidence of operating effectiveness can be obtained more readily.

IG 19.6 Tests of operating effectiveness of controls

Historically, the approach for financial statement audits of smaller, less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls.

Auditors have the latitude to determine an appropriate testing strategy to –

(a) Obtain sufficient evidence to support the auditor's opinion on internal financial controls as of year-end, and

(b) Obtain sufficient evidence to support the auditor's control risk assessments in the audit of the financial statements.

To express an opinion on internal financial controls taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant financial statement assertions. Because the auditor's opinion on internal financial controls is as of a point in time, he or she should obtain evidence that internal financial controls has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements.

In an audit of financial statements, the objective of tests of controls is to assess control risk. To assess control risk at less than the maximum, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so.

The auditor's assessment of control risk at the maximum for one or more relevant assertions in an audit of financial statements does not necessarily preclude the auditor from issuing an unqualified opinion in an audit of internal control. The objectives of the two audits are not identical. The auditor could obtain sufficient evidence to support his or her opinion on internal financial controls, even if the auditor decides not to test controls over the entire period of reliance to support a control risk assessment below the maximum. However, if the auditor assesses control risk at the maximum because of identified control deficiencies, the auditor should evaluate the severity of the deficiencies, individually or in combination, to determine whether a significant deficiency or material weakness exists.

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

doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal financial controls.

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

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

Evaluating entity-level controls

IG 19.7 An important aspect of performing an audit of internal financial *control is the process of identifying and evaluating entity-level controls. This Section discusses entity-level controls and explains how they can affect the nature, timing, and extent of the auditor's procedures in an audit of internal financial control for a smaller, less complex company.*

IG 19.8 For the purposes of this discussion, entity-level controls are controls that have a pervasive effect on a company's internal control. These controls include:

- *Controls related to the control environment;*
- *Controls over management override;*
- *The company's risk assessment process;*
- *Centralised processing and controls, including shared service environments;*
- *Controls to monitor results of operations;*
- *Controls to monitor other controls, including activities of the audit committee and self-assessment programs;*
- *Controls over the period-end financial reporting process; and*
- *Policies that address significant business control and risk management practices.*

In smaller, less complex companies, owner and/or senior management often is involved in many day-to-day business activities and performs many controls – including entity-level controls – that are important to effective internal financial controls. When this is the case, the auditor's evaluation of entity-level controls can be an important source of evidence about the effectiveness of internal financial controls.

Effective controls related to the control environment and controls that address the risk of management override are particularly important to the effective functioning of controls performed by senior management.

Auditors might find that limited formal documentation is available regarding the operation of some entity-level controls.

Identifying entity-level controls

IG 19.9 The process of identifying relevant entity-level controls could begin with discussions between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal financial controls (e.g., control environment, risk assessment, control activities, monitoring, and information and communication).

While evaluating entity-level controls, auditors might identify controls that are capable of preventing or detecting misstatements in the financial statements. The period-end financial reporting process and management's monitoring of the results of operations are potential sources of such controls.

Assessing the precision of entity-level controls

IG 19.10 The key consideration in assessing the level of precision is whether the control is designed in a manner to prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.

Factors that auditors might consider when judging the level of precision of an entity-level control include the following:

- *Purpose of the control. A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.*
- *Level of aggregation. A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.*
- *Consistency of performance. A control that is performed routinely and consistently generally is more precise than one performed sporadically.*
- *Correlation to relevant assertions. A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion.*
- *Criteria for investigation. For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.*
- *Predictability of expectations. Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.*

When forming an opinion on the effectiveness of a company's internal financial controls, the auditor should evaluate evidence obtained from all sources, including misstatements detected during the financial statement audit. Evidence regarding detected misstatements also might be relevant in assessing the level of precision of entity-level controls.

Effect of entity-level controls on testing of other controls

IG 19.11 The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

Example – Monitoring the effectiveness of other controls

IG 19.12 ***Scenario:*** *A small* niche software *developer conducts business in* India *and other countries, requiring the company to maintain many bank accounts. An Accounts Officer is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, reviews on a monthly basis, the bank reconciliations prepared by the Accounts Officer as a means to determine:*

- *whether reconciliations are being prepared on a timely basis,*
- *the nature of reconciling items identified through the process, and*
- *whether reconciling items are investigated and resolved on a timely basis.*

Audit Approach: *In this example, the purpose of the control is one of the factors that the auditor considers in assessing precision of the CFO's review. The auditor has noted that the purpose of the CFO's review is to check that the staff has performed the reconciliations as described above. Therefore, the auditor does not expect the CFO's review of the reconciliations to be sufficiently precise to detect misstatements by itself. However, the CFO's review could still influence the auditor's assessment of risk because it provides additional information about the nature and consistency of the reconciliation procedures. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, he or she could reduce the direct testing of the reconciliation controls, absent other indications of risk.*

Example – Entity-level controls related to payroll processing

IG 19.13 ***Scenario:*** *A manufacturer of* spares and parts *for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.*

The CFO has been with the company for 10 years and thoroughly understands its business processes, including the payroll process, and reviews monthly payroll summary reports prepared by the centralised accounting function. With the company's flat organisational design and smaller size, the CFO's background with the company and his understanding of the seasons, cycles, and workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.

Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal financial controls.

***Audit Approach:** The auditor evaluates the effectiveness of the CFO's reviews, including the precision of those reviews. He or she inquires about the CFO's review process and obtains other evidence of the review. He or she notes that the CFO's threshold for investigating significant differences from expectations is adequate to detect misstatements that could cause the financial statements to be materially misstated. He or she selects some significant differences from expectations that were flagged by the CFO and determines that the CFO appropriately investigated the differences to determine whether the differences were caused by misstatements. Also, in considering evidence obtained throughout the audit, the auditor observes that the results of the financial statement audit procedures did not identify likely misstatements in payroll expense.*

The auditor decides that the reviews could detect misstatements related to payroll processing because the CFO's threshold for investigating significant differences from expectations is adequate. However, he or she determines that the control depends on reports produced by the company's IT system, so the CFO's review can be effective only if controls over the completeness and accuracy of those reports are effective.

After performing the tests of the relevant computer controls, the auditor concludes that the review performed by the CFO, when coupled with relevant controls over the reports, meets the control objectives for the relevant aspects of payroll processing described above.

Assessing the risk of management override and evaluating mitigating actions

IG 19.14 The risk of management override of controls exists in all organisations, but the extensive involvement of owners and/or senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls in smaller, less complex companies. Company actions to mitigate the risk of management override are important to the consideration of the effectiveness of internal financial *controls.*

In a combined audit of internal financial *controls over financial reporting and financial statements, the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud, as he or she evaluates mitigating actions in connection with the evaluation of entity-level controls and selecting other controls to test.*

Assessing the risk of management override

IG 19.15 SA 240 requires the auditor to assess the risk of material misstatement due to fraud ("fraud risk"). *As part of that assessment, the auditor is directed to perform the following procedures to obtain information to be used in identifying fraud risks, which includes procedures to assess the risk of management override:*

- *Conducting an engagement team discussion regarding fraud risks. This discussion includes brainstorming about how and where management could override controls to engage in or conceal fraudulent financial reporting.*
- *Making inquiries of management, the audit committee, if any, and others in the company to obtain their views about the risks of fraud and how those risks are addressed. These inquiries can provide information about the possibility of management override of controls.*
- *Considering fraud risk factors. Fraud risk factors include events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalisations that enable management to justify override of controls.*

After identifying fraud risks, the auditor should assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks.

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is particularly important when considering the risk of material misstatement due to fraud, including the risk of management override of controls.

Evaluating mitigating controls

IG 19.16 Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that might address the risk of management override:

- *Maintaining integrity and ethical values;*
- *Active oversight by the audit committee;*
- *Maintaining a whistleblower program; and*
- *Controls over certain journal entries.*

When assessing a company's anti-fraud programs and controls, the auditor should evaluate whether the company has appropriately addressed the risk of management override. Often, a combination of actions might be implemented to address the risk of management override.

Evaluating integrity and ethical values

IG 19.17 An important part of an effective control environment is sound integrity and ethical values, particularly of top management, which are communicated and practiced throughout the company. A code of conduct or ethics policy is one way that a company can communicate its policies with respect to ethical behavior. This type of control can be effective if employees are aware of the company's policies and observe the policies in practice.

Auditors should evaluate integrity and ethical values as part of the assessment of the control environment component of internal control. One approach for testing the effectiveness of the company's communications regarding integrity and ethical values is to gain an understanding of what the company believes it is communicating to employees and interview employees to determine if they are aware of the existence of the company's policies for ethical behavior and what they understand those policies to be. A discussion with employees regarding observed behaviors can assist the auditor further in understanding management's past actions and determining whether management's behavior demonstrates and enforces the principles in its code of conduct. The auditor's experience with the company can also be an important source of information about whether management demonstrates integrity and ethical values in its business practices and supports the achievement of effective internal control in its day to day activities.

Evaluating audit committee oversight

IG 19.18 An active and independent audit committee evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss significant accounting estimates and reviewing the reasonableness of significant assumptions and judgements. The consideration of the effectiveness of the audit committee's oversight is part of the evaluation of the control environment.

In connection with the auditor's inquiries of the audit committee, the auditor may interview audit committee members to determine their level of involvement and their activities regarding the risk of management override. For example, the auditor might read minutes of audit committee discussions on matters related to the committee's oversight or might observe some of those discussions if the auditor attends the meetings in connection with the audit. In addition, the auditor can examine evidence of the board of directors or audit committee's activities that address the risk of management override, such as monitoring of certain transactions.

Evaluating whistleblower programs

IG 19.19 A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls. A key aspect of an effective whistleblower program is the appropriateness of responses to concerns expressed by employees through the program. The audit committee may review reports of significant matters and consider the need for corrective actions.

Audit procedures relating to a whistleblower program are intended to assess whether the program is appropriately designed, implemented, monitored, and maintained. Such procedures might include inquiry of employees, inspection of communications to employees about the program, and, if tips or complaints have been received, follow-up procedures to evaluate whether remedial actions were taken as necessary.

Evaluating controls over journal entries

IG 19.20 Controls that prevent or detect unauthorised journal entries can reduce the opportunity for the quarterly and annual financial statements to be intentionally misstated. Such controls might include, among other things, restricting access to the general ledger system, requiring dual authorisations for manual entries, or performing periodic reviews of journal entries to identify unauthorised entries.

As part of obtaining an understanding of the financial reporting process, the auditor should consider how journal entries are recorded in the general ledger and whether the company has controls that would either prevent unauthorised journal entries from being made to the general ledger or directly to the financial statements or detect unauthorised entries.

Considering the effects of other evidence

IG 19.21 The auditor might identify indications of management override in other phases of the combined audit of internal financial *controls over financial reporting and financial statements. For example, the auditor is required to perform procedures in response to the risk of management override, including examining journal entries for evidence of fraud, reviewing accounting estimates for bias, and evaluating the business rationale for significant, unusual transactions. Also, if the auditor performs walkthroughs during the audit of internal control, he or she could obtain information about potential management override by asking employees about their knowledge of override. Also, the auditor might identify indications of management override when evaluating the results of tests of controls or other audit procedures. If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.*

Example – Audit committee oversight

IG 19.22 ***Scenario:*** *The audit committee of a small IT services company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The audit committee performs the following procedures to address the risk of management override: (a) reviews the reasonableness of management's assumptions and judgements used to develop significant estimates; and (b) reviews the functioning of the company's whistleblower process and related reports, and from time to time, inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others), obtaining information regarding concerns about ethics or indications of management override of internal controls.*

Audit approach: *In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's oversight. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.*

Evaluating segregation of duties and alternative controls

IG 19.23 Segregation of duties 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. Assigning different people responsibility for authorising transactions, recording transactions, reconciling information, and maintaining

custody of assets reduces the opportunity for any one employee to conceal errors or perpetrate fraud in the normal course of his or her duties.

When a person performs two or more incompatible duties, the effectiveness of some controls might be impaired. For example, reconciliation procedures may not effectively meet the control objectives if they are performed by someone who also has responsibilities for transaction recording or asset custody.

Smaller, less complex companies' approach to segregation of duties

IG 19.24 By their nature, smaller, less complex companies have fewer employees, which limit their opportunities to implement segregation of duties. Due to these personnel restrictions, smaller, less complex companies might approach the control objectives relevant to segregation of duties in a different manner from larger, more complex companies. Despite personnel limitations, some smaller, less complex companies might still divide incompatible functions by using the services of external parties. Other smaller, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.

Audit strategy considerations related to segregation of duties

IG 19.25 It is generally beneficial for the auditor and the company to identify concerns related to segregation of duties early in the audit process to allow the auditor to design procedures that effectively respond to those concerns. Also, management might have already identified, as part of its risk assessment, risks relating to inadequate segregation of duties and alternative controls that respond to those risks. Where walkthroughs are performed, those procedures can help identify matters related to segregation of duties.

When management implements an alternative control or combination of controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative control or controls effectively meet the related control objectives. The auditor's approach to evaluating those alternative control or controls depends on the control objectives, the nature of the controls, and the associated risks.

Use of external resources

IG 19.26 Some small companies use external parties to assist with some of their financial reporting-related functions. Use of external parties can also help achieve segregation of certain incompatible duties without investing in additional full-time resources.

A company might use one or more types of external-party arrangements in meeting its control objectives. Consultants, other professionals, or temporary employees can assist companies in performing some controls or other duties. For more complex or specialised portions of internal control, such as cash receipts handling, payroll processing, or securities recordkeeping, the company might use an external party to perform an entire function.

When controls over a relevant assertion depend on the use of an external party to perform a particular function, the auditor could evaluate that function in relation to the company's other relevant controls and procedures. The audit approach used with respect to the externally performed function depends on the circumstances. For those controls that are documented or are observable by the auditor (e.g., controls performed by external professionals at the company's premises), the auditor's evaluation may be similar to what he or she could perform for

the company's other controls. For some externally performed functions, the direction relating to use of service organisations may be relevant.

Management oversight and review

IG 19.27 A smaller, less complex company might address some segregation of duties matters through alternative controls involving management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction reports, or taking periodic asset counts. Many of those types of management activities could be entity-level controls.

When the auditor applies a top-down approach to select the controls to test, starting at the financial statement level and evaluating entity-level controls, the auditor might identify entity-level controls that are designed to operate at a level of precision to effectively address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

Example – Alternative controls over inventory

IG 19.28 Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access to both the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the general ledger in addition to the inventory ledger. The components are also included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances in the general ledger.

Audit approach: The auditor observes the company's year-end inventory counting process. He or she inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he or she performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls.

Auditing information technology controls in a less complex information technology environment

IG 19.29 A company's use of information technology (IT) can have a significant effect on the audit of internal financial control. The IT environment is a consideration in the auditor's risk assessments, selection of controls to test, tests of controls, and other audit procedures. This Section discusses the auditor's evaluation of IT controls in a smaller company with a less complex IT environment. It explains how the auditor could decide which IT controls to evaluate and how the auditor could evaluate those controls. In addition, it provides an overview of the major categories of IT controls and related testing considerations for a smaller, less complex IT environment.

Characteristics of less complex IT environments

IG 19.30 In smaller companies, less complex IT environments tend to have the following characteristics:

- *Transaction processing. Data inputs can be readily compared or reconciled to system outputs. Management tends to rely primarily on manual controls over transaction processing.*
- *Software. The company typically uses off-the-shelf packaged software without programming modification. The packaged software requires relatively little user configuration to implement.*
- *Systems configurations and security administration. Computer systems tend to be centralised in a single location, and there are a limited number of interfaces between systems. Access to systems is typically managed by a limited number of personnel.*
- *End-user computing. The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to initiate, authorise, record, process, and report the results of business operations, and, in many instances, perform straightforward calculations using relatively simple formulas.*

The complexity of the IT environment has a significant effect on the risks of misstatement and the controls implemented to address those risks. The auditor's approach in an environment with the preceding characteristics may be different from the approach in a more complex IT environment.

Determining the scope of the evaluation of IT controls

IG 19.31 The following matters affect the scope of the auditor's evaluation of IT controls in a smaller company with a less complex IT environment –

- *The risks, i.e., likely sources of misstatement, in the company's IT processes or systems relevant to financial reporting, and the controls that address those risks.*
- *The reports produced by IT systems that are used by the company for performing important controls over financial reporting.*
- *The automated controls that the company relies on to maintain effective internal financial controls.*

The IT controls that are important to effective internal financial *controls generally relate to at least one of the preceding matters, which are discussed in more detail in the following paragraphs. IT control categories and testing procedures are discussed later in this Section.*

The following types of IT-related risks that could affect the reliability of financial reporting –

- *Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;*
- *Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions or inaccurate recording of transactions;*
- *Unauthorised changes to data in master files;*
- *Unauthorised changes to systems or programs;*
- *Failure to make necessary changes to systems or programs;*
- *Inappropriate manual intervention;*

- *Potential loss of data.*

The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment. In a less complex environment, the auditor could identify many of the risks by understanding the software being used and how it is installed and used by the company. After understanding the relevant IT-related risks, the auditor should identify the controls that address those risks. These controls could include automated controls and IT-dependent controls and the IT general controls that are important to the effective operation of the selected controls. For example, even the simplest IT environments generally rely on controls that are designed to make sure that necessary software updates are appropriately installed, access controls that are designed to prevent unauthorised changes to financial data, and other controls that address potential loss of data necessary for financial statement preparation.

As the complexity of the software or environment increases, the type and number of potential IT risks increase, which could lead the auditor to devote more attention to IT controls.

IT-dependent controls

IG 19.32 Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depends on the accuracy and completeness of the information in the reports. When those IT-dependent controls are selected for testing, it may also be necessary to select controls over the completeness and accuracy of the information in the reports in order to address the risk of misstatement.

Other automated controls

IG 19.33 Although smaller, less complex companies tend to rely primarily on manual controls, they could rely on certain automated controls built into the packaged software to achieve some control objectives. For example, software controls can be used to maintain segregation of duties, prevent certain data input errors, or to help make sure that certain types of transactions are properly recorded. The auditor might focus some of his or her testing on these automated controls and the IT general controls that are important to the effective operation of the automated controls.

Consideration of deficiencies in general IT controls on tests of other controls

IG 19.34 IT general controls support operation of the application controls by ensuring the proper access to, and functioning of, the company's IT systems. Deficiencies in the IT general controls may result in deficiencies in the operation of the automated or IT dependent controls. One of the factors in the auditor's evaluation of the identified deficiencies in the IT general controls is the interaction of an IT general control and the related automated or IT-dependent controls.

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test the related automated or IT-dependent manual control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could

conclude that the automated or IT-dependent manual controls operated effectively at that point in time e.g., as of the issuer's fiscal year end. On the other hand, deficient program change controls might result in unauthorised changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example – IT-dependent controls

IG 19.35 Scenario: A company has a small finance department. For the accounting processes that have a higher risk of misstatement, senior management performs a number of business process reviews and analyses to detect misstatements in transaction processing.

The company has a small IT department that supports a packaged financial reporting system whose software code cannot be altered by the user. Since the company uses packaged software, and there have been no changes to the system or processes in the past year, the IT general controls relevant to the audit of the internal financial *controls are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.*

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analysis and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example –

- *Evaluating management's review procedures including assessing whether those controls operate at an appropriate level of precision.*
- *Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that –*
    - *The data included in the report are accurate and complete. This evaluation might be accomplished through testing controls over the initiation, authorisation, processing, and recording of the respective transactions that feed into the report.*
    - *The relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.*

The auditor verifies that the code in the packaged software cannot be changed by the user. The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT controls

IG 19.36 The remaining paragraphs of this Section discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

General IT controls

IG 19.37 IT general controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and access

Security and access controls are controls over operating systems, critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorised personnel.

In a small, less complex IT environment, security administration is likely to be centralised, and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be detective controls rather than preventive. Access controls tend to be monitored informally.

Tests of security and access controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users.

Computer operations

Computer operations controls relate to day-to-day operations and help ensure that computer operational activities are performed as intended, processing errors are identified and corrected in a timely manner, and continuity of financial reporting data is maintained through effective data backup and recovery procedures.

A smaller, less complex IT environment might not have a formal operations function. There might not be formal policies regarding problem management or data storage and retention, and backup procedures tend to be initiated manually.

Tests of controls over computer operations could include evaluating the backup and recovery processes, reviewing the process of identifying and handling operational problems, and, if applicable, assessing control over job scheduling.

Systems development and system changes

Systems development and system change controls are controls over systems selection, design, implementation, and configuration changes that help ensure that new systems are appropriately developed, configured, approved, and migrated into production, and controls over changes – whether to applications, supporting databases, or operating systems – that help to ensure that those changes are properly authorised and approved, tested, and implemented. Although they might be viewed as separate categories, in less complex environments, systems development and system change procedures often are combined for ease of implementation, training, and ongoing maintenance.

A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code. Modifications to software are prepared by and, in some cases, implemented by, the software vendor in the form of updates or patches or via a network connection between the vendor and the organisation.

Typically, a small number of individuals or a single individual (employees or consultants) support all development and production activities.

Examples of possible tests of controls over systems development and system changes include examining the processes for selecting, acquiring, and installing new software; evaluating the process for implementing software upgrades or patches; determining whether upgrades and patches are authorised and implemented on a timely basis; and assessing the process for testing new applications and updates.

Application controls

Application controls are automated or IT-dependent controls intended to help ensure that transactions are properly initiated, authorised, recorded, processed, and reported. For example, in a three-way match process, received vendor invoices are entered into the system, which matches them automatically to the purchase order and goods receipt based on the document reference numbers, price, and quantity. The system's simultaneous matching of the information within the three documents upon their entry to authorise a payment to the vendor is an automated application control.

Management's review and reconciliation of an exception report generated by the system is an example of an IT-dependent manual control. The general nature of application controls tends to be similar in most IT environments, although in less complex environments, the controls tend to be manual and detective rather than automated and preventive. The testing procedures could also be similar. In most IT environments, the auditor could focus on error correction procedures over inputting, authorising, recording, processing, and reporting of transactions when evaluating application controls. However, in less complex IT environments there might be fewer financial applications affecting relevant assertions and fewer application controls within those applications.

Regardless of the complexity of the IT environment, the audit plan for testing application controls could include a combination of inquiry, observation, document inspection, and re-performance of the controls. Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent application controls if IT general controls are designed and operating effectively. In some situations, benchmarking of certain automated controls might be an appropriate audit strategy.

End-user computing controls

End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications, and other user-based applications. These applications might be used as the basis for making journal entries or preparing other financial statement information. End-user computing is especially prevalent in smaller, less complex companies.

End-user computing controls are controls over spreadsheets and other user developed applications that help ensure that such applications are adequately documented, secured, backed up, and reviewed regularly for process integrity. End user computing controls include general and application controls over user-developed spreadsheets and applications.

Tests of controls over end-user computing could include assessing access controls to prevent unauthorised access: testing of controls over spreadsheet formulas or logic of queries and

scripts; testing of controls over the completeness and accuracy of information reported by the end-user computing applications; and reviewing the procedures for backing up the applications and data.

Considering financial reporting competencies and their effects on internal financial controls

IG 19.38 To maintain effective internal financial controls, a company needs to retain individuals who are competent in financial reporting and related oversight roles. Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting. Also, resource limitations might prevent a smaller, less complex company from employing personnel who are familiar with the accounting required for unique, complex, or non-routine transactions or relevant changes in rules, regulations, and accounting practices.

Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals.

The following Section discusses the auditor's consideration of financial reporting competencies at a smaller, less complex company, including situations in which a smaller, less complex company enlists outside assistance in financial reporting matters.

Understanding and evaluating a company's financial reporting competencies

IG 19.39 The evaluation of competence is one aspect of evaluating the control environment and the operating effectiveness of certain controls. For example, when evaluating entity-level controls, such as risk assessment and the period-end financial reporting process, the auditor could obtain information about whether –

- *Management identifies the relevant financial reporting issues on a timely basis (e.g., issues arising from new transactions or lines of business or changes to accounting standards); and*
- *Management has the competence to ensure that events and transactions are properly accounted for and that financial statements and related disclosures are presented in conformity with generally accepted accounting principles ("GAAP").*

For recurring clients, the auditor's experience in prior audit engagements can be a source of information regarding management's financial reporting competencies. The auditor could be aware of specific accounts or disclosures that have caused problems in prior engagements, or of management's response to past changes in accounting pronouncements. These experiences can inform the auditor about management's financial reporting competencies, including whether and how management identifies and responds to financial reporting risks. The procedures performed to evaluate the period-end financial reporting process could also be valuable to the evaluation of financial reporting competency.

The auditor's inquiries and observations pertaining to the company's overall commitment to competence, which is part of the evaluation of the control environment, can also inform the auditor's assessment of financial competency. The auditor can consider whether and how the company and management –

- *Establish and agree on the knowledge, skills and abilities needed to carry out the required responsibilities prior to hiring individuals for key financial reporting positions,*
- *Train employees involved in financial reporting processes and provide them with the appropriate tools and resources to perform their responsibilities, and*
- *Periodically review and evaluate employees relative to their assigned roles, including whether the audit committee (or board of directors) evaluates the competencies of individuals in key financial reporting roles, such as the chief executive and financial reporting officers.*

Auditors may keep in mind that company financial reporting personnel do not need to be experts in all areas of accounting and financial reporting but need to be sufficiently competent with respect to the accounting for current and anticipated transactions and changes in accounting standards to identify and address the risks of misstatement.

Supplementing competencies with assistance from outside professionals

IG 19.40 Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered. In these circumstances, a company might 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). When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting.

When an outside professional provides accounting assistance related to relevant assertions or the period-end financial reporting process, the auditor might begin by considering how the company assures itself that events and transactions are properly accounted for and that financial statements and the related disclosures are free of material misstatement. The company might have differing levels of involvement with outside professionals, depending upon the nature of the services provided. The auditor could evaluate management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks. In performing this evaluation, the auditor can consider –

- *Whether management recognises situations for which additional expertise is needed to adequately identify and address risks of misstatement.*
- *How management determines that the outside professionals possess the necessary qualifications. For example, management might obtain information from the professional about his or her skills and competence.*
- *Whom management designates to oversee the services and whether they possess the suitable skill, knowledge, or experience to sufficiently oversee the outside professionals. (Note: Management is not required to possess the expertise to perform or re-perform the services.)*
- *Whether management has established controls over the work of the outside accounting professional and over the completeness and accuracy of the information provided to the outside professional. For example, in addition to reviewing the work of the outside professional, management might inquire about the professional's*

monitoring and review procedures related to the work performed by the professional for the company.

- *How management participates in matters involving judgement, for example, whether management understands and makes significant assumptions and judgements underlying accounting calculations prepared by an outside professional.*
- *How management evaluates the adequacy and the results of the services performed, including the form and content of the outside accounting professional's findings, and accepts responsibility for the results of the services.*

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor could also inspect documentation that provides support for management's oversight of the outside professional.

Example – Assistance from outside professionals

IG 19.41 Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. The company retains a third party accounting firm (not its auditor) to prepare the income tax provision, including deferred tax. Management obtains information from the third-party accounting firm about the training and experience of the staff assigned to do this work. The company's CFO, who has basic knowledge of tax accounting, reviews and discusses the tax provision with the accounting firm that prepared it, and compares the provision to CFO's expectations based on past periods, budgets, and knowledge of business operations.

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages an outside professional to provide technical assistance. Further, the auditor evaluates management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks of material misstatement regarding the income tax provision. As part of this evaluation, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

Obtaining sufficient appropriate evidence when the company has less formal documentation

IG 19.42 Implementing and assessing effective internal financial *controls by a company's management generally involves some level of documentation. A smaller, less complex company often has different needs for documentation, and the nature of that documentation might differ from that of a larger or more complex organisation. Differences in the form and extent of control documentation of smaller, less complex companies generally relate to their operating characteristics, particularly to fewer resources and more direct interaction of senior management with controls.*

The nature and extent of a company's documentation of internal financial *controls can have a significant effect on the auditor's strategy regarding the audit of internal financial control. This*

Section discusses how the auditor could adapt his or her audit strategy to obtain sufficient appropriate evidence in an environment with less formal documentation.

Audit strategy considerations relating to audit evidence

IG 19.43 The auditor must plan and perform the audit to obtain evidence that is sufficient to obtain reasonable assurance about whether significant deficiencies or material weaknesses exist as of the date specified in management's assessment. The auditor can obtain this evidence through direct testing or using the work of others, as appropriate. Procedures the auditor could perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control. The nature, timing, and extent of tests of controls depend on the risk associated with the controls. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Documentation of processes and controls

IG 19.44 Larger companies with complex operations are more likely to have formal documentation of their processes and controls, such as in-depth policy manuals and systems flowcharts of processes. In a smaller, less complex company, documentation of processes and controls might take a variety of forms. For example, information about processes and controls might be found in other documentation, such as memoranda, questionnaires, software manuals, source documents, or job descriptions. This documentation might not cover every process and might not be in a consistent form across all processes.

Where walkthroughs are performed, auditors could use those procedures to obtain an understanding of the flow of transactions affecting relevant assertions and to assess the design effectiveness of certain controls, even when documentation is limited.

Documentation of operating effectiveness of controls

IG 19.45 In a smaller, less complex business, the nature and extent of documentation of the operating effectiveness of controls may vary. Also, evidence of a control's operation might exist only for a limited period. The type and availability of evidence regarding controls to be tested can affect the auditor's testing strategy. In particular, company documentation can influence the nature and timing of audit procedures performed. For example, the nature of some audit procedures e.g., document inspection, requires documentation. Also, the timing of some tests of controls might be determined, in part, based on when the evidence of the controls' operation is available.

Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation. In those situations, inquiry combined with other procedures, such as observation of activities, inspection of documentation produced or used by the controls, and re-performance of certain controls, might provide sufficient evidence about whether a control is effective.

As a practical matter, the auditor also needs to obtain documentation of the work of others to use that work to reduce the auditor's own testing.

Other considerations

IG 19.46 When auditing a smaller, less complex company with limited documentation, generally it is helpful to obtain an understanding of the nature and availability of audit evidence relating to internal financial *controls as early in the audit process as practical. This understanding ordinarily includes consideration of existing documentation regarding –*

- *Company processes and procedures, particularly for transactions affecting relevant assertions and controls that the auditor is likely to select for testing.*
- *Monitoring of other controls performed by management or others. The auditor can then identify gaps in important documentation so alternatives can be explored. For example, if the CFO prepares contemporaneous documentation of certain controls and retains it for a limited period, the auditor might arrange to obtain access to that documentation for testing purposes. Early conversations with management about these matters can help provide auditors with the most flexibility in developing efficient and effective audit strategies.*

If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation. A practical way to identify such other documentation is to look at the information that the company uses to run the business.

One of the practical considerations when selecting controls to test and determining the nature, timing, and extent of testing is the nature and availability of evidence of operating effectiveness. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor could select the control for which evidence of operating effectiveness can be obtained more readily.

Example - Obtaining information about processes and controls

IG 19.47 Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorisation, and recording of these purchases, although the company has not developed in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed.

When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. He or she follows up with inquiries of personnel involved in the process of authorising, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. He or she summarises understanding of the transaction flow in a memo and includes a copy of a purchase form in the work papers.

The auditor uses his or her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example – Obtaining evidence about operating effectiveness of controls

IG 19.48 Scenario: One control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of the review but does retain copies of the financial statements with handwritten notes and other markings for reference purposes. The review comments are sent to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. The auditor can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision of the CFO's review. He or she can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He or she can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he or she can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

Auditing smaller, less complex companies with pervasive control deficiencies

IG 19.49 In some audits of internal financial control, auditors might encounter companies with numerous or pervasive deficiencies in internal financial controls. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls.

Auditing internal financial *controls in companies with pervasive deficiencies can be challenging. The auditor's strategy is influenced by the nature of the control deficiencies and factors such as the effect of the deficiencies on other controls and the availability of audit evidence. Although the facts and circumstances can vary significantly, the auditor might not be able to express an unqualified opinion on the effectiveness of internal* financial *controls in some of these situations.*

Pervasive deficiencies that result in material weaknesses

IG 19.50 The auditor's objective in an audit of internal financial *control is to express an opinion on the adequacy and operating effectiveness of the company's internal* financial *controls over financial reporting. Because a company's internal* financial *controls cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.*

Ordinarily, the auditor's strategy should include tests of controls as necessary to support a conclusion that internal financial *controls are adequate and effective. However, the auditor's existing knowledge of the company or information obtained early in the audit process might lead an auditor to a preliminary judgement that internal* financial *controls is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses. In those situations, the auditor's strategy for testing selected controls may depend on the effect of the pervasive deficiencies on other controls, as discussed in the following paragraphs.*

Considering the effect of pervasive control deficiencies on other controls

IG 19.51 When the auditor encounters pervasive control deficiencies, he or she might decide that those deficiencies also impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. For example, certain deficient entity-level controls, such as the following, might impair the effectiveness of other controls over relevant assertions:

- *Ineffective control environment (considering the risk profile of the company). An ineffective control environment can increase the risk associated with a control by rendering its design ineffective or preventing it from operating effectively. Also, certain controls in the control environment, such as maintaining financial reporting competencies, might be necessary for the effective functioning of other controls.*
- *Ineffective IT controls or information systems. Ineffective information systems could impair the effectiveness of certain IT-dependent controls (e.g., monitoring controls that rely on the reports produced by an ineffective information system).*
- *Pervasive lack of segregation of duties without appropriate alternative controls. When a person performs two or more incompatible duties, the design of some controls might be ineffective without appropriate alternative controls.*
- *Frequent management override of controls. A control that is frequently overridden is less likely to operate effectively. The effectiveness of controls that depend on an overridden control also might be impaired.*

The top-down audit approach can help the auditor identify pervasive control deficiencies earlier in the audit process and take them into account in determining the audit approach for testing other controls.

The auditor's preliminary judgements regarding the effect of the pervasive control deficiencies can help determine the approach to gathering audit evidence. When the pervasive control deficiencies adversely affect other controls, the auditor may modify the planned testing of the other controls because less evidence generally is needed to support a conclusion that controls are not effective than a conclusion that controls are effective. For example, if a control is likely to be impaired because of another control's deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary (e.g., if a walkthrough has not been performed) to conclude that a control is not operating effectively. Also, detected misstatements from the audit of the financial statements could indicate that a control is not effective.

Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness. The pervasive control deficiencies may affect the risk associated with the controls selected for testing, and, in turn, the amount of audit evidence needed.

Scope limitation due to lack of sufficient audit evidence

IG 19.52 Pervasive deficiencies in a company's internal financial *controls do not necessarily prevent an auditor from obtaining sufficient audit evidence to express an opinion on internal financial controls. If the auditor determines that sufficient evidence is available to express an opinion, the auditor should perform tests of those controls that are important to the auditor's conclusion about the effectiveness of the company's internal* financial *controls and evaluate the severity of the identified control deficiencies.*

In some audits of companies with pervasive control deficiencies, the auditor could become aware that there is minimal available evidence about the design and operation of internal financial controls. Such situations could lead the auditor to conclude that the lack of available evidence constitutes a scope limitation that will prevent him or her from obtaining reasonable assurance necessary to express an opinion on internal financial controls, including identification of existing material weaknesses.

The auditor may issue a report disclaiming an opinion on internal financial *controls as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.*

The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion. The auditor's report should disclaim an opinion on internal control and disclose the substantive reasons for the disclaimer. The report should also disclose the material weaknesses of which the auditor is aware.

Even if the auditor lacks sufficient evidence to express an opinion on internal financial control, the auditor might still be able to obtain sufficient evidence to perform an audit of the financial statements. The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal financial control in assessing control risk and determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.

Example – Pervasive deficiencies and testing of controls

IG 19.53 Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures.

The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.

Audit Approach: Based on the auditor's experience with the company, he or she expects that controls over the valuation/allocation and disclosures related to stock based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the

respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and he or she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, auditor concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.

Example – Lack of sufficient audit evidence

IG 19.54 Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a bank book and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal financial *controls and evaluate entity-level controls, he or she notes that there is minimal information available about the controls that existed at year-end.*

Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations, or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but he or she determines that the lack of evidence results in a scope limitation because he or she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal financial control. The auditor's report on internal financial *controls contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that he or she identified.*

IG 20 Reporting Considerations (Refer Paragraph 153–156 and 163)

IG 20.1 The auditor should modify the audit report on internal financial controls if any of the following conditions exist:

a. The auditor has identified deficiencies in the design or operation of internal controls, which individually or in combination has been assessed as material weakness.

b. There is a restriction on the scope of the engagement.

IG 20.2 A deficiency in internal control exits if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing. Such a misstatement may occur

on an annual basis (either before or after an audit), or through interim financial reporting (e.g., quarterly results, which are un-audited).

IG 20.3 In evaluating the severity of a deficiency in internal financial controls, the auditor should primarily consider two factors: the likelihood that the deficiency will result in a financial misstatement, and the magnitude of such an outcome. Thus, this process is, in essence, an exercise of risk analysis. Like the generally accepted accounting principles (GAAP) that govern the preparation of financial statements, there are no clear bright-line tests based solely on quantitative measures for assessing a deficiency or combination of deficiencies as a significant deficiency or material weakness; qualitative measures must also be considered, and professional judgement is required.

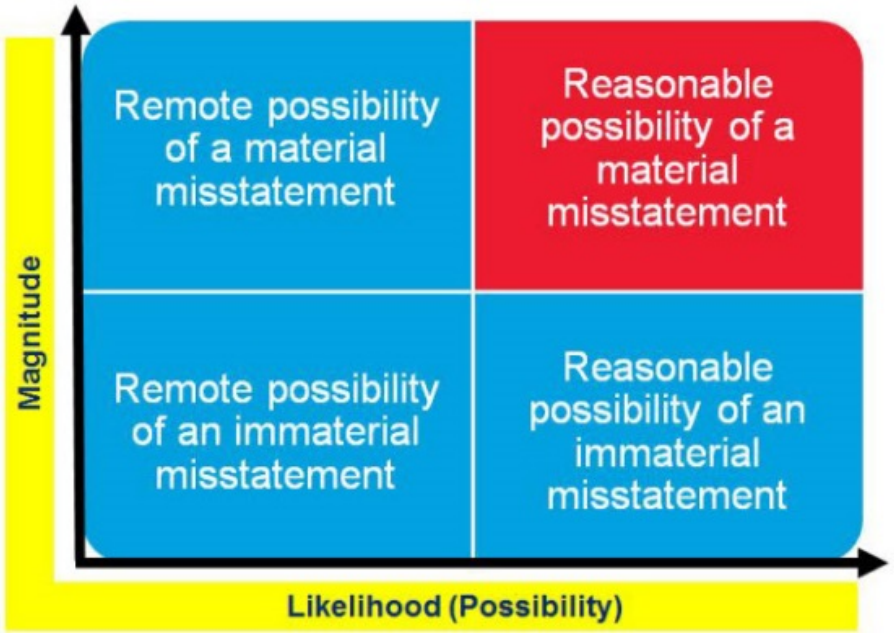


Figure: Evaluation of Deficiencies

Refer **Appendix V** for additional factors for evaluating deficiencies and examples of different categories of deficiencies.

Modified opinion on internal financial controls over financial reporting

IG 20.4 For purposes of this Guidance Note, the following terms have the meanings attributed below:

(a) Pervasive – A term used, in the context of control deficiencies, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to the internal controls not being adequate and / or not operating effectively. Pervasive effects on the internal financial controls over financial reporting are those that, in the auditor's judgment:

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

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

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

(b) Modified opinion – A qualified opinion, an adverse opinion or a disclaimer of opinion.

Circumstances When a Modification to the Auditor's Opinion on Internal Financial Controls Over Financial Reporting Is Required

IG 20.5 The auditor shall modify the opinion in the auditor's report on internal financial controls over financial reporting when:

(a) The auditor concludes that, based on the audit evidence obtained, the internal financial controls over financial reporting is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the internal financial controls over financial reporting is adequate and / or operating effectively to provide reasonable assurance that it is designed, implemented or operated in such a way that it is able to prevent, or detect and correct material misstatements in the financial statements on a timely basis.

Determining the Type of Modification to the Auditor's Opinion on Internal Financial Controls Over Financial Reporting

Qualified Opinion

IG 20.6 The auditor shall express a qualified opinion on Internal Financial Controls Over Financial Reporting when the auditor, having obtained sufficient appropriate audit evidence, concludes that such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing, but the effects/possible effects of the material weakness in such internal controls are material but is not pervasive to the financial statements. (Refer Scenario 1 and 3 in Example 2 of Appendix III)

Adverse Opinion

IG 20.7 The auditor shall express an adverse opinion on Internal Financial Controls Over Financial Reporting when the auditor, having obtained sufficient appropriate audit evidence, concludes that:

(a) such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis; or the control is missing, and the effects/possible effects of the material weakness in such internal controls are both material and pervasive to the financial statements, even if the audit opinion on the financial statements is unmodified; (Refer Scenario 2 and 4 in Example 2 of Appendix III)

(b) the system of internal financial controls over financial reporting adopted by the Company does not consider / adequately consider the essential components of internal control as stated in Section III of Part B of this Guidance Note (Refer Scenario 5 in Example 2 of Appendix III); or

(c) the audit opinion on the financial statements is required to be modified and such modification is also consequent to the material weakness in the company's internal financial controls over financial reporting. (Refer Example 4 of Appendix III) .

IG 20.8 The qualified or adverse opinion on internal financial controls over financial reporting may relate only to the operating effectiveness of such controls or may relate to both the adequacy and operating effectiveness of such controls, based on the audit evidence obtained.

Disclaimer of Opinion

IG 20.9 The auditor shall disclaim an opinion on the company's internal financial controls over financial reporting:

(a) if the company has not established its system of internal financial control over financial reporting considering the essential components of internal control stated in this Guidance Note (Refer Scenario 1 in Example 3 of Appendix III); or

(b) the auditor is unable to obtain sufficient appropriate audit evidence to express an opinion on the internal financial controls over financial reporting but is able to perform appropriate substantive procedures to express an opinion on the financial statements (Refer Scenario 2 in Example 3 of Appendix III); or

(c) when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion on the company's internal financial controls over financial reporting, and / or the auditor concludes that consequent to the material weakness in such internal controls the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. (Refer Scenario 3 in Example 3 of Appendix III)

IG 20.10 When the auditor plans to issue a modified opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report should also include –

- The definition of a material weakness as stated in this Guidance Note.
- The description of the material weakness identified in the company's internal financial controls over financial reporting. This description should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the preparation and presentation of the company's financial statements issued during the existence of the deficiency. This description should also address the requirements in paragraph 157.
- The consideration of the effect of the modified opinion on internal financial controls over financial reporting on the audit opinion on the financial statements of the company.

Effect of a modified report on internal financial controls over financial reporting on the audit of financial statements

IG 20.11 A modified report on internal financial controls over financial reporting does not in effect imply that the audit report on financial statements should also be qualified. In an audit of financial statements, the assurance obtained by the auditor is through both internal controls and substantive procedures.

IG 20.12 Effect of Tests of Controls on Substantive Procedures: If, during the audit of internal financial controls, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

IG 20.13 Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal financial controls does not diminish this requirement.

IG 20.14 If, as a result of the substantive procedures, the auditor is of the opinion that sufficient reliable audit evidence has been obtained to address the risk identified or gain assurance on the account balance being tested, the auditor should not qualify the audit opinion on the financial statements.

For example, if a material weakness is identified with respect to customer acceptance, credit evaluation and establishing credit limits for customers resulting in a risk of revenue recognition where potential uncertainty exists for ultimate realisation of the sale proceeds, the auditor may modify the opinion on internal financial controls in that respect. However, in an audit of financial statements, the auditor when performing substantive procedures obtains evidence of confirmation of customer balances and also observes that all debtors as at the balance sheet date have been subsequently realised by the date of the audit, the audit opinion on the financial statements should not be qualified, though the internal control deficiency exists.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls:

IG 20.15 In an audit of internal financial controls, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal financial controls. This evaluation should include, at a minimum:

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures - The extent of such misstatements might alter the auditor's judgement about the effectiveness of controls.

IG 20.16 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. The absence of misstatements detected by substantive procedures, however, should guide the auditor's risk assessments, and in determining the testing necessary to conclude on the effectiveness of a control.

Interpretation of an unmodified report on financial statements with a modified report on internal financial controls over financial reporting

IG 20.17 When an auditor issues an unmodified opinion on the company's financial statements, this is a representation to the users of financial statements that the auditor has followed applicable auditing and related professional standards so as to allow the auditor to conclude with reasonable assurance that the financial statements are in conformity with the generally accepted accounting principles in all material respects. An unmodified audit opinion is not a guarantee of error-free financials, but is rather the conclusion by an auditor – using audit procedures and professional judgement that are reasonable to the circumstances – that the statements are fairly presented.

IG 20.18 Neither the auditor nor the company is required to disclose whether the audit process itself revealed financial statement errors that were corrected before the statements were approved. The degree to which the auditor is involved in requiring management to correct financial statements prior to their issuance is an indication of whether the company – using only its own personnel (either employees or third party consultants) – will produce financial information that is materially accurate.

IG 20.19 Whilst the auditors apply both test of controls and substantive testing to gain assurance on the financial statements, the management relies solely on its internal financial controls when preparing financial statements. The ability of a company to accurately describe its own financial condition is particularly relevant when the company discloses un-audited financial information, as in quarterly result filed with the Stock Exchanges. Thus, while the audit report of a company's financial statements may be unmodified, this provides little information to those outside the company as to whether other financial information (such as interim financial information) is of similar reliability.

Scope limitations

IG 20.20 The auditor can express an opinion on the company's internal financial controls only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the adequacy or effectiveness of internal financial controls.

IG 20.21 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal financial controls (paragraph 157 (f), (g), and (h)); to do so might overshadow the disclaimer.

IG 20.22 If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in writing, to

management and the audit committee[8] that the audit of internal financial controls cannot be satisfactorily completed.

Impact of modified opinion on internal financial controls over financial reporting in subsequent interim period financial reporting

IG 20.23 As stated in paragraph IG 20.19, the management relies solely on its internal financial controls when preparing financial statements and as such the ability of a company to accurately describe its own financial condition is dependent on the adequacy and operating effectiveness of the internal financial controls.

IG 20.24 If the auditor's report for the audit of internal financial controls under the Act for the financial year proceeding the interim period was modified consequent to material weakness, the auditor should consider the effect of such modification when carrying out a review of interim financial statements / information under SRE 2400 or SRE 2410 issued by the Institute of Chartered Accountants of India.

IG 20.25 Accordingly, the auditor should carry out additional procedures to determine if the material weakness and the significant deficiency in the internal financial controls as reported in the previous financial year have been remediated. The auditor should consider the guidance provided for testing design of controls, testing operating effectiveness of controls and remediation testing in determining the timing, nature and extent of testing.

IG 20.26 If after performing such additional procedures as explained in paragraph IG 20.25, the auditor concludes that the significant deficiency or material weakness in internal control reported earlier has not been remediated, the auditor shall modify his or her report on the interim financial statements / information describing the material weakness reported earlier and stating that based on the procedures carried out by him or her, the said material weakness in internal control does not appear to have been remediated. If any of the significant deficiencies reported to those charged with governance in the earlier year has not been remediated and such deficiency in control is considered as a material weakness in the current period, the report of the auditor on the interim financial statements / information should describe the deficiency and state that the same is viewed as a material weakness in the current interim period.

IG 20.27 If the interim financial statements are subject to audit, the auditor should comply with the Standards on Auditing for reporting on such interim financial statements. In planning and performing the audit, the auditor should consider the effect of the significant deficiency or material weakness reported in the previous financial year on the interim financial statements. Since such audit is not carried out as per the provisions of the Act, the auditor is not required to separately test and report on the internal financial controls in the interim period

IG 21 Understanding and Evaluating Financial Reporting Process

IG 21.1 The financial reporting process, while an undefined term in the professional standards, generally refers to the process that begins when the underlying flows of transactions at the account/ assertion level culminate (e.g., typically in a subsidiary ledger or the general

[8] In case of a small or a one person company as defined in the Act, since there is no requirement to have an audit committee, the auditor would make such communication to the Board of Directors.

ledger). For a company, the financial reporting process encompasses the activities necessary to prepare, review, and approve the quarterly and annual financial statements, including the required disclosures, for filing in accordance with the required rules and regulations.

IG 21.2 Because of its importance to financial reporting and to the auditor's opinions on internal financial controls and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following:

- Procedures used to enter transaction totals into the general ledger;
- Procedures related to the selection and application of accounting policies;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and non-recurring adjustments to the annual and quarterly financial statements; and
- Procedures for preparing annual and quarterly financial statements and related disclosures.
- With regard to the consolidated financial statements, the understanding the financial reporting process would include understanding the procedures for:
    a) identification of subsidiaries, associates and joint ventures that would form part of the consolidation process;
    b) identification of inter-company transactions for elimination and elimination of any unrealised profits on such transactions;
    c) identification and quantification of minority interest;
    d) ensuring consistency of accounting policies amongst the consolidating entities;
    e) ensuring consistency of the classification of account balances amongst the consolidating entities;
    f) recording recurring and non-recurring adjustments to the annual and quarterly consolidated financial statements; and
    g) ensuring appropriate disclosures in the consolidated financial statements.
- In addition to the above, the auditor should also assess the impact, if any, of the subject matter of any qualification, adverse opinion or disclaimer stated by any of the component auditors in their respective components, and any remedial measures effected by the parent company to mitigate the effect of such observations in the component audit reports on the financial reporting process for the consolidated financial statements.

IG 21.3 As part of evaluating the period-end financial reporting process, the auditor should assess:

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;

- The extent of information technology ("IT") involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and eliminating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Understanding the financial reporting process

IG 21.4 The auditor is required to obtain a sufficient understanding of the processes and flows of transactions for significant accounts and disclosures to validate the points at which a material misstatement could occur, and for identifying the controls that mitigate those potential misstatements. His/her understanding of the flows of transactions and processes of the significant accounts and disclosures begins at the initiation of a transaction and concludes with its presentation in the financial statements. For practical purposes, the auditor typically bifurcate understanding of significant accounts and disclosures (including the process for consolidating and preparing the financial statements) into two parts: (1) the account/assertion level process and (2) the financial reporting process (depicted in Figure below):

- Significant Accounts: Separately understand the flows of transactions and processes (and related controls) for each significant account as part of the account /assertion level process until the transactions reach an appropriate “hand-off” point to the financial reporting process (e.g., a subsidiary ledger or the general ledger).
- Disclosures: Understand the flows of transactions and processes (and related controls) for the preparation of each disclosure as part of the financial reporting process (although the controls related to the underlying transactions and events may have already been addressed at the account/assertion level.

Note: Disclosures may alternatively be addressed in conjunction with the related significant account balance at the account/assertion level until they are accumulated at the financial reporting process level.

- Preparation of the Financial Statements: Understand the processes (and related controls) for the preparation, review, and approval of the financial statements as part of the financial reporting process.

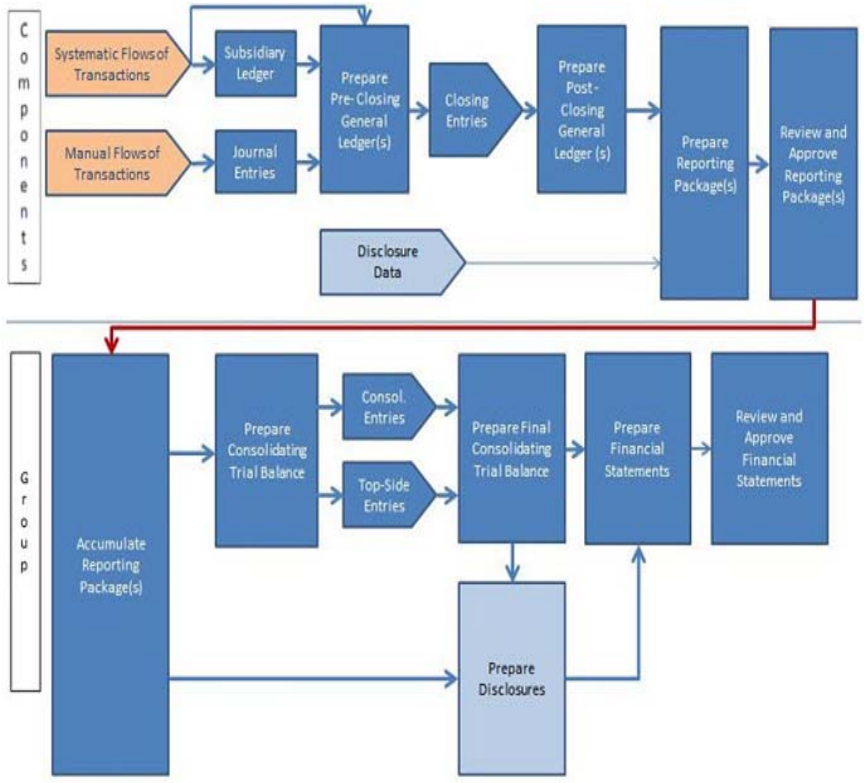


Figure: Understanding financial reporting process

IG 21.5 Similar to how the auditor obtains an understanding of the processes and relevant controls relating to individual account balances and disclosures, performing a walkthrough of the financial reporting process is likely to be the most effective way to understand the financial reporting process from beginning-to-end, and provides the basis for identifying the risks of material misstatement and the relevant controls, any relevant IPE, and any relevant application systems.

IG 21.6 Reviews and financial analysis of the draft financial statements and related disclosures by management, the disclosure committee, the audit committee, or the board of directors are important controls that support their assertion and certifications. However, while these controls may be considered “direct” controls, they are often not designed to operate at a sufficient level of precision to address a risk of material misstatement by themselves (e.g., the purpose of such a control is to identify anomalies, not verify that the amounts are fairly stated). Nonetheless, these controls are typically selected for testing, as they are important to the overall reliability of financial reporting even when they are not sufficiently precise on their own.

Understanding the application systems and controls over financial reporting process

IG 21.7 Many entities use technology to automate aspects of the financial reporting process. Identifying the relevant application systems that support the financial reporting processes is necessary to identify the IT risks and general IT controls or other controls (e.g., direct controls) that are relevant to the financial reporting process.

Considerations when identifying controls relevant to the financial reporting process may include:

- Automated interfaces: Data typically flows into the general ledger either systematically through automated interfaces or via journal entries that are manually input. When the system users rely on automated interfaces (i.e., the electronic transfer of transactions and data between systems), similar to an automated control, auditor subject the automated interface to testing. The extent of testing depends in part on whether the application is subject to effective general IT controls.
- Consolidation applications/tools: Financial reporting application systems (e.g., Hyperion) may be used to automate the consolidation process and may interface with one or more data warehouses or other application systems. Accordingly, when the system users rely on the application's automated controls, the reliability of the data, and/or the reports generated by the application systems (which are IPE), the application is relevant to ICFR and the relevant IT risks and controls (e.g., general IT or other similar controls) are identified.

For example, the entity uploads the financial data received from its branches into Hyperion in which the consolidation with head office is performed as well as the output of financial data for analysis. Hyperion (including the underlying data warehouse) is within the scope of the general IT controls; therefore, the identified IT risks are addressed by the general IT controls that operate over Hyperion.

For example, the entity uploads data from the general ledger system into a data warehouse that is not within the scope of the general IT controls. Therefore, the entity implemented controls such as manual input/output controls to verify that the data coming out of the data warehouse agrees with the data that was uploaded into the data warehouse and we test the reports (which are IPE) more extensively since the application is not subject to general IT controls.

In addition, review-type controls (e.g., a review of financial information and data by management, the disclosure committee or the board of directors) are often dependent upon the accuracy and completeness of the reporting packages and data (which are IPE) derived from these applications/tools; therefore, consideration and testing of the design and operating effectiveness of the relevant controls, including the general IT controls, may also be relevant for purposes of evaluating the effectiveness of such review-type controls.

IG 21.8 The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including:

- The classes of transactions in the company's operations that are significant to the financial statements;
- The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;
- The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;
- How the information system captures events and conditions, other than transactions that are significant to the financial statements; and
- The period-end financial reporting process.

Understanding accounting policies

IG 21.9 The company’s process and controls to select and apply its accounting principles, financial reporting policies, and related disclosures, underpin effective financial reporting. Accordingly, the auditor is required to obtain an understanding of the entity’s selection and application of accounting policies and principles, including related disclosures.

The following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- The methods the company uses to account for significant and unusual transactions; and
- Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.

For internal financial reporting purposes, the auditor considers the company’s controls over the selection and application of GAAP (i.e., the company’s controls over applying GAAP to new transactions or events or implementing new GAAP requirements). Implicit in this evaluation is the auditor’s evaluation of the competence of those individuals responsible for the selection, development, and application of such policies and principles.

Understanding the process for recording journal entries

IG 21.10 The process for initiating, reviewing, authorizing and recording journal entries is integral to the financial reporting process. For many entities, this process may involve a combination of automated and manual procedures for transferring transactions and data from a source (e.g., sub-ledger, manual spreadsheet, analysis) to the general ledger.

Many entities utilise different journal entry types, for example:

- Entries to record transaction activity
- Routine closing entries
- Non-routine closing entries
- Consolidating and eliminating entries
- Top-side entries

When such entries are subject to different processes and controls, they are evaluated and tested separately; that is, it is not appropriate to design a testing strategy on the basis of the controls being common if the characteristics of a common control are not met.

IG 21.11 In understanding and testing the relevant controls over the journal entry process, area based considerations specific to journal entries include the following:

- Segregation of duties (e.g., who prepares, reviews and posts entries)
- The review and approval process, including the purpose of the review (e.g., the level of management at which the review is performed "reasonableness" review versus a detailed review of the supporting documentation)
- Adequacy of the supporting documentation for the journal entry to enable a reviewer to determine whether the entry is appropriate
- Competence of the preparer
- Competence and authority of the reviewer.

IG 21.12 Management override of controls over journal entries is a presumed risk of fraud (and therefore a significant risk) that is addressed by controls at either the financial statement level (e.g., entity-level controls designed to address the risk of management override of controls) or the account balance level for each account. Accordingly, auditor focuses additional attention on the effectiveness of the design and the operating effectiveness of controls that mitigate such risk.

Understanding the process for disclosures

IG 21.13 The auditor identifies which disclosures are significant disclosures (and therefore included in the scope of a combined audit of internal financial controls over financial reporting and financial statements), then identify the relevant assertions for each significant disclosure. As the GAAP requirements are not applicable to immaterial items, it would be rare for a disclosure in an entity's financial statements not to be considered a significant disclosure. The relevant assertions for presentation and disclosure are as follows:

- Occurrence and rights and obligations — Disclosed events, transactions, and other matters have occurred and pertain to the entity.
- Completeness — All disclosures that should have been included in the Financial Statements have been included.
- Classification and understandability — Financial information is appropriately presented and described, and disclosures are clearly expressed.
- Accuracy and valuation — Financial and other information are disclosed fairly and at appropriate amounts.

There are two key considerations when developing the audit approach for disclosures:

- Identify the process steps (and controls) that are unique to each disclosure (i.e., when the process, risks and controls are not common).

  For example, the preparation of the legal disclosure may be subject to different processes, risks and controls than the preparation of the stock compensation

disclosures, in which case those relevant controls would be subject to testing separately. However, the use of a GAAP disclosure checklist is an example of a control that is performed on an overall basis (and therefore the control operates with respect to all disclosures).

- Identify which disclosures are derived from transactions or events for which auditor has already tested the relevant controls.

  For example, the inventory footnote is typically derived from data within the general ledger. Since auditor has already tested the relevant controls over inventory into the general ledger, auditor only needs to test the controls over the accuracy and completeness of the presentation of the footnote in the draft financial statements for ICFR purposes.

APPENDIX I

Illustrative Engagement Letter

(Referred to in Paragraph 75)

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

The following factors need to be considered by an auditor when agreeing the terms of an audit engagement for the audit of internal financial controls. These factors are in addition to those stated in SA 210 “Agreeing the terms of Audit Engagements” for an audit of the financial statements.

1. In order to establish whether the preconditions for an audit of internal financial controls are present, the auditor shall:

(a) Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For laying down internal financial controls to be followed by the company;

(ii) For ensuring that that such internal financial controls are adequate and are operating effectively; (this is in addition to the requirement in Paragraphs A15 to A18 of SA 210;

(iii) To provide the auditor with:

- Access to all information, such as records and documentation, and other matters that are relevant to their assessment of internal financial controls;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Determining the acceptability of the internal financial controls criteria

2. Factors that are relevant to the auditor’s determination of the acceptability of the internal financial controls criteria include:

a) Whether the aforesaid controls are based on the essential components of internal controls as stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.

b) The nature of the entity (for example, whether it is a business enterprise, or not for profit organization);

c) The size of the entity (for example, internal controls in a smaller entity are comparatively lesser than that of a large entity);

d) Whether the entity is listed or unlisted; and

e) Whether law or regulation prescribes any requirement for internal financial controls.

Limitation on scope prior to audit engagement acceptance

3. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the internal financial controls, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Agreement on audit engagement terms

4. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(a) The objective and scope of the audit of the internal financial controls;

(b) The responsibilities of the auditor;

(c) The responsibilities of management;

(d) Identification of the applicable criteria to be applied for establishing the internal financial controls; and

(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Form and content of the audit engagement letter

5. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter may be based on SA 210. The auditor may issue a combined engagement letter for reporting on financial statements and reporting on internal financial controls or a separate engagement letter for each. In addition to including the matters required by SA 210, an audit engagement letter may make reference to, for example:

- The agreement of management's responsibilities for establishing and maintaining adequate and effective internal financial controls based on the control criteria [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".] 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.
- The agreement of management to make available to the auditor their evaluation and assessment of the adequacy and effectiveness of the company's internal financial controls, based on the control criteria as mentioned above.
- The agreement of management to inform the auditor of any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.
- The agreement of providing management's conclusion over the company's internal financial controls based on the control criteria set above as of the balance sheet date;

- The agreement of providing the component auditors' report under section 143(3)(i) in the case of components that are companies covered under the Companies Act, 2013 that form part of the consolidated financial statements of the parent company

Example of a Separate Audit Engagement Letter for Audit of Internal financial controls over financial reporting

The following is an example of an engagement letter for an audit of internal financial controls over financial reporting in the case of standalone financial statements that is separate from the engagement letter for an audit of the financial statements prepared in accordance with the Accounting Standards notified under Section 133 of the Companies Act, 2013. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 210. It will need to be varied according to individual requirements and circumstances.

***

To the Board of Directors of ABC Company Limited:

The objective and scope of the audit

You have requested that I / we carry out an audit of the internal financial controls over financial reporting of ABC Company Limited (the 'Company') as at March 31, 20X1 [balance sheet date] in conjunction with our audit of the standalone and consolidated financial statements of the Company for the year ended on that date.

I am / We are pleased to confirm my / our acceptance and my / our understanding of the audit engagement by means of this letter. My / Our audits will be conducted with the objective of expressing our opinion under Section 143(3)(i) of the Companies Act, 2013 ("2013 Act") on the adequacy of the internal financial controls system over financial reporting and the operating effectiveness of such controls as at March 31, 20X1 based on the internal control *criteria* established by you.

Audit of internal financial controls over financial reporting

I / We will conduct our audit of the internal financial controls over financial reporting in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ("the Guidance Note") and the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, to the extent applicable to an audit of internal financial controls over financial reporting. These Guidance Note and Standards require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness as at the balance sheet date.

An audit of internal financial controls over financial reporting involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness.

The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

Inherent limitations in an audit 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.

Management's responsibility

My / Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

(a) For establishing and maintaining adequate and effective internal financial controls based on [state criteria] [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"] 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.

(b) To provide me / us with:

(i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) All information, such as records and documentation, and other matters that are relevant to my / our assessment of internal financial controls;

(iii) Management's evaluation and assessment of the adequacy and effectiveness of the company's internal financial controls, based on the control criteria [mention the control criteria] and all deficiencies, significant deficiencies and material weaknesses in the design or operations of internal financial controls identified as part of management's evaluation.

(iv) Additional information that I / we may request from [management] for the purpose of the audit.

(v) Unrestricted access to persons within the entity from whom I / we determine it necessary to obtain audit evidence. This includes my / our entitlement to require from the officers of the Company such information and explanations as I / we may think necessary for the performance of my / our duties as auditor.

(vi) Any communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.

(vii) Management’s conclusion over the company's internal financial controls based on the control criteria set above as at the balance sheet date [insert date].

(viii) Informing me / us of significant changes in the design or operation of the Company’s internal financial controls that occurred during or subsequent to the date being reported on, including proposed changes being considered.

(ix) Providing me / us with the component auditors’ report under section 143(3)(i) in the case of components that are companies covered under the Companies Act for the purposes of our reporting in the case of the consolidated financial statements of the Company.

(c) As part of my / our audit process, I / we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to me / us in connection with the audit.

I / We also wish to invite your attention to the fact that my / our audit process is subject to 'peer review' / ‘quality review’ under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of my / our working papers during the course of the peer review.

Reporting

My / Our audit report will be issued pursuant to the requirements of Section 143(3)(i) of the Act. The form and content of my / our report may need to be amended in the light of my / our audit findings.

Our opinion on the adequacy and operating effectiveness of internal financial controls over financial reporting in the case of the consolidated financial statements of the Company, in so far as it relates to subsidiary companies, jointly controlled companies and associate companies incorporated in India, will be based solely on the reports of the auditors of such companies.

[Insert any other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Any other relevant information]

This letter should be read in conjunction with my / our letter dated ___ for the audit of the standalone and consolidated financial statements of the Company under the Act.

I / We look forward to full cooperation from your staff during my / our audits.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for my / our audit of the internal financial controls over financial reporting including our respective responsibilities.

(Signature)

XYZ & Co.

Chartered Accountants

Place:

Date:

Acknowledged on behalf of ABC Company Limited by

……..

(Signature)

Name and Designation

Date

Appendix II

Illustrative Management Representation Letter for Matters Relating to Audit of internal financial controls over financial reporting

(Referred to in paragraphs 150 - 152)

The following illustrative letter includes written representations that are required by this Guidance Note and SA 580 "Written Representations" and other Standards on Auditing as applicable to an audit of internal financial controls over financial reporting, which are in effect as at _____[balance sheet date]. It is assumed in this illustration that the relevant internal financial controls are based on the essential components of internal control identified in the Guidance Note on Audit of Internal Financial Controls over Financial Reporting, issued by the Institute of Chartered Accountants of India; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the internal financial controls over financial reporting in the audit of ABC Company Limited ("the Company") in conjunction with your audit of the standalone/ consolidated financial statements of the Company for the year ended March 31, 20X1, for the purpose of expressing an opinion as to whether the Company had, in all material respects, an adequate internal financial controls system over financial reporting and the operating effectiveness of such controls in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting ("the Guidance Note") and the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) and deemed to be prescribed by the Central Government in accordance with Section 143(10) of the 2013 Act, to the extent applicable to an audit of internal financial controls over financial reporting.

We confirm that to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves:

1. We are responsible for establishing and maintaining adequate and effective internal financial controls based on [mention control criteria] and the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated [insert date] and, in particular, the assertions to you on the internal financial controls in accordance with the _____ [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"].

2. We have performed an evaluation and made an assessment of the adequacy and effectiveness of the company's internal financial controls and based on the following control criteria [mention the control criteria].

3. We have not used the procedures performed by you during the audit of internal financial controls over financial reporting as part of the basis for our assessment of the effectiveness of internal financial controls.

4. Based on the assessment carried out by us and the evaluation of the results of the assessment, we conclude that the Company has adequate internal financial controls system that was operating effectively as at the March 31, 20X1 [balance sheet date] (or) Except for the below mentioned deficiencies noted during our assessment and evaluation of internal financial controls, the other relevant controls were determined adequate and were operating effectively as at March 31, 20X1 [balance sheet date].

a. (brief of design deficiencies)
b. (brief of deficiencies in operating effectiveness)

5. We have disclosed to you all deficiencies in the design or operation of internal financial controls identified as part of management's evaluation, including separately disclosing to you all such deficiencies that we believe to be significant deficiencies or material weaknesses in internal financial controls in paragraph [4].

6. There were no instances of fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal financial controls. (or) The following instances of fraud that resulted in material misstatement of financial statements in earlier years and frauds involving senior management or management or other employees who have a significant role in the company's internal financial controls were noted: (list instances and amounts involved).

7. The control deficiencies identified in the previous engagement of audit of internal financial controls and communicated to the Company and those charged with governance have been remediated, except for the following: (list control deficiencies not remediated as at the balance sheet date) (This issue is not applicable in the first year when the Company is subject to an audit of internal financial controls under the Companies Act, 2013)

8. There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices.

9. We have provided you with:

- All information, such as records and documentation, and other matters that are relevant to your assessment of internal financial controls;
- Additional information that you have requested from us; and
- Unrestricted access to those within the entity.
- Audit reports of the component auditors, including their report under Section 143(3)(i) of the Act for the following subsidiary companies, jointly controlled companies and associate companies to whom reporting under Section 143(3)(i) is applicable:

- There are no other subsidiary companies, jointly controlled companies and associate companies of the company to whom reporting under Section 143(3)(i) is applicable and whose auditors have not issued their report under Section 143(3)(i) of the Act.
- In the case of the following subsidiary companies, jointly controlled companies and associate companies of the company to whom reporting under Section 143(3)(i) is applicable, the respective component's year end is other than that of the Company:

  With respect to these components, we have provided to you the audit reports of the component auditors, including their report under Section 143(3)(i) of the Act for their respective financial year under the Act that has been considered in the preparation of the consolidated financial statements of the Company.

10. There are no changes in the internal financial controls system from March 31, 20X1 [balance sheet date] till the date of this representation letter. (or) The following changes have been made to the internal financial controls system since March 31, 20X1 [balance sheet date] and the date of this letter: (list changes and reason for the change).

11. These changes include corrective actions taken by us with regard to significant deficiencies or material weaknesses noted with respect to the following: (list significant deficiency or the material weakness and the related change in internal controls).

12. The following changes to internal financial controls system have been proposed as on date of this representation letter but have not yet been implemented: (list proposed changes and reason for the proposed change).

13. The changes to the internal financial controls since March 31, 20X1 [balance sheet date] and the proposed changes that are under consideration by the Company do not impact our assessment, evaluation and conclusion of the internal financial controls system as at March 31, 20X1 [balance sheet date]

14. [Any other matters that the auditor may consider appropriate.]

For and on behalf of ABC Company Limited

……..	……..
(Signature)	(Signature)
Name and Designation	Name and Designation

APPENDIX III

Illustrative Reports on Internal Financial Controls Over Financial Reporting

(Referred to in paragraphs 157 - 164)

Example 1 – Separate Reports

The following is an **example of separate unmodified audit report for an audit of internal financial controls over financial reporting in the case of standalone financial statements.** This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 "Forming an Opinion and Reporting on financial Statements". The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

***

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

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

I / We have audited the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the standalone financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

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

Auditors' Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my / our audit. I / We conducted my / our audit in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, issued by ICAI and deemed to be prescribed under section 143(10) of the Companies Act, 2013, to the extent applicable to an audit of internal financial controls, both applicable to an audit of Internal Financial Controls and, both issued by the Institute of Chartered Accountants of India. Those Standards and the Guidance

Note require that I / we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether adequate internal financial controls over financial reporting was established and maintained and if such controls operated effectively in all material respects.

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

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

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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 my / our opinion, the Company has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 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"].

For XYZ & ASSOCIATES

Chartered Accountants

(Firm‘s Registration No._____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Example 2 – Separate Reports

The following is an example of separate modified (qualified / adverse) audit report for an audit of internal financial controls over financial reporting and not impacting the audit opinion on the standalone financial statements of the company. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 "Forming an Opinion and Reporting on Financial Statements". The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

***

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

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

I / We have audited the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the standalone financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

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

Auditors' Responsibility

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

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

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

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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.

Scenario 1 - Qualified Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting

Qualified opinion

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:

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

b) [list other deficiencies identified]

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

In my / our opinion, except for the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has maintained, in all material respects, adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were operating effectively as of March 31, 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 / our opinion on the standalone financial statements of the Company.

Scenario 2 - Adverse Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting

Adverse opinion

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:

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

b) The Company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification. Further, the internal control system for identification and allocation of overheads to inventory was also not adequate. These could potentially result in material misstatements in the Company’s trade payables, consumption, inventory and expense account balances.

c) [list other deficiencies identified]

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

In my / our opinion, because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were not 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 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 / our opinion on the financial statements of the Company.

Scenario 3 - Qualified Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls

Qualified opinion

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 in the operating effectiveness of the Company’s internal financial controls over financial reporting as at March 31, 20X1:

a) The Company’s internal financial controls over customer acceptance, credit evaluation and establishing customer credit limits for sales, were not operating effectively which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

b) [list other deficiencies identified]

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

In my / our opinion, the Company has, in all material respects, maintained adequate internal financial controls over financial reporting 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”], and 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’s internal financial controls over financial reporting were operating effectively as of March 31, 20X1.

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 financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the standalone financial statements of the Company.

Scenario 4 - Adverse Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls

Adverse opinion

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 in the operating effectiveness of the Company's internal financial controls over financial reporting as at March 31, 20X1:

a) The Company's internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, were not operating effectively which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

b) The Company's internal control system for inventory with regard to receipts, issue for production and physical verification were not operating effectively. Further, the internal control system for identification and allocation of overheads to inventory was also not operating effectively. These could potentially result in material misstatements in the Company's trade payables, consumption, inventory and expense account balances.

c) [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, the Company has, in all material respects, maintained adequate internal financial controls over financial reporting 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"], and because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company's internal financial controls over financial reporting were not operating effectively as of March 31, 20X1.

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 / our opinion on the financial statements of the Company.

Scenario 5 - Adverse Opinion on Internal Financial Controls Over Financial Reporting – essential components of internal controls not adequately considered in the internal financial controls established by the company

Adverse opinion

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:

a) The Company did not have an appropriate internal financial control system over financial reporting since the internal controls adopted by the Company did not adequately consider risk assessment, which is one of the essential components of internal control, with regard to the potential for fraud when performing risk assessment,

b) [list other deficiencies identified]

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

In my / our opinion, because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate and effective internal financial controls over financial reporting as of March 31, 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 / our opinion on the standalone financial statements of the Company.

For XYZ & ASSOCIATES

Chartered Accountants

(Firm's Registration No._____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Example 3 – Separate Reports

The following is an example of separate modified (disclaimer) audit report for an audit of internal financial controls over financial reporting with / without impact on audit opinion on the standalone financial statements. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 "Forming an Opinion and Reporting on Financial Statements". The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

***

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

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

I / We were engaged to audit the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the financial statements of the Company for the year ended on that date.

Management's Responsibility for Internal Financial Controls

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

Auditors' Responsibility

My / Our responsibility is to express an opinion on the Company's internal financial controls over financial reporting based on my/our audit conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting (the "Guidance Note") and the Standards on Auditing, to the extent applicable to an audit of internal financial controls, both issued by the Institute of Chartered Accountants of India.

Because of the matter described in Disclaimer of Opinion paragraph below, I / we was / were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on internal financial controls system over financial reporting of the Company.

Meaning of Internal Financial Controls Over Financial Reporting

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

and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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.

Disclaimer of Opinion

Scenario 1 – Framework for internal financial control over financial reporting not established but does not impact the audit opinion on financial statements

According to the information and explanation given to us, the Company has not established its internal financial control over financial reporting on criteria based on or considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India. Because of this reason, we are unable to obtain sufficient appropriate audit evidence to provide a basis for my / our opinion whether the Company had adequate internal financial controls over financial reporting and whether such internal financial controls were operating effectively as at March 31, 20X1.

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

Scenario 2 – Auditor unable to obtain sufficient appropriate audit evidence on internal financial controls over financial reporting but does not impact audit opinion on the financial statements

The system of internal financial controls over financial reporting with regard to one of the significant branches of the Company at _____ were not made available to me / us to enable me / us to determine if the Company has established adequate internal financial control over financial reporting at the aforesaid branch and whether such internal financial controls were operating effectively as at March 31, 20X1.

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

Scenario 3 – Auditor unable to obtain sufficient appropriate audit evidence on internal financial controls over financial reporting and impacting audit opinion on the financial statements

The system of internal financial controls over financial reporting with regard to the Company were not made available to me / us to enable me / us to determine if the Company has established adequate internal financial control over financial reporting and whether such internal financial controls were operating effectively as at March 31, 20X1.

I / We have considered the disclaimer reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the standalone financial statements of the Company, and the disclaimer has affected my / our opinion on the financial statements of the standalone Company and I / we have issued a qualified (/ adverse / disclaimer of) opinion on the financial statements.

For XYZ & ASSOCIATES

Chartered Accountants

(Firm Registration No._____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Example 4 – Separate Reports

The following is an example of separate modified (adverse) audit report for an audit of internal financial controls over financial reporting causing a modified report on the standalone financial statements. This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 "Forming an Opinion and Reporting on Financial Statements". The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

***

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE STANDALONE FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

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

I / We have audited the internal financial controls over financial reporting of ABC Company Limited ("the Company") as of March 31, 20X1 in conjunction with my / our audit of the financial statements of the Company for the year ended on that date

Management's Responsibility for Internal Financial Controls

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

Auditors' Responsibility

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

My / Our audit involves performing procedures to obtain audit evidence about the adequacy of the internal financial controls system over financial reporting and their operating effectiveness.

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

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

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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.

Adverse Opinion

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:

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

(b) [list other deficiencies identified]

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

In my / our opinion, because of the effect of the material weakness/es described above on the achievement of the objectives of the control criteria, the Company has not maintained adequate and effective internal financial controls over financial reporting as of March 31, 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 has / have affected my / our opinion on the standalone financial statements of the Company and I / we have issued a qualified (/ adverse / disclaimer of) opinion on the standalone financial statements.

For XYZ & ASSOCIATES

Chartered Accountants

(Firm Registration No._____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Example 5 – Separate Report in case of Consolidated Financial Statements

Note:

The following illustrative format is based on the assumptions that

- The Group has:
    - Certain components which have been audited by auditor/s other than the Principal Auditor and such component/s is/ are material to the consolidated financial statements of the Group. The auditors of such components which are Indian companies, have submitted report on section 143(3)(i) of the Companies Act, 2013.
    - Certain components which are unaudited and such component/s is/ are not material to the consolidated financial statements of the Group.
- The independent auditor of Consolidated Financial Statements
    - Gives a clean opinion in respect of section 143(3)(i) of the Companies Act, 2013
    - Discloses the aforementioned facts about the Components in the "Other Matters" Paragraph in accordance with the Announcement issued by the Auditing and Assurance Standards Board under the authority of the Council of ICAI in February 2014.

.....

Illustrative Report on Internal Financial Controls Over Financial Reporting in the case of Consolidated financial statements

(Referred to in paragraphs 157 - 164)

The following is an **example of unmodified audit report for an audit of internal financial controls over financial reporting in the case of consolidated financial statements.** This report is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this Guidance Note and SA 700 "Forming an Opinion and Reporting on financial Statements". The report is also not an exhaustive report which includes all aspect of reporting by the auditor under Sub-sections 2 and 3 of Section 143 of the Companies Act, 2013. It will need to be varied according to individual requirements and circumstances.

***

ANNEXURE TO THE INDEPENDENT AUDITOR'S REPORT OF EVEN DATE ON THE CONSOLIDATED FINANCIAL STATEMENTS OF ABC COMPANY LIMITED

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

In conjunction with my / our audit of the consolidated financial statements of the Company as of and for the year ended March 31, 20X1, I / We have audited the internal financial controls over financial reporting of ABC Company Limited (hereinafter referred to as “the Holding Company”) and its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, as of that date.

Management’s Responsibility for Internal Financial Controls

The respective Board of Directors of the of the Holding company, its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, are 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 (ICAI)”.] 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 the respective company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information, as required under the Companies Act, 2013.

Auditor’s Responsibility

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

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

I / We believe that the audit evidence I / we have obtained and the audit evidence obtained by the other auditors in terms of their reports referred to in the Other Matters paragraph below, is sufficient and appropriate to provide a basis for my /our audit opinion on the Company’s internal financial controls system over financial reporting.

Meaning of Internal Financial Controls Over Financial Reporting

A company's internal financial control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal financial control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with 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 my / our opinion, the Holding Company, its subsidiary companies, its associate companies and jointly controlled companies, which are companies incorporated in India, have, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 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”].

Other Matters

Our aforesaid reports under Section 143(3)(i) of the Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting insofar as it relates to __(number) subsidiary companies, __(number) associate companies and __(number) jointly controlled companies, which are companies incorporated in India, is based on the corresponding reports of the auditors of such companies incorporated in India.

For XYZ & ASSOCIATES

Chartered Accountants

(Firm‘s Registration No._____)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place:

Date:

Appendix IV*

Illustrative Risks of Material Misstatement, Related Control Objectives And Control Activities

(Referred to in paragraphs 77 and 100)

Standard on Auditing (SA) 315 requires understanding of the entity in order to identify and respond to the risks of material misstatement in the financial statements. In doing so, auditors focus their risk-assessment process on the classes of transactions; account balances, including transaction types within account balances; and disclosures that are material and, thus, have a reasonable possibility of containing a misstatement that, individually or when aggregated with others, has a material effect on the financial statements. The determination of whether a class of transactions, account balance, or disclosure is material is a matter of professional judgment that takes into account quantitative and qualitative factors and is made without regard to the effectiveness of controls.

Once the material classes of transactions, account balances, and disclosures [significant accounts and disclosures] are identified, one needs to identify and assess the risks of material misstatement at the financial-statement level and the assertion level for those classes of transactions, account balances, and disclosures. Following the identification of risks of material misstatement, one has to identify relevant controls that may address the risks of material misstatement that are responsive to the risks of material misstatement and the related assertion.

This appendix has been developed to provide guidance and examples to assist in identifying risks of material misstatement at the assertion level and relevant controls that may address the applicable risks of material misstatement.

For each class of transactions and account balance, risks of material misstatement and relevant controls are divided into two categories: “Core Risks and Controls,” which may be applicable for normal risks of material misstatement on most entities, and “Other Possible Risks and Controls,” which may or may not be applicable.

The risks of material misstatement included in this appendix are illustrative only and are intended to provide examples of common risks. As a result, the risks of material misstatement are described using generic terminology. It is critical that users identify the risks of material misstatement that are relevant to the entity based on professional judgment and not rely solely on the risks of material misstatement provided in this appendix. Additionally, when the risk of material misstatement is considered significant, further tailoring or complete customisation is often appropriate.

The Example Controls included in this appendix are illustrative only and are intended to provide examples of controls that may address the relevant risks of material misstatement. Actual controls in place at the entity that address the relevant risks of material misstatement may and often do differ; thus, the Example Controls may (1) require some degree of tailoring to describe

* The complete Appendix IV is given in CD along with this Guidance Note.

the control more specifically or (2) be replaced entirely by a control in place at the entity that addresses the risk of material misstatement. Users who use this appendix should not interpret the existence of more than one Example Control to indicate that all controls would need to be tested to address the risk of material misstatement. It is critical that practitioners identify the actual controls in place at the entity that address the risks of material misstatement and not rely solely on the Example Controls provided in this appendix.

This appendix will assist in the identification of relevant controls that may address the applicable risks of material misstatement. This includes specific application or general IT controls.

This appendix also illustrates the risk of material misstatement and the control related to the risk that is likely to be reflected in the Other Affected Accounts.

Material classes of transactions or account balances relevant to the entity may not be included in this appendix. Therefore, it is critical that users identify the relevant transaction types for each material class of transaction, account balance, and disclosure for the specific circumstances of the entity.

Certain example controls illustrated in this appendix may use computer-generated information as source data. Users should consider the controls related to this computer-generated information and tailor the control description accordingly.

Certain example controls involve an application control. Users should identify specific controls at the entity related to application controls and tailor the control description accordingly.

Certain reports relevant to example controls may be electronically generated by an ERP system. If such reports are generated from an ERP system, users should consider the controls related to this computer-generated information and tailor the control description accordingly.

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

1. Cash/Bank Balances
2. Prepaid Expenses
3. Trade Receivables
4. Inventory
5. Fixed Assets
6. Goodwill and Intangible Assets
7. Trade payables
8. Provision for expenses
9. Loans/Borrowings
10. Employee Benefits

11. Income Taxes
12. Deferred Taxes
13. Provision for Income taxes/Advance Income taxes
14. Share Capital
15. Revenue from Operations
16. Cost of Sales
17. Depreciation/ Amortisation and Other Expenses
18. Finance Cost
19. Journal Entries
20. Financial Reporting

Appendix V

Examples of Control Deficiencies

(Referred to in paragraph IG 20)

(Depending on severity could also be significant deficiencies and material weaknesses)

Examples of Deficiencies in the Design of Controls

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply generally accepted accounting principles in recording the entity's financial transactions or preparing its financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.

Examples of Failures in the Operation of Internal Control

- Failure in the operation of effectively designed controls over a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy, for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. This circumstance may need careful consideration before it is

evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

- Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

Examples of Significant Deficiencies

Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles. Having sufficient expertise in selecting and applying accounting principles is an aspect of such controls.
- Antifraud programs and controls.
- Controls over non-routine and non-systematic transactions.
- Controls over the period end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and non-recurring adjustments to the financial statements.

Examples of Material Weaknesses

Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight of the entity’s financial reporting and internal control by those charged with governance.

- Restatement of previously issued financial statements to reflect the correction of a material misstatement. (The correction of a misstatement includes misstatements due to error or fraud; it does not include restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control.
- This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.
- Identification of fraud of any magnitude on the part of senior management. (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud. However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude including fraud resulting in immaterial misstatements on the part of senior management, of which he or she is aware.)
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.

Appendix VI

(Referred to in Paragraph IG 14)

Standard on Internal Audit (SIA) 5 - Sampling*

Contents

The following is the text of the Standard on Internal Audit (SIA) 5, Sampling, issued by the Council of the Institute of Chartered Accountants of India. These Standards should be read in conjunction with the Preface to the Standards on Internal Audit, issued by the Institute.

In terms of the decision of the Council of the Institute of Chartered Accountants of India taken at its 260th meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standards shall become mandatory from such date as notified by the Council.

* Published in the October 2008 issue of The Chartered Accountant.

Introduction

1. The purpose of this Standard on Internal Audit (SIA) is to establish standards on the design and selection of an audit sample and provide guidance on the use of audit sampling in internal audit engagements.

The SIA also deals with the evaluation of the sample results. This SIA applies equally to both statistical and non-statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence.

2. When using either statistical or non-statistical sampling methods, the internal auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence to meet the objectives of the internal audit engagement unless otherwise specified by the client.

Definitions

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the internal auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form a conclusion concerning the population. Certain testing procedures, however, do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying internal audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

4. “Error” means either control deviations when performing tests of controls, or misstatements, when performing tests of details.

5. “Population’’ means the entire set of data from which the sample is selected and about which the internal auditor wishes to draw conclusions. A population may be divided into various strata, or subpopulations, with each stratum being examined separately.

6. “Sampling risk‘” means the risk that from the possibility that the internal auditor’s conclusions, based on examination of a sample may be different from the conclusion reached if the entire population was subjected to the same types of internal audit procedure. The two types of sampling risk are –

(a) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are more effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement does not exist when in fact it does.

(b) The risk that the internal auditor concludes, in the case of tests of controls (TOC), that controls are less effective than they actually are, or in the case of tests of details (TOD), that a material error or misstatement exists when in fact it does not.

The mathematical complements of these risks are termed confidence levels.

7. “Sampling unit” means the individual items or units constituting a population, for example, credit entries in bank statements, sales invoices or debtors’ balances.

8. “Statistical sampling” means any approach to sampling procedure which has the following characteristics –

(a) Random selection of a sample; and

(b) Use of theory of probability to evaluate sample results, including measurement of sampling risk.

9. “Tolerable error” means the maximum error in a population that the internal auditor is willing to accept.

Use of Sampling in Risk Assessment Procedures and Tests of Controls

10. The internal auditor performs risk assessment procedures to obtain an understanding of the entity, business and its environment, including the mechanism of its internal control. Ordinarily, risk assessment procedures do not involve the use of sampling. However, there are cases, where the internal auditor often plans and performs tests of controls concurrently with obtaining an understanding of the design of controls and examining whether they have been implemented.

11. Tests of controls are performed when the internal auditor‘s risk assessment includes an expectation of the operating effectiveness of controls. Sampling of tests of controls is appropriate when application of the control leaves audit evidence of performance (for example, initials of the credit manager on a sales invoice indicating formal credit approval).

12. Sampling risk can be reduced by increasing sample size for both tests of controls and tests of details. Non-sampling risk can be reduced by proper engagement planning, supervision, monitoring and review.

Design of the Sample

13. When designing an audit sample, the internal auditor should consider the specific audit objectives, the population from which the internal auditor wishes to sample, and the sample size.

Internal Audit Objectives

14. The internal auditor would first consider the specific audit objectives to be achieved and the internal audit procedures which are likely to best achieve those objectives. In addition, when internal audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the internal auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of controls over an entity's purchasing procedures, the internal auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved.

On the other hand, when performing substantive procedures on invoices processed during the period, the internal auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the periodic financial statements. When performing tests

of controls, the internal auditor makes an assessment of the rate of error the internal auditor expects to find in the population to be tested. This assessment is on the basis of the internal auditor’s understanding of the design of the relevant controls, and whether they have actually been implemented or the examination of a small number of items from the population.

Population

15. The population is the entire set of data from which the internal auditor wishes to sample in order to reach a conclusion. The internal auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. For example, if the internal auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

16. The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. For example, if the internal auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The internal auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

17. It is important for the internal auditor to ensure that the population is appropriate to the objective of the internal audit procedure, which will include consideration of the direction of testing. The population also needs to be complete, which means that if the internal auditor intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

18. When performing the audit sampling, the internal auditor performs internal audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate.

Stratification

19. To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification, therefore, enables the internal auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, the internal auditor may direct attention to larger value items for accounts receivable to detect overstated material misstatements. In addition, stratification may result in a smaller sample size.

Sample Size

20. When determining the sample size, the internal auditor should consider sampling risk, the tolerable error, and the expected error. The lower the risk that the internal auditor is

willing to accept, the greater the sample size needs to be. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2 to the Standard.

21. The sample size can be determined by the application of a statistically based formula or through exercise of professional judgment applied objectively to the circumstances of the particular internal audit engagement.

Statistical and Non-Statistical Approaches

22. The decision of using either statistical or non-statistical sampling approach is a matter for the internal auditor’s professional judgment. In the case of tests of controls, the internal auditor’s analysis of the nature and cause of errors will often be of more importance than the statistical analysis of the mere presence or absence of errors. In such case, non-statistical sampling approach may be preferred.

23. When applying statistical sampling, sample size may be ascertained using either probability theory or professional judgment. Sample size is a function of several factors. Appendices 1 and 2 discuss some of these factors.

Tolerable Error

24. Tolerable error is the maximum error in the population that the internal auditor would be willing to accept and still conclude that the result from the sample has achieved the objective(s) of the internal audit.

Tolerable error is considered during the planning stage and, for substantive procedures, is related to the internal auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

25. In tests of controls, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the internal auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the internal auditor would be willing to accept so that when the results of all audit procedures are considered, the internal auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

26. If the internal auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the internal auditor would consider such matters as error levels identified in previous internal audits, changes in the entity's procedures, and evidence available from other procedures.

Selection of the Sample

27. The internal auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

28. While there are a number of selection methods, three methods commonly used are:

a. Random selection and use of CAATs
b. Systematic selection
c. Haphazard selection

Appendix 3 to the Standard discusses these methods.

Evaluation of Sample Results

29. Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the internal auditor should:

(a) analyse the nature and cause of any errors detected in the sample;

(b) project the errors found in the sample to the population;

(c) reassess the sampling risk; and

(d) consider their possible effect on the particular internal audit objective and on other areas of the internal audit engagement.

30. The internal auditor should evaluate the sample results to determine whether the assessment of the relevant characteristics of the population is confirmed or whether it needs to be revised.

Analysis of Errors in the Sample

31. In analysing the errors detected in the sample, the internal auditor will first need to determine that an item in question is in fact an error. In designing the sample, the internal auditor will have defined those conditions that constitute an error by reference to the audit objectives.

For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

32. When the expected audit evidence regarding a specific sample item cannot be obtained, the internal auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been requested and no reply was received, the internal auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the internal auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the internal auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

33. The internal auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

34. In analysing the errors discovered, the internal auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In

such circumstances, the internal auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The internal auditor would then perform a separate analysis based on the items examined for each sub-population.

Projection of Errors

35. The internal auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the internal auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

36. For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

Reassessing Sampling Risk

37. The internal auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the internal auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the internal auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative internal audit procedures.

38. If the evaluation of sample results indicate that the assessment of the relevant characteristic of the population needs to be revised, the internal auditor, may:

(a) Request management to investigate the identified errors and the potential for any further errors, and to make necessary adjustments, in cases where management prescribes the sample size; and / or

(b) Modify the nature, timing and extent of internal audit procedures. In case of tests of controls, the internal auditor might extend the sample size, test an alternative control or modify related substantive procedures; and / or

(c) Consider the effect on the Internal Audit Report.

Documentation

39. Documentation provides the essential support to the opinion and/ or findings of the internal auditor. In the context of sampling, the internal auditor’s documentation may include aspects such as:

i. Relationship between the design of the sample vis-à-vis specific audit objectives, population from which sample is drawn and the sample size.

ii. Assessment of the expected rate of error in the population to be tested vis-à-vis auditor’s understanding of the design of the relevant controls

iii. Assessment of the sampling risk and the tolerable error.
iv. Assessment of the nature and cause of errors.
v. Rationale for using a particular sampling technique and results thereof.
vi. Analysis of the nature and cause of any errors detected in the sample.
vii. Projection of the errors found in the sample to the population.
viii. Reassessment of sampling risk, where appropriate.
ix. Effect of the sample results on the internal audit's objective(s).
x. Projection of sample results to the characteristics of the population.

Appendix 1 to SIA 5 – Sampling

Examples of Factors Influencing Sample Size for Tests of Controls

The following are some factors which the internal auditor considers when determining the sample size required for tests of controls (TOC). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOC or otherwise modify the approach to substantive procedures in response to assessed risks.

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

Notes –

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

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

3. The higher the rate of deviation that the internal auditor expects, the larger the sample size needs to be so as to make a reasonable estimate of the actual rate of deviation.

4. The higher the degree of confidence that the internal auditor requires that the results of the sample are indicative of the actual incidence of errors in the population, the larger the sample size needs to be.

5. For large populations, the actual population size has little effect on sample size. For small populations, sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

Appendix 2 to SIA 5 - Sampling

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

The following are some factors which the internal auditor considers when determining the sample size required for tests of details (TOD). These factors need to be considered together assuming the internal auditor does not modify the nature or timing of TOD or otherwise modify the approach to substantive procedures in response to assessed risks.

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

Appendix 3 to SIA 5 - Sampling

Methods of Sample Selection

The principal methods of sample selection are as –

1. **Using a computerised random number generator** or through random number tables.

2. **Systematic selection** – In this method, the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 20, and having thus determined a starting point within the first 20, each 20th sampling unit thereafter is selected. Although the starting point may be haphazardly determined, the sample is likely to be truly random if the same is determined by using a computerised random number generator or random number tables. In this method, the internal auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with any particular pattern within the population.

3. **Haphazard selection** – In this method, the internal auditor selects the sample without following any structured technique. **The internal auditor should attempt to ensure that all items within the population have a chance of selection, without having any conscious bias or predictability.** This method is not appropriate when using statistical sampling technique.

4. **Block selection** – This method involves selection of a block(s) of adjacent or contiguous items from within the population. Block selection normally cannot be used in internal audit sampling because most populations are structured in such a manner that items forming a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. This method would not be an appropriate sample selection technique when the internal auditor intends to draw valid inferences about the entire population, based on the sample.

Appendix 4 to SIA 5 - Sampling

Frequency of Control Activity and Sample Size

The following guidance related to the frequency of the performance of control may be considered when planning the extent of tests of operating effectiveness of manual controls for which control deviations are not expected to be found. The internal auditor may determine the

appropriate number of control occurrences to test based on the following minimum sample size for the frequency of the control activity dependant on whether assessment has been made on a lower or higher risk of failure of the control.

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

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