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Internal Financial Control over Financial Reporting
ICAI Seminar

Sachin Paranjape, November 2015

Begin with an End in Mind…

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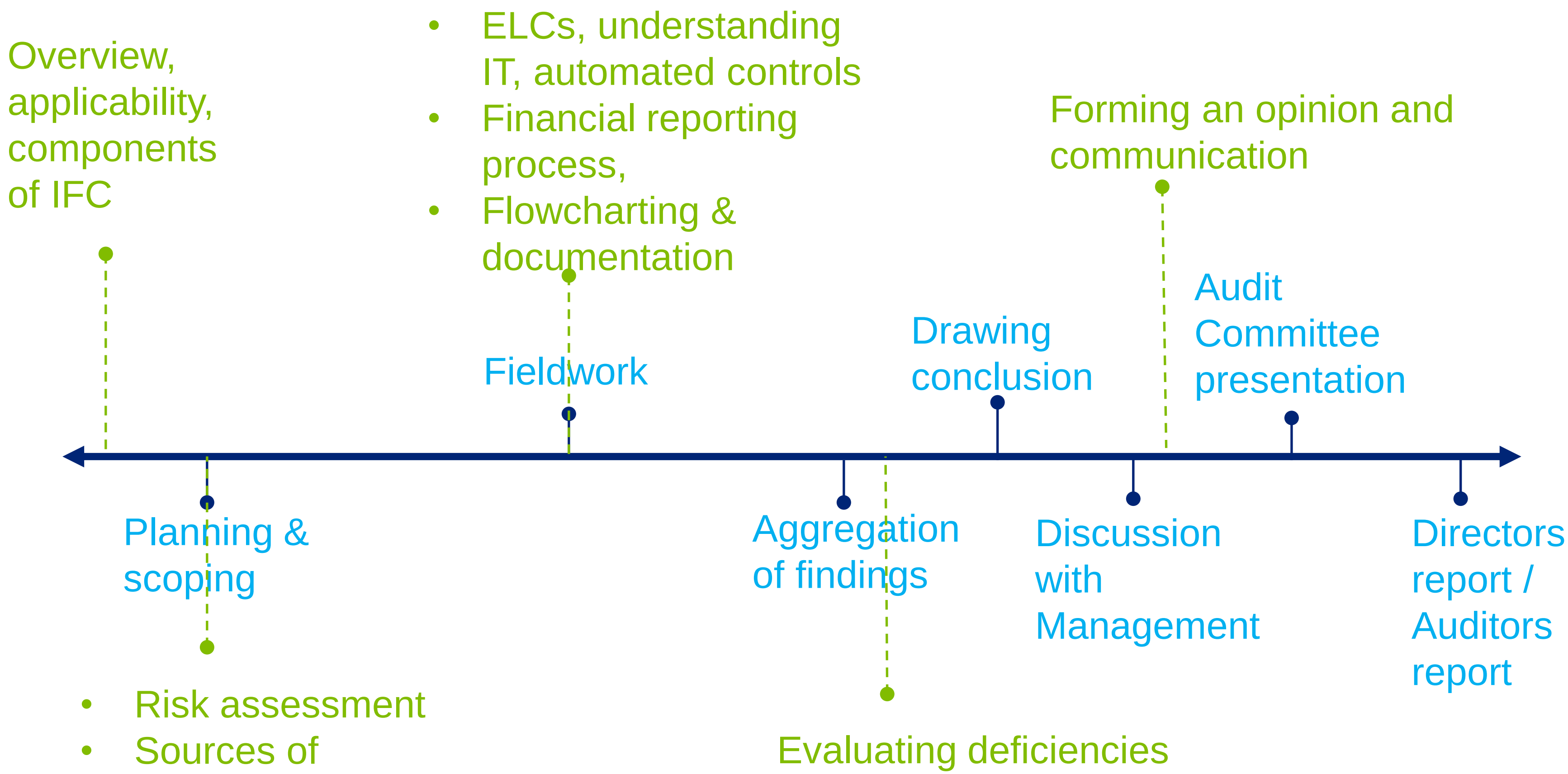
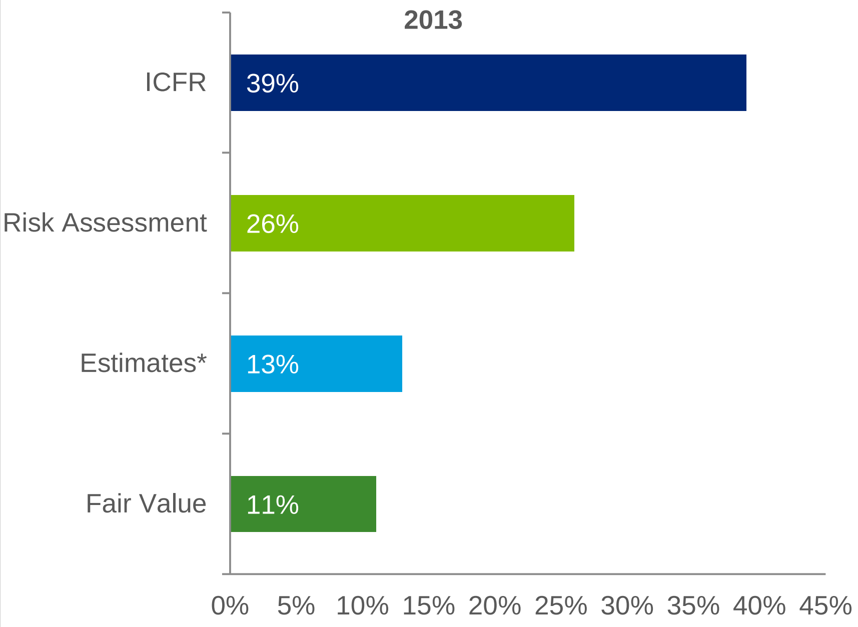


- Typical milestones in the IFC journey and
- Topics addressed by this seminar

2015 PCAOB Inspections - Highlights

Areas of Most Frequently Identified Deficiencies

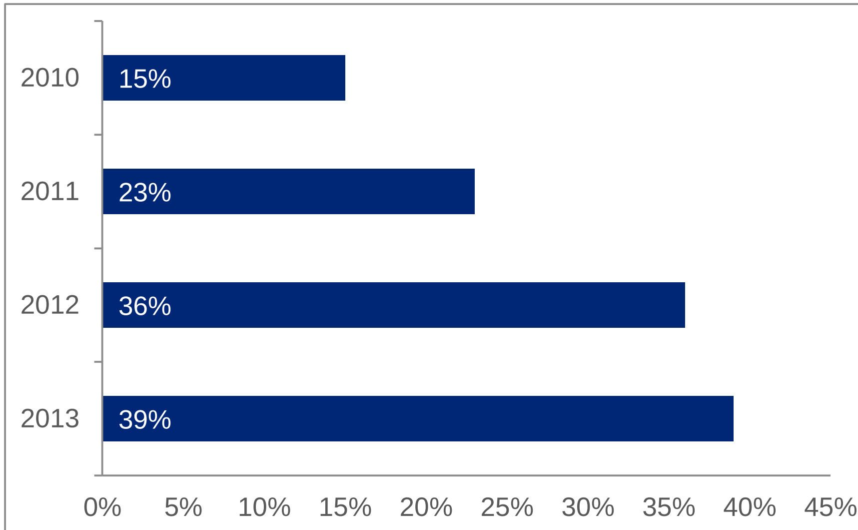


Of all relevant audits inspected (as detailed in separate tables below), percentage in which Inspections staff identified, in the specified area, auditing deficiencies that resulted in insufficiently supported audit options. ("Risk assessment" deficiencies relate to auditing standards that were not in effect for audits inspected before 2012.)

* Estimate other than fair value.

2015 PCAOB inspections found a high rate of deficiencies in audits of ICFR. The auditor did not perform sufficient procedures to test the effectiveness of controls

Areas of Most Frequently Identified Deficiencies



Of all integrated audits inspected, percentage in which Inspection staff identified deficiencies in auditing ICFR that resulted in an insufficiently supported audit opinion

Obtaining Written Representations

In an audit of internal control over financial reporting, the auditor should obtain written representations from management that it has;

- Established and maintained an effective internal control over financial reporting;
- On evaluation and assessment of the effectiveness of the company's internal control over financial reporting, specifying the control criteria;
- Usage of auditor's procedures as basis for management's assessment of the effectiveness of internal control over financial reporting;
- Management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;
- Disclosure of all deficiencies in the design or operation of internal control over financial reporting identified in management's evaluation, including significant deficiencies or material weaknesses;
- Any fraud resulting in a material misstatement to the company's financial statements
- Resolution of the previous control deficiencies
- Changes in internal control over financial reporting.

The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit

Evaluating Deficiencies

Are Auditors Asking Right Questions?

1. Auditing internal control over financial reporting:

Q. What are the points within the company's critical systems processes where material misstatements could occur? How has the audit plan addressed the risks of material misstatement at those points? How will the auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?

Q. What is the auditor's approach to evaluating the company's controls over financial reporting for significant unusual transactions or events ?

Q. If the company enters into a significant unusual transaction during the year, how will the auditor adjust the audit plan, including the plan for testing IFCFR related to the transaction?

Q. If the company or the auditor has identified a potential material weakness or significant deficiency in internal control, what has been done to probe the accuracy of its description? Could the identified control deficiency be broader than initially described? Could it be an indication of a deficiency in another component of internal control?

Are Auditors Asking Right Questions?

2. Assessing and responding to risks of material misstatement:

Q. Which audit areas are designated by the auditor as having significant risks of material misstatement and what audit procedures are planned to address those risks?

Q. In auditor’s view, how have the areas of significant risk of material misstatement changed since the prior year? What new risks has the auditor identified? What is auditor's process to make sure that it identifies new or changing risks of material misstatement and tailors the audit plan appropriately?

Q. How does auditor's audit plan address the varied risks in a multi-location environment? If auditor assumes that controls are uniform across multiple locations, how does he support that assumption?

3. Auditing estimates, including fair value measurements, and disclosures:

Q. What does the auditor do to obtain a thorough understanding of the assumptions and methods the company used to develop critical estimates, including fair value measurements?

Q. What is the auditor's approach to auditing critical accounting estimates, such as allowances for loan losses, inventory reserves, and tax-related estimates?

Q. Will audit engagement team use its firm's in-house valuation specialists? If so, how are the specialists integrated into the engagement team? How are specialists supervised, and how are significant issues they identify resolved? If the firm does not have in-house valuation specialists, does the firm engage external specialists to assist the auditor with their audit of complex estimates?

Controls Activities

Requirements of a Control Activity - FRASA

Frequency	Responsible Party	Activity	Source	Action Taken
The frequency or timing of occurrence, e.g., "On a daily basis…,""Upon completion of the reconciliation …,"	The party responsible for conducting the risk mitigating activity, e.g., "the Director of Trading reviews…," "the Accounting Associate compares…,"	The specific risk mitigating activity e.g., "Team Leader reviews the invoice posted by the Team Member"	The sources of information (if applicable).	The action taken with the results of the control activity, e.g., "Discrepancies are researched and reported to the Client Management's Finance team for resolution."

Evaluate Design of Control

Entity Level Controls

- Controls setting tone at the top of an organization, creating control consciousness. Example : Code of Conduct, Whistle Blower policy

Process Level Controls

- At senior levels of management : The control activities are more likely to be high-level procedures performed by management and are likely to involve greater aggregation of data and less consideration of detail.
- At lower levels, the control activities are likely to be focused on distinct sets of data and at a much greater level of detail.
- At the lowest level, detailed control activities are likely to relate to specific transactions.

General IT Controls

- Include : Data center operation controls, system software controls, access security controls ,application system development and maintenance controls
- Information provided by Entity (IPE)

Evaluate the design of control

Process level controls generally operate at number of levels:

At senior levels of management, the control activities are more likely to be high-level procedures performed by management and are likely to involve greater aggregation of data and less consideration of detail.

At lower levels, the control activities are likely to be focused on distinct sets of data and at a much greater level of detail.

At the lowest level, detailed control activities are likely to relate to specific transactions.

Evaluate the design of control

Commonly performed process controls are as under:

- Reviews – Analytical & Transactional
- Reconciliations & Comparisons
- Safeguarding of assets
- Controls relating to information technology
  - Data center operations controls
  - System software controls
  - Access security controls
- Application controls
  - Tolerances, Authorizations, edits and validations, data reasonableness tests, predefined data listings, balancing control activities

Which controls to be evaluated

Any controls that fall under these categories should be evaluated:

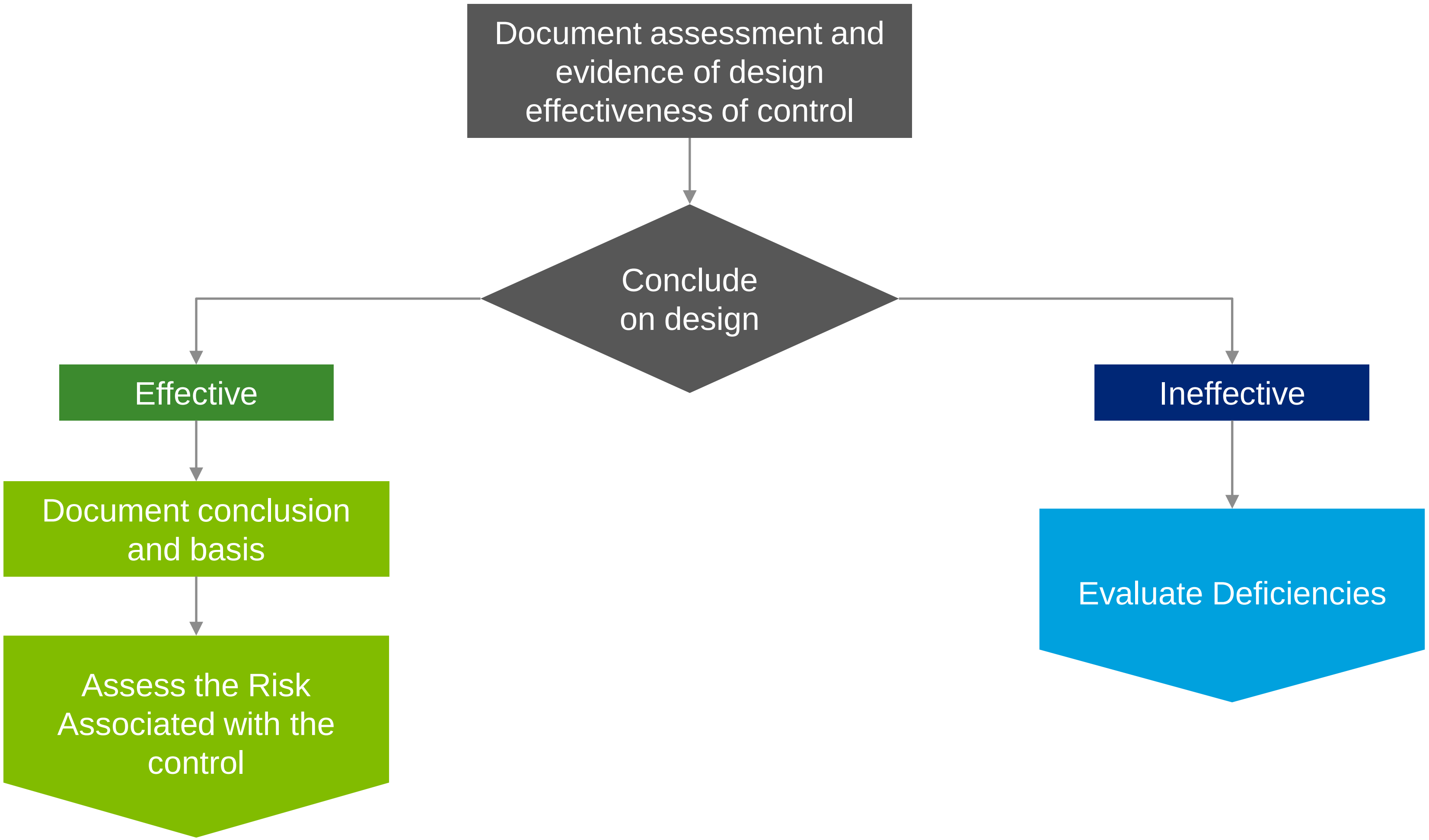
- controls related to the initiation, recording, processing and reconciling of account balances, classes of transactions,
- disclosures, and related assertions included in the financial statements
- controls related to the initiation and processing of non-routine and nonsystematic transactions
- controls related to the selection and application of accounting policies
- controls related to the prevention, identification, and detection of fraud
- controls, including information technology general controls, on which other controls are dependent. General controls include:
  - data center operation controls
  - system software controls
  - access security controls
  - application system development and
  - maintenance controls

Evaluate Design Effectiveness

In performing design effectiveness we need to evaluate the following:

- Owner of control
- Description of process flow
- Properly designed i.e. is the control meeting the desired control objective
- Document control deficiencies, if any
- Classify deficiencies into:
  - Material weakness
  - Significant deficiency
  - Internal control deficiency
- Prepare remediation plan

Test and Conclude Design Effectiveness



Test Operative Effectiveness of Controls

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

Inquiry consists of seeking information from knowledgeable persons in financial or non financial roles within the company or outside the company . Evaluating responses to inquiries is an integral part of the inquiry process

Observation consists of looking at a process or procedure being performed by others

Reperformance involves the independent execution of procedures or controls that were originally performed by the company personnel

Inspection involves examining of documents, whether internal or external, in paper form, or other media, or physically examining an asset

Illustration

Illustration : Evaluating Design and Operating Effectiveness of a sample control

Control Objective	Fixed assets are recorded accurately
Review status	Senior Accountant generates the Fixed Asset Register Report on a monthly basis from ERP and reconciles the asset figures with the General ledger. Senior Finance Manager reviews the reconciliation done.

Illustration

Illustration : Evaluating Design and Operating Effectiveness of a sample control

SOD (Y/N)?	No
Type of Control	Manual
Frequency	Monthly
Population	12
Who performs this activity?	Mr. XXXX Senior Accountant.
Procedures performed when an individual is absent	No such procedure
Reports and other information used, as well as, how such information is used	Fixed Asset Register Report
What is the individual looking for to determine if there is an error and what kinds of errors have been identified.	Verifying whether there are any non-reconciling items in the Fixed Asset register - General Ledger reconciliation. Non-reconciling items such as depreciation amount differences caused to system technical error.
Procedures performed when an error is identified and how the error was resolved	Errors such as depreciation differences caused due to some system technical error are resolved by manually changing rate of depreciation in asset workbench etc. after obtaining approval from Senior Finance Manager and Business Controller.
Procedures performed with respect to unusual and non-routine transactions.	Proposed Activity: Any unusual transaction needs to be highlighted to the management.

Illustration

Illustration : Evaluating Design and Operating Effectiveness of a sample control

Whether the individual has ever been asked to override the process of controls or if other people have performed activities or made entries, and if so, to describe the situation, why it occurred, and what happened.	No
What (if any) changes have occurred to control activities during the period, including changes in personnel who perform them?	No such changes have occurred
Procedures Performed to Evaluate Design and Determine Implementation of Control/ Reference to Work Performed	Primary Testing: Confirmed through inquiry with Mr. XXX, Senior Accountant, on 8th December, 2014 that Monthly reconciliation is being done for figures from Fixed Asset Register to General Ledger. This reconciliation is prepared by Mr. XXX. But there is no review of this reconciliation being done. Secondary Testing: There is no documentary evidence of review of the reconciliation statement . We obtained the sample reconciliation for the month of November 2014 and found that the figures haven't been reconciled. We were told that the reasons for non-reconciling items were audit entries to be passed. But the reasons for non-reconciling items have not been documented in the reconciliation statement.

Illustration

Illustration : Evaluating Design and Operating Effectiveness of a sample control

Conclusion on Design of Controls	Ineffective
Conclusion on implementation of Controls	Ineffective
Description of the deficiency identified in control design / implementation.	Absence of review of FAR vs. GL reconciliation.

Illustration

Illustration : Evaluating Design and Operating Effectiveness of a sample control

Sample Size	2
Procedures Performed to Evaluate Test of Operating Effectiveness of Control	There is no documentary evidence of review of the reconciliation statement . We obtained the sample reconciliation for the month of July 2014 and September 2014 and found that the figures haven't been reconciled. We were told that the reasons for non-reconciling items were audit entries to be passed. But the reasons for non-reconciling items have not been documented in the reconciliation statement.
Results of test of Operating Effectiveness	Ineffective
Description of Deficiency	Absence of review of FAR vs. GL reconciliation.

Illustration

Identifying Relevant Controls over IPE

1. Identify the relevant controls that address the relevant risks of material misstatements

2. Determine if the relevant control uses IPE

3. Understand the IPE and determine which aspects (e.g., the specific data) of the IPE are important to the effectiveness of the relevant control

4. Determine whether the control (user) sufficiently addresses (“validates”) the accuracy and completeness of the IPE, or whether the control (user) is dependent upon other controls over the accuracy and completeness of the IPE

Validates

Our evaluation of the design and evidence of operating effectiveness of the relevant control that uses the IPE supports why the precision of the control is sufficient to validate the IPE.

No need to identify additional controls to address the accuracy and completeness of the IPE.

Dependent

Identify and test other controls that address the accuracy and completeness of the IPE

Consider:

- The source data
- The report logic (extraction & calculations)
- User-entered parameters

Illustration

IPE - Example

Description of Account & Risk Assessment	• Allowance for Doubtful Accounts • Significant risk
Summary Control Description	• At month end, the Controller reviews and challenges the appropriateness of the allowance. - Controller uses the A/R Aging Report (Report) as an important data point.
IPE that the Control Uses	• The Report is IPE since it is information prepared by the entity and used in the operation of a relevant control. • Report is generated monthly by the system (i.e., no user-entered parameters are required). • The report logic program and the database from which the Report is extracted are subject to effective general IT controls (e.g., access and program change controls).

Illustration

IPE - Example

Conclusion and Basis of Conclusion

The Controller's review of the allowance for doubtful accounts is dependent on other controls that address the accuracy and completeness of the A/R Aging Report.

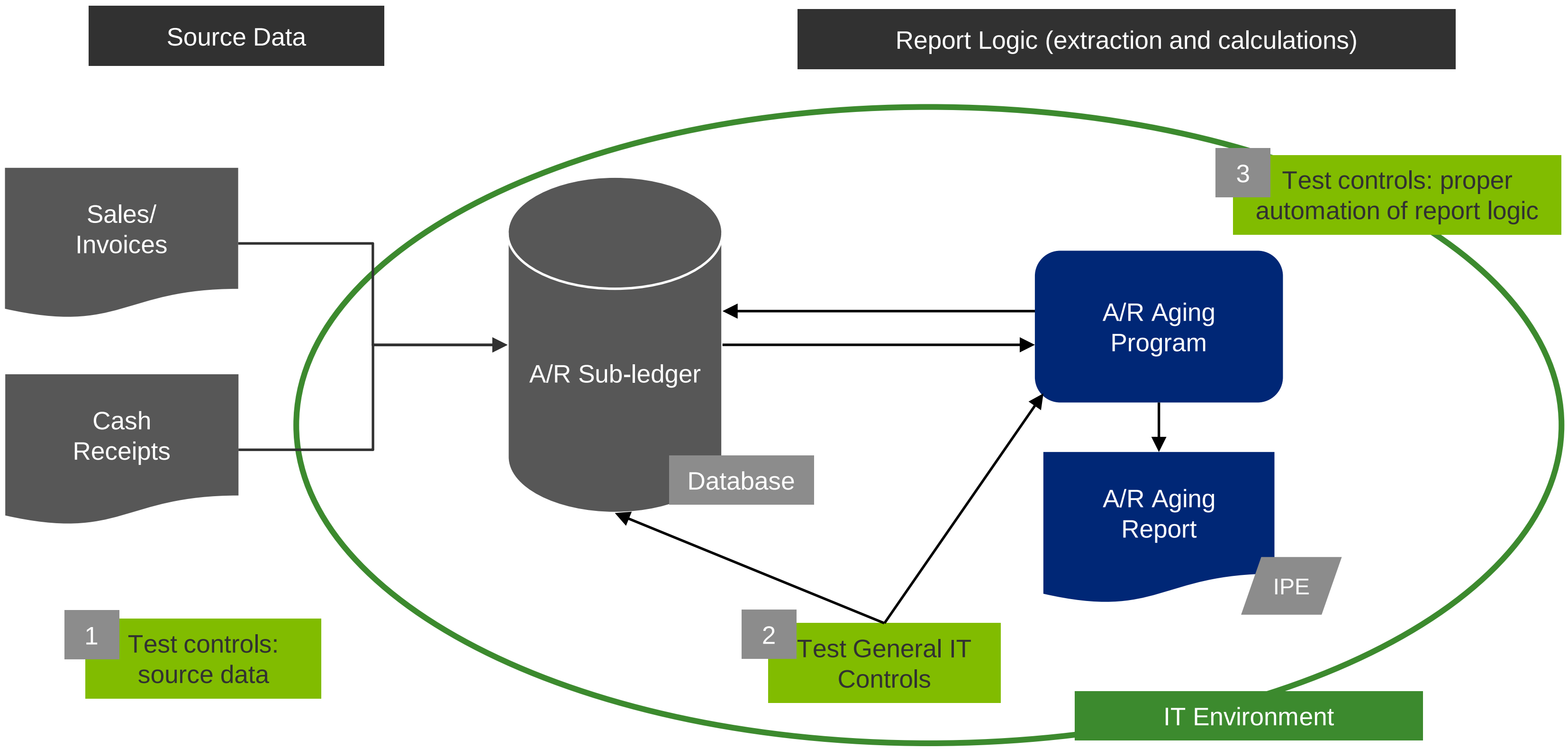
- Controller does not specifically perform procedures to validate the accuracy or completeness of the Report.
- Although the Controller may be in a position to conclude whether the Report appears reasonable or to identify anomalies, this type of review is not considered to be precise enough to conclude that the Report is accurate and complete because:
  - There is a large volume of transactions (invoices and cash receipts) underlying the report which have been summarized in the Report, making it more unlikely the Controller could identify a significant error.
  - The Controller is not involved in the day-to-day management and monitoring of accounts receivable and therefore likely would not be in a position to have a sufficiently precise expectation of the aging to identify significant errors in the report.

Illustration
IPE - Example

Control: Reviewer uses the A/R Aging Report to assess the appropriateness of the allowance for doubtful accounts

Reviewer is dependent on the accuracy and completeness of the A/R Aging Report

System-generated report, subject to effective general IT controls (no user-entered parameters)



Illustration

IPE - Example

IPE Element	Auditor’s Example Test of Operating Effectiveness of Controls that Address the Accuracy and Completeness of IPE
Controls Over Source Data	*Summary Control Description: Controls over the initiation, authorization, processing, and recording of sales/invoices and cash receipts into the A/R Sub-ledger database that the report is extracted from.* Test the operating effectiveness of the relevant controls.
General IT Controls Over Source Data and Report Logic	*Summary Control Description: Access and program change controls that prevent unauthorized changes to the data and the program that generates the Report and which ensure that any authorized changes were subjected to appropriate program change procedures.* Test the operating effectiveness of the relevant general IT controls.

Illustration

IPE - Example

IPE Element	Auditor's Example Test of Operating Effectiveness of Controls that Address the Accuracy and Completeness of IPE

Controls Over Report Logic Configuration	*Summary Control Description: Automation of the Report Logic*
	
	For one month (since the report is automated and subject to effective ITGCs) test operating effectiveness of the proper configuration of the automated report logic by:
	• Verifying that the automation of the extraction function operates correctly; e.g.:
	    • Compare the totals of the A/R Aging Report to the totals of the A/R Sub-ledger to verify that it agrees(completeness)
	    • Select one line item from the A/R Aging Report and agree the details back to the data in the A/R Sub-ledger (accuracy)
	• Verifying that the automation of each important calculation (considering variations) is consistent with the use of the A/R Aging Report by the Controller in his review; e.g. for each:
	    • Type of transaction (e.g. invoices, unapplied cash receipt)
	    • Aging bucket

Assess and Evaluate Deviations & Deficiencies

The Auditor should assess findings and conclude on the adequacy & operating effectiveness of controls

Determining whether a deviation is identified.

Determining the nature and cause of the deviation(s).

Evaluating whether the deviation is a control deficiency.

Deviations are evaluated and concluded upon to be either

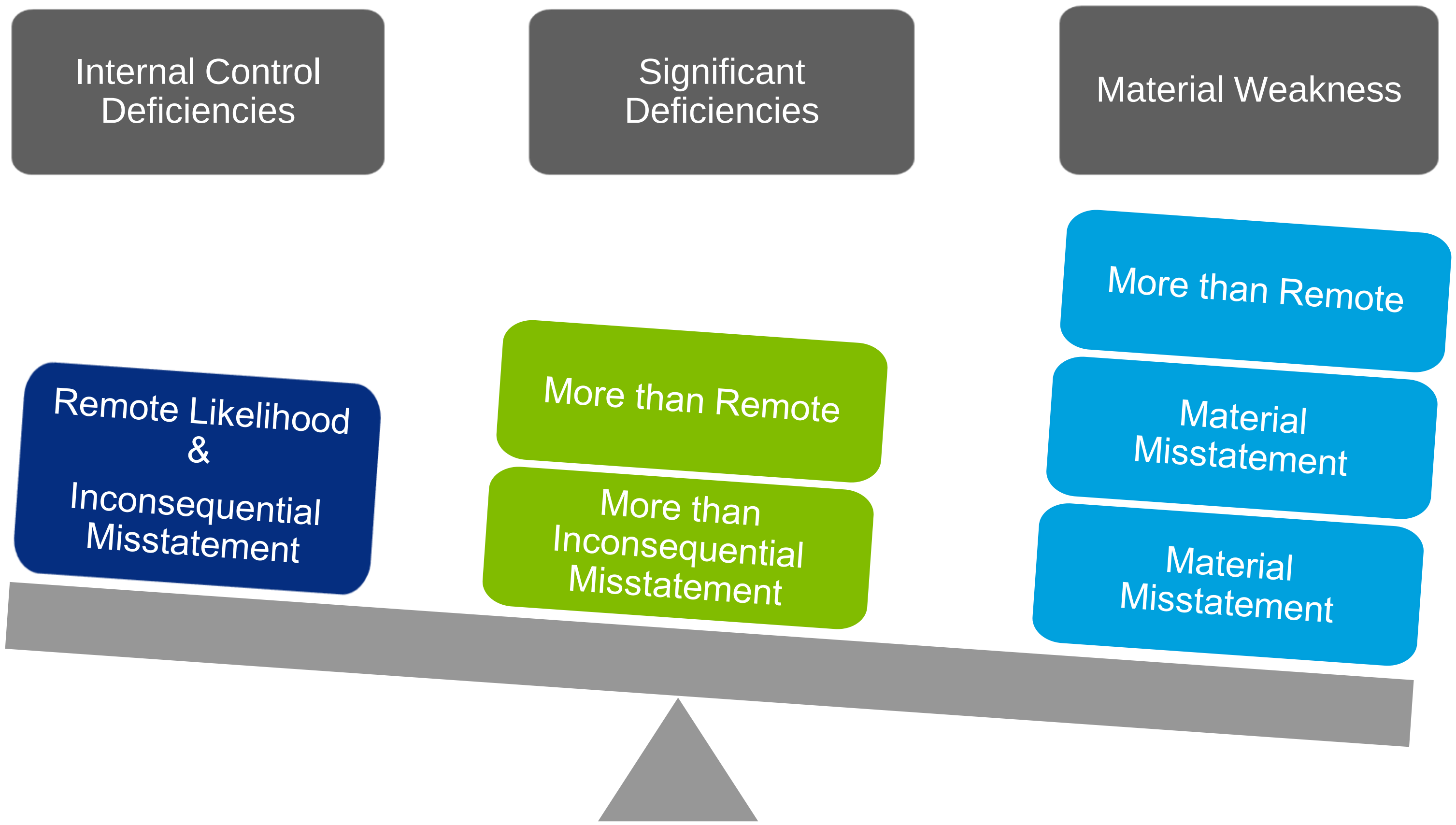
- Only a deviation and not a deficiency In this case, no further consideration is necessary;

OR

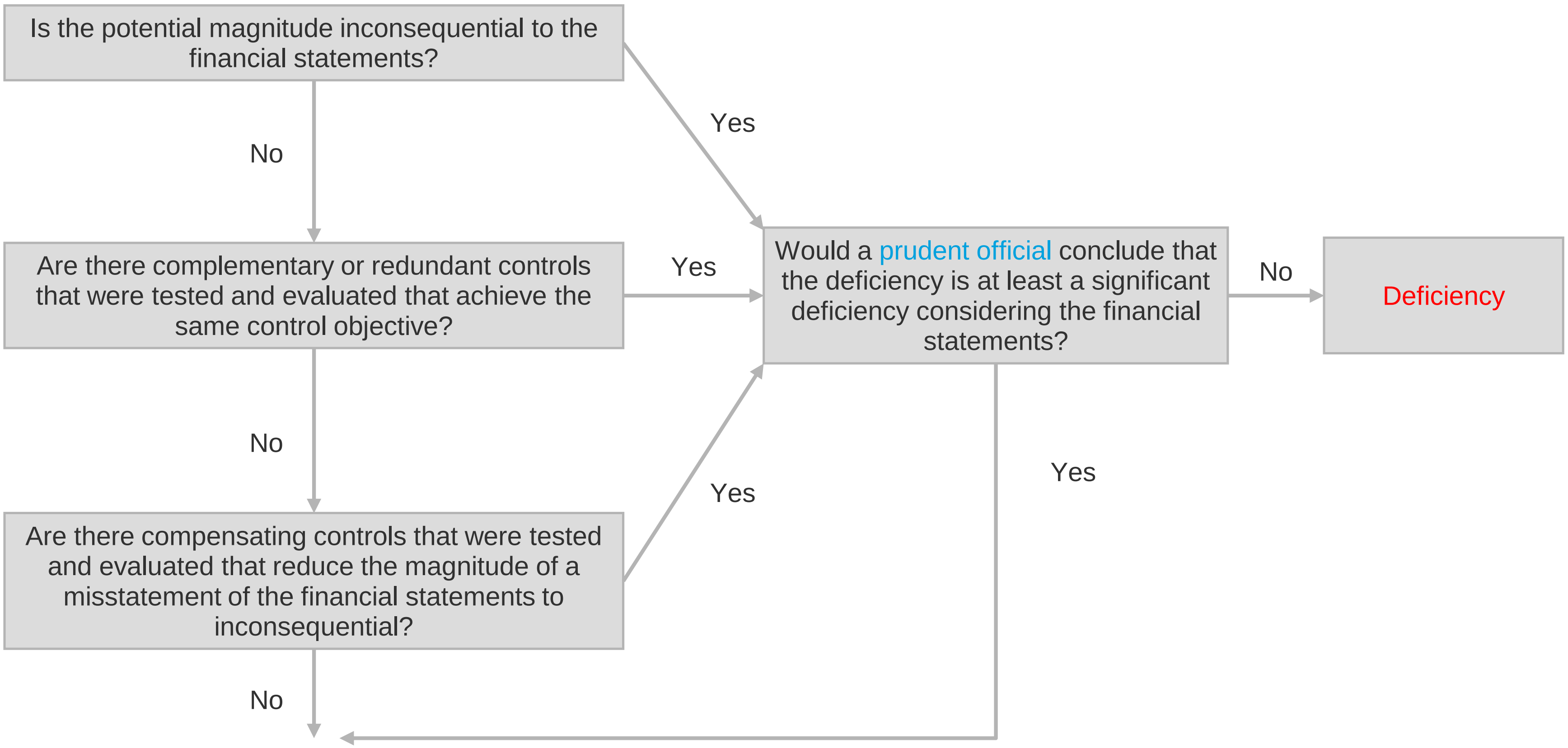
- A deficiency: In this case, the deficiency is further evaluated to assess its severity and implications on the financial statements audit

Deficiencies Categorization

Suggested approach for classifying deficiencies:

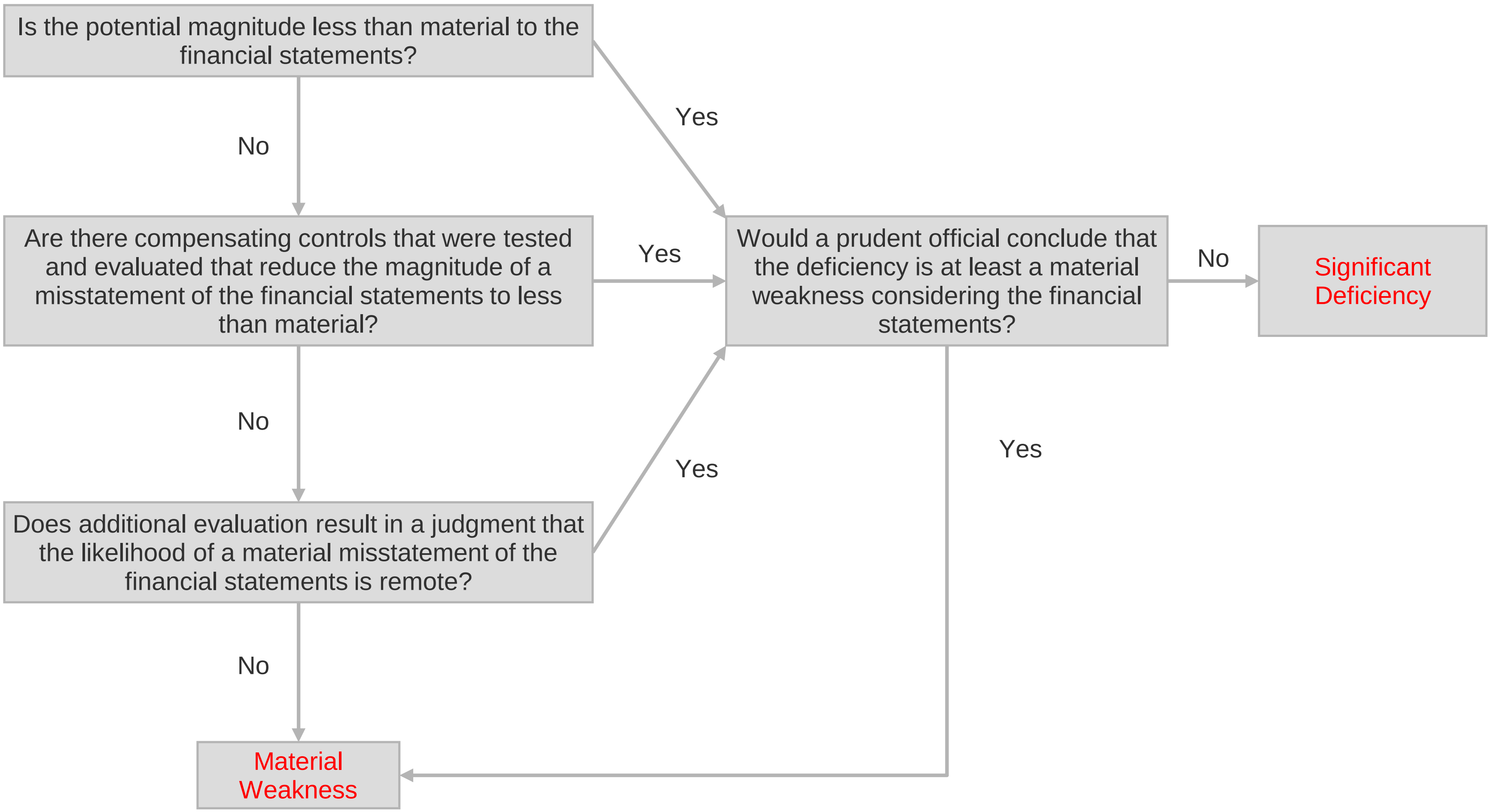


Evaluating a Deficiency



Prudent Official: *When evaluating the significance of a deficiency in ICFR, consider qualitative factors such as the "prudent official".*

Evaluating a Significant Deficiency and Material Weakness



Risk Factors

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.

1

The nature of the financial statement accounts, disclosures, and assertions involved

2

The susceptibility of the related asset or liability to loss or fraud

3

The subjectivity, complexity, or extent of judgment required to determine the amount involved

4

The interaction or relationship of the control with other controls, including whether they are interdependent or redundant

5

The interaction of the deficiencies

6

The possible future consequences of the deficiency

Classification of Control Deficiency

Evaluation and classification of control deficiencies as only deficiencies (Ds), significant deficiencies (SDs) or material weaknesses (MWs) can also be spread across following areas:

- Pervasive controls (ELC)
- Process/transaction-level controls
- General computer controls (GCCs)

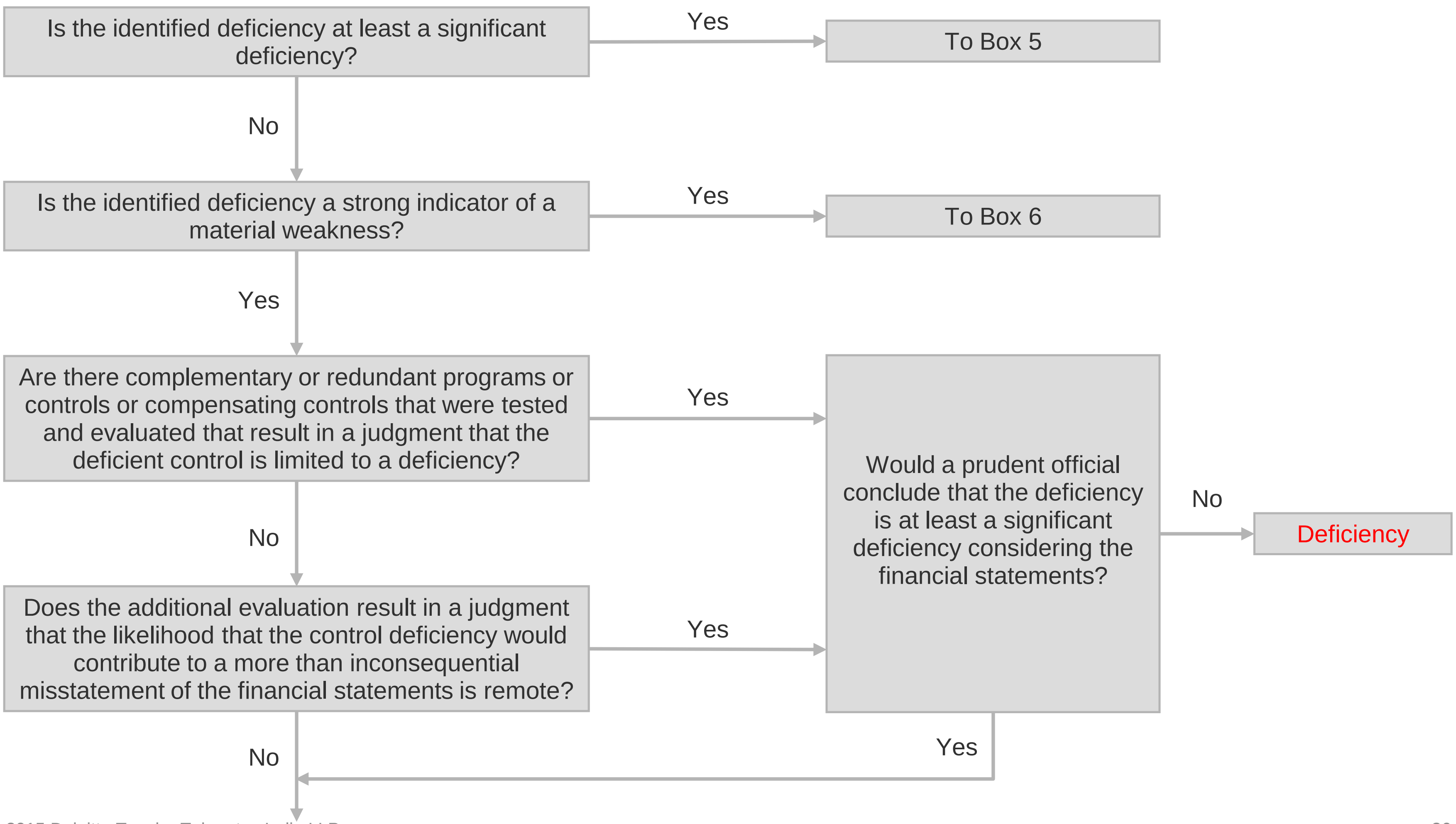
Key Themes - Pervasive Control Deficiencies

- Pervasive control deficiencies do not directly result in a misstatement.
- May contribute to likelihood of misstatement at process level.
- Evaluation based on the likelihood that deficiency would contribute to circumstances that could result in a misstatement.
- Quantitative methods generally not useful.

Illustration of Pervasive control deficiencies

- Lack of approved documentation on delegation of authority – **Material Weakness**
  - The non existence of authorization matrix would create difficulty to fix responsibility and accountability for any transaction done. The key assertions of **'Validity'** and **'authorization'** of transactions cannot be concluded with reasonable certainty.
- No employee confirmation to the Code of Conduct in an organization – **Control Deficiency**
  - Code of conduct creates a control consciousness among the employees and make them aware of responsibilities towards the organization. Non affirmation from employee on COC may amount to lack of control consciousness at employee level.

Evaluating Pervasive Control Deficiencies



Evaluating Pervasive Control Deficiencies

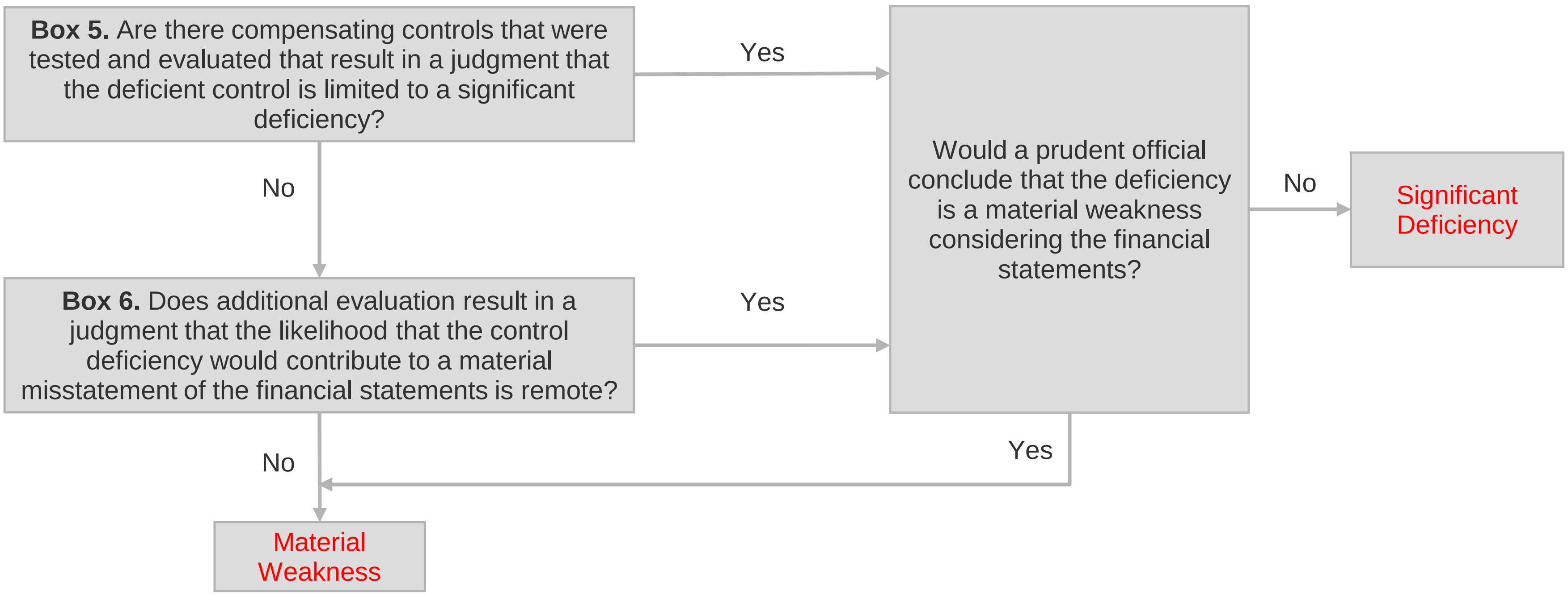


Illustration of Process level deficiencies

- Unauthorized access in application to the users – **Significant Deficiency**
  - The users creating the PO have access to process payment to vendors. Such excessive access in application to user can be misused to do fraudulent activities.
- Lack of review of Debtors Ageing report – **Significant Deficiency**
  - Lack of review of debtor ageing report by Finance Manager will provide accounts executive to manipulate the receipts from debtors, untimely identification of probable bad debts etc. lead to accounting of uncollectable revenue.

Principles – GCC Deficiencies

Three situations in which a GCC deficiency can rise to the level of a material weakness

- An application control deficiency related to or caused by a GCC deficiency is classified as a material weakness.
- A GCC deficiency classified as a significant deficiency remains uncorrected after some reasonable period of time.
- The pervasiveness and significance of a GCC deficiency leads to a conclusion that there is a material weakness in the company's control environment.

GCCs are fundamental to ICFR

- Underpin the effective functioning of controls in all COSO components.
- Support all aspects of the integrated audit.

Evaluating GCC Deficiencies

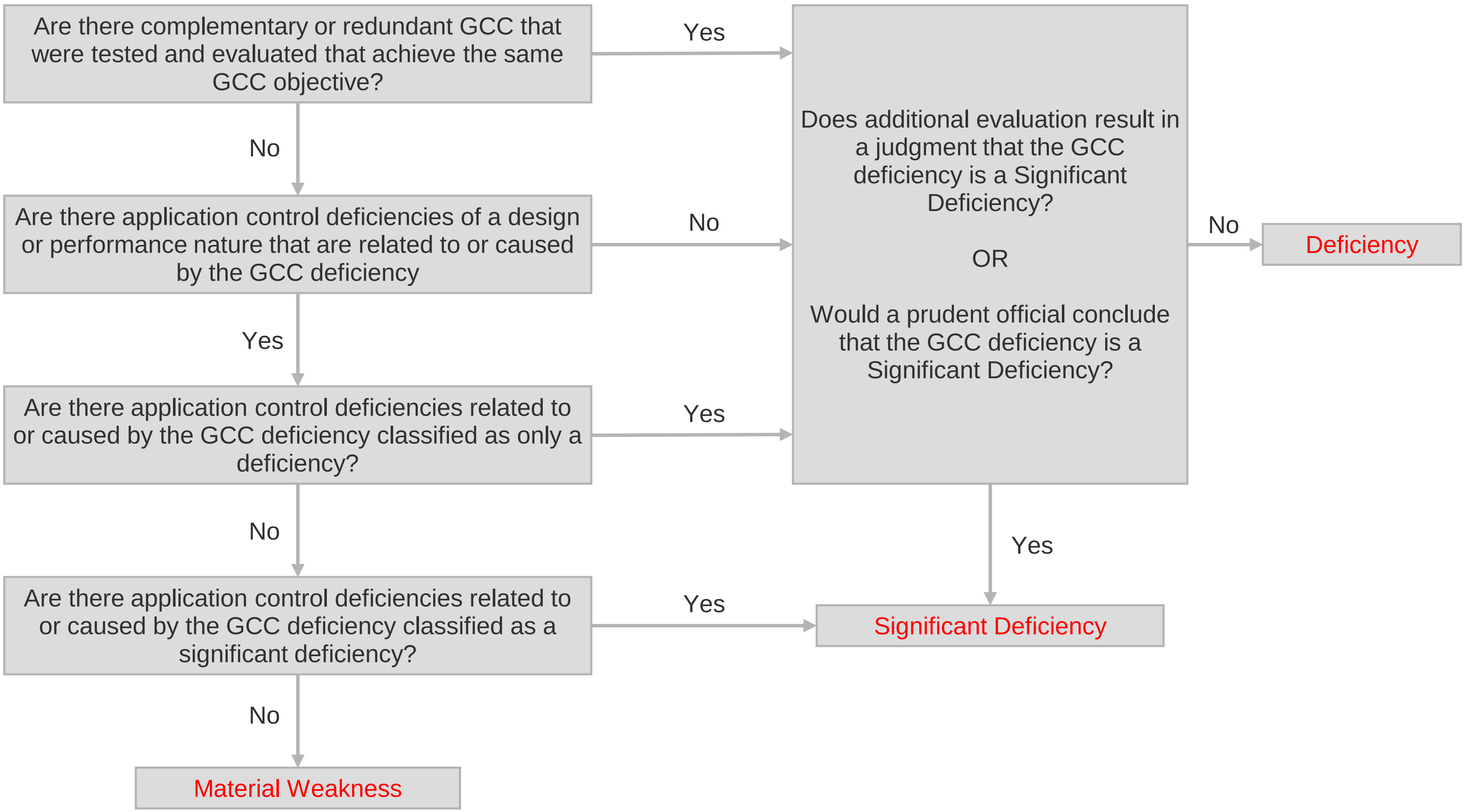


Illustration of ITGC deficiencies

- No formalization of changes management process – **Significant Deficiency**
- No formal user access review at application / DB and OS level – **Control Deficiency**
- No physical and environmental controls in data center – **Control Deficiency**

Aggregating Control Deficiencies

Process/transaction-level control deficiencies

- By significant account balance or disclosure

GCC deficiencies are not separately aggregated

- Considered in combination with related application control deficiencies

Pervasive control deficiencies (other than GCCs)

- By Internal control component

Consider

- Other controls
- Qualitative factors

Illustration of Deficiencies

Control Deficiencies	Significant Deficiencies	Material Weakness
• Inadequate design of internal control over a significant account or process • Inadequate documentation of the components of internal control • 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. • Management override of controls.	• Controls over non routine and nonsystematic 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 nonrecurring adjustments to the financial statements.	• 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. Non existence of DOA documents • For complex entities in highly regulated industries, an ineffective regulatory compliance function. • An ineffective internal audit function

Control Deficiency: Design of Controls & Operation of Controls (examples)

Design	Inadequate documentation of the components of internal control
Operation	Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
Design	Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
Operation	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.

Control Deficiency: Design of Controls & Operation of Controls (some more examples)

Design	The absence of an internal process to report deficiencies in internal control to management on a timely basis
Operation	Management override of controls
Design	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).
Operation	Misrepresentation by client personnel to the auditor (an indicator of fraud).

Forming an Opinion and Communication

Form opinion on Internal Financial controls over financial reporting

The Auditor should form an opinion on

- **The adequacy and**
- **Operating effectiveness of IFC over financial reporting**

Evaluate evidence obtained from

- All sources
- Auditor's testing of controls
- Separate management representation letter
- Misstatements detected
- Any other identified control deficiencies
- Review Internal Audit Report

- Evaluate the disclosures that the management and board of directors is required to make

Form opinion on Internal Financial controls over financial reporting

Auditor can form either of below opinion

- **Unmodified Opinion**
- **Modified Opinion**
- **Qualified Opinion**
  - Significant deficiency - material but is not pervasive to the financial statements
- **Adverse Opinion**
  - Due to existence of material weakness

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

- **Disclaimer of Opinion**

OR

- **Withdraw from Audit**
  - Due to limitation on scope of Audit

Reporting of Deficiencies

Nature of Deficiency	Management	Audit Committee	Directors' Report / Auditor's Report
Control Deficiency	✓	✗	✗
Significant Deficiency	✓	✓	✗
Material Weakness	✓	✓	✓

Impact of Continuing failures of Controls

There is a strong indicator for any continuing deficiencies to count as material weakness if there is continuing 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.

Example : Excessive authorizations and segregation of duties conflicts.

Audit Report on IFCFR

Auditor can provide either

- Separate report for IFCFR and Financial Statement or
- Combined Report for IFCFR and Financial Statement

The contents of Audit Report of IFCFR is similar to that of Financial Statement with addition of new contents:

- Introduction
- Management's Responsibility for Internal Financial Controls
- Auditors' Responsibility
- Meaning of Internal Financial Controls Over Financial Reporting
- Inherent Limitations of Internal Financial Controls Over Financial Reporting
- Opinion

Audit Report on IFCFR

Amongst other things, an auditor should consider in report :

- An identification of the **benchmark criteria** used by the management for establishing internal financial controls over financial reporting
- 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;
- A paragraph stating **inherent limitations** of internal financial controls over financial reporting. *(Note: Internal controls provide only reasonable assurance and hence this para is crucial for an independent reader to draw appropriate conclusion from the auditors report.)*

Scenarios of Audit Opinion on IFCFR

Scenarios of Qualified/Adverse Opinions

- Qualified Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting
- Adverse Opinion on adequacy (and therefore operating effectiveness) of Internal Financial Controls Over Financial Reporting
- Qualified Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls
- Adverse Opinion on operating effectiveness of Internal Financial Controls Over Financial Reporting and unmodified opinion on adequacy of such controls
- 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

Scenarios of Disclaimer of Opinion

- Framework for internal financial control over financial reporting not established but does not impact the audit opinion on financial statements
- 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

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: 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.

As at period end there were aged receivables for which we were not able to obtain balance confirmation. Also there were no subsequent receipts from these customers.

a) 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.

Significant deficiencies were noted during year end physical stock take. Proper quantitative records to inventory were not available to confirm on consumption stated in books of accounts.

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 affect my / our opinion on the financial statements of the Company

Illustration: Forming Opinion based on Process level deficiencies

Illustration on Forming opinion on IFCFR and FS

Identified material weakness in customer acceptance, credit evaluation and establishing credit limits for customers resulting in a risk of revenue recognition where potential uncertainty exists for ultimate realization of the sale proceeds.

→ The auditor may modify the opinion on internal financial controls in that respect

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 realized by the date of the audit.

→ The audit opinion on the financial statements should not be qualified, though the internal control deficiency exists

Audit Report of IFC over Consolidated Financial Statement

The report of IFC over Consolidated Financial Statement is similar to that of standalone entity's IFCFR report with addition of additional para of "Other Matters" after the opinion para in the report.

"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."

Assess Impact on Audit Opinion of FS

Modified report on IFC over FS ≠ **The audit report on financial statements should also be qualified**

Auditor report on IFC over FS provides basis for nature, timing and extent of Substantive procedure of FS.

If the control design & operating effectiveness is deficient then

- More substantive procedures to be undertaken for FS audit
- FS Audit opinion then based on the evidence obtained thru substantive procedures.
- The controls evaluation is not a replacement of substantive procedures but a complementary to FS Audit

Illustration of Disclaimer Opinion of IFCFR

“ 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.”

Scenario – Affecting opinion on Financial Statement

“ 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.”

Scenario – Not Affecting opinion on Financial Statement

“ 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.”

Form Audit Opinion on Financial Statement

Regardless of the assessed level of control risk

The auditor should perform substantive procedures for all relevant assertions to obtain:

- Sufficient &
- Appropriate audit evidence, to support audit opinion on financial statement

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.

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

Form Audit Opinion on Financial Statement

Interpretation of an unmodified report on FS with a modified report on IFCFR

Unmodified opinion on the company's financial statements

The auditor concludes with reasonable assurance that the financial statements are in conformity with GAAP in all material respects and that the FS are fairly presented

Modified opinion on IFCFR

Since management relies solely on its IFC when preparing financial statements. While the audit report of a company's FS may be unmodified, this provides ***little information*** to those outside the company as to whether other financial information (such as financial information, as in quarterly result filed with the Stock Exchanges) is of similar reliability.

Contact

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