



The Institute of Chartered Accountants of India
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यशस्विनी - An IDOL- Live Webinar



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Evaluation and Reporting of Internal Financial Controls (IFC) in Statutory Audit

This presentation will delve into the critical role of Internal Financial Controls (IFC) within the statutory audit process. Our objective is to ensure the reliability of financial reporting and promote compliance, ultimately strengthening corporate governance and bolstering investor confidence. We will cover the auditor's mandate, evaluation methodologies, and the reporting of findings, culminating in the auditor's opinion on IFC over financial reporting.

 **by CA Maitree Panchal**



Understanding Internal Financial Controls (IFC)



Internal Financial Controls (IFC) encompass policies and procedures designed to ensure the orderly and efficient conduct of business operations. This includes adherence to company policies, safeguarding assets, preventing and detecting fraud and errors, maintaining accurate and complete accounting records, and ensuring the timely preparation of reliable financial information. The primary focus in audit is on IFC over financial reporting (IFC-FR), which aims to provide reasonable assurance regarding the reliability of financial statements.

Regulatory Landscape and Auditor's Mandate

The Companies Act, 2013 in India, specifically Section 143(3)(i), mandates statutory auditors to report on the adequacy and operating effectiveness of Internal Financial Controls. This legal requirement underscores the importance of robust internal controls for corporate governance.

Auditors rely on key auditing standards such as SA 315 (Identifying and Assessing Risks of Material Misstatement) and SA 330 (The Auditor's Responses to Assessed Risks) as foundational principles. Further guidance is provided by the Institute of Chartered Accountants of India's (ICAI) Guidance Note on Audit of Internal Financial Controls over Financial Reporting (GN on IFC-FR), which outlines specific methodologies for conducting this audit. These regulations and guidelines are applicable to all companies required to prepare financial statements under the Act, ensuring a uniform approach to IFC reporting.

Auditor's Evaluation Methodology: Phase 1 - Design Assessment

Understand Entity & Environment

Gain in-depth knowledge of business processes, IT systems, and the relevant regulatory landscape to frame the audit.

Identify Significant Accounts & Disclosures

Link identified accounts and disclosures to financial statement assertions, such as existence, completeness, and valuation.

Document Controls

Utilize tools like flowcharts, narratives, and Risk & Control Matrices (RCMs) to thoroughly map processes and controls.

Assess Control Design

Evaluate whether the controls, if functioning as intended, are capable of preventing or detecting material misstatements.

Walkthroughs

Perform step-by-step walkthroughs of transactions (e.g., purchase-to-pay cycle) to confirm understanding and design effectiveness.

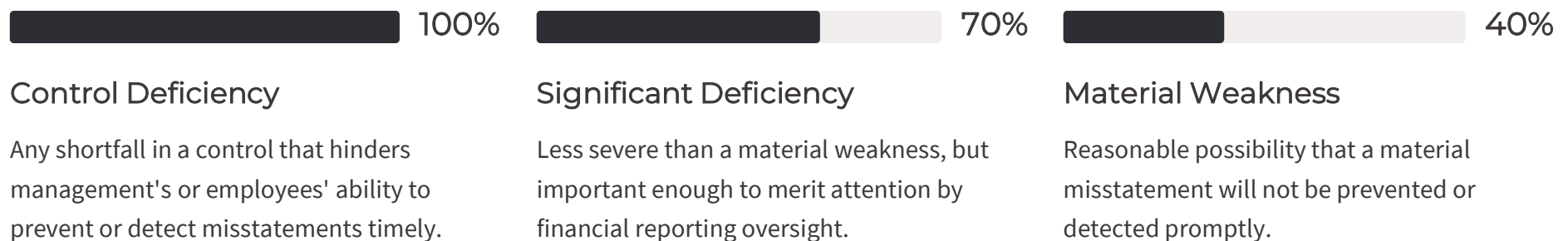
The first phase of the auditor's evaluation methodology involves a meticulous design assessment of Internal Financial Controls. This process begins with a comprehensive understanding of the entity's operations and its surrounding environment, including business processes, IT systems, and the regulatory framework.

Auditor's Evaluation Methodology: Phase 2 - Operating Effectiveness Testing

The second crucial phase in the auditor's methodology is the testing of operating effectiveness, also known as Test of Operating Effectiveness (TOE). This involves designing specific tests to verify that controls are functioning as intended throughout the entire audit period. The nature, timing, and extent of these tests vary depending on the type and frequency of the control, as well as the auditor's risk assessment. For instance, a control related to quarterly bank reconciliations would be tested differently than a daily cash reconciliation.

Auditors employ various techniques, including inquiry, observation, inspection of documentation (such as approval signatures), and re-performance of control activities. Sampling is often utilized to select representative transactions for testing, ensuring that a sufficient number of items are examined, for example, 25 transactions for a high-frequency control. Furthermore, IT General Controls (ITGCs) are critically assessed, as their effectiveness is paramount for relying on automated controls and ensuring data integrity, covering areas like access security and program changes.

Identifying and Classifying Control Deficiencies



Identifying and classifying control deficiencies is a critical step in the IFC audit. A **Control Deficiency** is a shortcoming in a control that prevents management or employees from timely preventing or detecting misstatements. More severe are **Significant Deficiencies**, which, while less severe than a material weakness, are important enough to warrant attention from those overseeing financial reporting. The most severe classification is a **Material Weakness**, indicating a reasonable possibility that a material misstatement in the financial statements will not be prevented or detected on a timely basis. All deficiencies are communicated to management, while significant deficiencies and material weaknesses are also escalated to Those Charged with Governance (TCWG) and the audit committee.

Auditor's Reporting on IFC-FR

Auditors are required to provide a separate and distinct opinion on Internal Financial Controls over Financial Reporting (IFC-FR) within their statutory audit report, as mandated by Section 143(3)(i) of the Companies Act, 2013. This ensures transparency and accountability regarding the effectiveness of a company's internal controls.

There are several types of opinions an auditor can issue. An **Unmodified (Clean) Opinion** signifies that the IFC-FR are adequate and operating effectively. A **Qualified Opinion** indicates minor deficiencies, but that the overall IFC-FR remains effective. An **Adverse Opinion** is issued when material weaknesses are identified, concluding that IFC-FR is not effective. Lastly, a **Disclaimer of Opinion** is provided when the auditor cannot form an opinion due to insufficient appropriate audit evidence. The report must clearly state the basis for the opinion and provide a detailed description of any identified material weaknesses, including their potential impact on the financial statements. An example of an unmodified opinion statement is: "In our opinion, the Company has, in all material respects, adequate IFC-FR and such IFC-FR were operating effectively as at March 31, 20XX."

Key Considerations and Future Outlook



Management's Responsibility

Management holds primary responsibility for establishing and maintaining IFC, with the auditor reporting on their effectiveness.



Dynamic Environment

IFC must continuously adapt to evolving business changes, new technologies, and emerging risks.



Leveraging Technology

Increased use of data analytics and automation tools for more efficient and comprehensive control testing.

