

Internal Financial Controls



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Coverage



- ∞ Background
- ∞ Regulatory framework
- ∞ Applicability
- ∞ IFC / ICFR- its meaning

Coverage



- ❧ Compliance and obligations of Board of Directors / Audit Committee
- ❧ Audit and Reporting requirements in respect of Statutory auditors
- ❧ Practical considerations for audit of ICFR
- ❧ Challenges

Background



- ❧ Corporate frauds / Bankruptcy
- ❧ Objective is to improve the integrity and reliability of the financial statements which are shared with the stakeholders
- ❧ Need for Internal Control framework to tighten controls prevalent in Organizations
- ❧ International practices-SOX, J-SOX,
- ❧ COSO framework

Regulatory Framework



- ❧ Companies Act, 2013 has formally brought the concept of Internal Financial Controls (IFC)
 - Section 134 (5) applicable to Board of Directors' report
 - Section 143(3)(i) applicable to Statutory Auditors while reporting
 - Section 177 (4)(vii) applicable to Audit committee
 - Schedule IV(II)(4) applicable to Independent Directors

Regulatory Framework



☞ Companies (Accounts) Rules, 2014: Rule 8(5)(viii)

☞ Companies (Audit and Auditors Rules), 2014- Rule 10A

☞ SEBI Guidelines for listed companies

Regulatory Framework (in relation to Board of Directors)



- ❧ Section 134(5)(e) of the Companies Act, 2013 (applicable only to Listed companies)-Directors' responsibility statement
- ❧ Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 (applicable to every company- listed/non-listed, public/private)

Reporting on IFC by Board of Directors



Companies Act 2013: Sec 134(5):

☞ Directors' Responsibility Statement

a) to d) Same

e) 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.

☞ Companies' (Accounts) Rules, 2014: Rule 8(5)(viii)

The Board report shall include details in respect of adequacy of Internal Financial Controls with reference to the Financial Statements

Obligations of Board / Audit Committee



∞ Evaluation of IFC by Audit Committee [Sec 177 (4)(vii)]

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.**

∞ Integrity of FS validation by independent directors [Sch. IV(II)(4)]

Independent Directors shall satisfy themselves on the integrity of financial information and that of financial controls.

Reporting on IFC under SEBI Regulations



☞ SEBI (Listing Obligations and Disclosure requirements) Regulations, 2015 (*effective 1st December 2015*)

Chapter IV – obligations of listed entity- lays down the rules and requirements for Board and Audit Committee

☞ The role of Audit Committee and information to be reviewed

☞ As per Sch. II, Part C, B – 11, the role of Audit Committee includes *Evaluation of IFC and risk management systems.*

What is IFC? Its meaning



☞ Meaning of IFC [explanation to sec 134(5)(e)]

For purpose of this section, “**internal financial controls**” means 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 accounting records, and
- ☞ the timely preparation of reliable financial information.

Reporting requirement on IFC for Auditors



❧ Section 143(3)(i)

Whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

❧ As per Rule 10A of Companies (Audit and Auditors) Rules, 2014, “For the purposes of clause (i) of sub-section (3) of section 143, for the financial years commencing on or after 1st April, 2015, the report of the auditor shall state about existence of adequate internal financial controls system and its operating effectiveness

Provided that auditor of a company may voluntarily include the statement referred to in this rule for the financial year commencing on or after 1st April, 2014 and ending on or before 31st March, 2015.”

Implications for improper reporting on IFC / ICFR



☞ Penalty under the Companies Act, 2013

As per Section 134(8), if a company **contravenes** the provisions of this section, the company shall be punishable with fine which shall not be less than Rs. 50,000 but which may extend to Rs. 25 lakhs and **every officer of the company who is in default** shall be punishable with **imprisonment** for a term which may extend to **3 years** or with **fine** which shall not be less than Rs. **50,000** but which may extend to **Rs. 5 lakhs**, or with both...

Reporting on IFC by Auditors



- ❧ ICAI has issued Guidance note on Audit of Internal Financial Controls Over Financial Reporting (September 2015)
- ❧ ICAI Guidance note makes it clear that the auditors' responsibility with internal financial controls extends only with respect to financial reporting (i.e. ICFR)
- ❧ Companies Amendment Bill, 2016 seeks to modify section 143(3)(i), by replacing the words "internal financial controls system" with the words "internal financial controls with reference to financial statements"

What is Internal Financial Control over Financial Reporting (ICFR)?



As per the GN -ICFR is a **process** designed by the **company's principal executive and principal financial officers**, and effected by the **company's board of directors, management, and other personnel**, to provide **reasonable assurance** regarding the **reliability of financial reporting** and **preparation of FS** for external purposes in accordance with GAAP.

What is ICFR?



∞ The process includes policies and procedures that –

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the **transactions and dispositions of the assets;**
- Provide reasonable assurance that transactions are recorded as necessary to permit **preparation of FS in accordance with GAAP**, and that receipts and expenditures of the company are being made only in accordance with **authorizations of management and directors of the company**, and

What is ICFR?



☞ Provide reasonable assurance regarding **prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets** that could have a material effect on the Financial *statements*.

Difference between IFC and ICFR



- ❧ ICFR is a part of IFC (IFC is a larger concept)
- ❧ IFC compliance is applicable to Listed Companies (responsibility of Board of Directors)
- ❧ ICFR is applicable to Unlisted companies
- ❧ For Auditors of all types of companies (whether Listed or unlisted) scope of audit and reporting is limited to ICFR

Difference between IFC and ICFR



Internal Financial Control over Financial Reporting (ICFR)

+

Operational Controls

+

Fraud Prevention

=

Internal Financial Controls (IFC)

Components of ICFR



- ❧ Maintenance of Financial records
- ❧ Authorisation of Transactions
- ❧ Safeguarding assets of the company
- ❧ Preparation of financial statements as per the requirements of GAAP

IFC Framework



- ❧ The Management is required to adopt the IFC framework and design and implement IFC in the Organisation. Further, the adequacy and operating effectiveness of IFC is the responsibility of the Management.
- ❧ No mandatory framework prescribed under the Companies Act, 2013
- ❧ Most common framework used worldwide is 5 component approach (as given under COSO framework and also SA-315)

Components of IFC Framework



- ❧ Control Environment (Install Entity Level Controls)
- ❧ Risk Assessment (Prepare Risk Control Matrix)
- ❧ Control Activities (Frame policies and procedures)
- ❧ Information system and Communication (IT Controls)
- ❧ Monitoring (Testing of controls)

Control Environment



1. Entity demonstrates commitment to integrity and ethical values
2. Board exercises oversight of the development and performance of internal control mechanism
3. Management establishes structure, authority, and responsibility
4. Entity demonstrates commitment to attract and retain competent individuals
5. Entity enforces accountability for internal control responsibilities

Risk Assessment



6. Entity objectives to enable the identification and assessment of related risks
7. Identifies and analyses risk related to the objectives
8. Considers the potential for fraud
9. Identifies and analyses significant changes that would impact the internal control system

Control Activities



10. Entity selects and develops control activities for risk mitigation
11. Selects and develops general controls over technology
12. Deploys control activities through policies and procedures

Information and Communications



13. Entity obtains/generates/uses relevant information
14. Communicates internally to support the internal control functioning
15. Communicates externally matters affecting the functioning of internal control

Monitoring



16. Entity conducts ongoing and/or separate evaluations of internal controls

17. Evaluates and communicates internal control deficiencies to those responsible for remedial actions including the board/senior management

Board of Directors / Audit Committee to ensure that..



- ❧ All transactions actually occurred during the reporting period.
- ❧ Completeness of booking of Assets Liabilities Incomes and Expenses.
- ❧ Accuracy of Information presented in financial statements.
- ❧ Ensuring that all assets are legally owned by the entity and all liabilities are its legal obligations.
- ❧ All assets and Liabilities have been properly valued by the entity and all costs have been properly allocated.
- ❧ The financial report is presented in the proper form and all disclosures required to be made are made.

Audit Committee / Board to ensure that ...



- ❧ The transactions are in compliance with the applicable laws and regulations.
- ❧ Identification of issues in the Accounting system related controls which may result in inaccurate reporting of financial information.
- ❧ Identification of risks related to financial reporting in an entity and the controls in place to mitigate the same.
- ❧ Whether there are standard operating processes and Manuals prepared for ensuring adherence to processes.
- ❧ Consideration of possibility of frauds.

Evaluation of ICFR by Auditors



- ❧ Objective of an Auditor in an audit of IFC over financial reporting (ICFR) is to express an opinion on the effectiveness of the company's ICFR.
- ❧ Auditor cannot consider a company's internal financial controls to be effective if one or more material weakness exists – this is so even if the overall FS are not materially misstated.
- ❧ Auditor is therefore required to plan and perform the audit to obtain Sufficient Appropriate Audit Evidence (SAAE) to obtain reasonable assurance about whether any material weakness exists.

Guidance from ICAI GN



- ❧ Technical Guidance on Audit of Internal Financial Controls Over Financial Reporting
- ❧ Implementation Guidance
- ❧ Contains Illustrative Engagement letter, MRL, audit reports, Risk Control Matrix etc.
- ❧ *GN has several extracts from Auditing Standard 5 'An Audit of Internal Control Over Financial Reporting that is integrated with an Audit of Financial Statements' issued by PCAOB, USA.*

Audit of ICFR involves:



I. Planning the Audit

II. Design and Implementation

III. Testing Operating effectiveness

IV. Reporting

Evaluation of ICFR by Auditors-

Audit approach



- ❧ Execute separate ICFR Audit engagement letter (refer suggested format given in the GN) along with normal Audit engagement letter
- ❧ Understand the business model
- ❧ Understand various policies and procedures
- ❧ Identify various risks associated at entity level and process level

Evaluation of ICFR by Auditors-

Audit approach



- ❧ Identify significant account balances from the Trail balance / Financial statements (drill down / Top down approach)
- ❧ Identify significant disclosure items in the Financial statements
- ❧ Identify Significant class of Transactions [SCOT} and its flows (obtain process narrative in respect of those transactions)

Evaluation of ICFR by Auditors-

Audit approach



- Some of the examples of SCOT (varies from entity to entity):
 - Procurement to payment
 - Order to cash
 - Inventory
 - Fixed Asset procurement, retirement and disposal
 - Hire to retirement (HR Process / payroll process / employee related payments)
 - Statutory compliances
 - Year end book closure and preparation of financial statements

Evaluation of ICFR by Auditors-

Audit approach

- ❧ Conduct the Walkthrough
- ❧ Test the design of the controls (review process narratives)
- ❧ Test the controls (based on samples selected)
- ❧ Identify the risks associated
- ❧ Identify the controls which address the risk of material misstatement

Evaluation of ICFR by Auditors-

Audit approach



- ❧ Check whether any significant deficiency in control exist?
- ❧ Document the results of control testing
- ❧ Discuss the findings with the management / communicate significant deficiencies
- ❧ Obtain Management Representation letter
- ❧ Report (as per audit report format given in the GN)

Types / nature of controls (conceptual understanding of controls)



∞ Entity level Control

∞ Process level Control / Transaction level control

∞ Manual Control

∞ Automated Control

Types / nature of controls (conceptual understanding of controls)



∞ IT General Controls

∞ Mitigating Controls

∞ Physical Controls

Testing of Controls



☞ Nature of test of controls:

- Inquiry
- Observation
- Inspection of underlying documents

Testing of controls



☞ Timing of test of controls is influenced by:

- The risk associated with the control
- The frequency with which specific controls operate

Testing of controls



Extent of tests of controls is determined by:

- The frequency of performance of control by the entity
- The nature of control-whether manual or automated
- The extent of risk associated with the control
- The expected deviation from the control

Evaluation of ICFR by Auditors



- ❧ Is evaluation of ICFR necessary for all controls within the company or only for controls over financial reporting?
- ❧ Globally, auditor's reporting in internal controls is together with the reporting on FS and such **internal controls only relate to internal controls over financial reporting (ICFR)**
- ❧ Companies Act, 2013 specifies reporting on IFC only in the context of Financial Statements
- ❧ Consistent with the international practice, the term **IFC in section 143(3)(i) would relate only to ICFR**

Evaluation of ICFR by Auditors



- ❧ **Is evaluation of ICFR necessary for interim results?**
- ❧ Reporting on ICFR by the Auditor is a requirement specified under u/s 143 of the Companies Act, 2013
- ❧ Would therefore apply only in case of reporting on FS prepared under the Act and reported to u/s 143.
- ❧ Accordingly, reporting on IFC will **not be applicable for interim Financial Statements** (quarterly / half-yearly results) [unless required by any other law or regulation].

Reporting on ICFR in case of CFS (Consolidated Financial Statements)



- ❧ As per section 129(4) of the Companies Act, all provisions for preparation, adoption and audit of FS of a holding company also apply *mutatis mutandis* to CFS also;
- ❧ Hence reporting u/s 143(3)(i) on IFC also applies to CFS
- ❧ As per GN, reporting on adequacy and operating effectiveness of IFC in the case of components to be on basis of the reports submitted by the respective Auditors

Reporting on ICFR in case of CFS (Consolidated Financial Statements)



- ❧ Applicable only for subsidiaries / JVs / Associates in India as 143(3)(i) does not apply to foreign entities
- ❧ The Auditor of the holding company needs to apply the concept of materiality and his professional judgment while reporting on this aspect.

Role of Statutory Auditor in combined audit of ICFR and Financial Statements



- ❧ Auditor should design testing of controls to accomplish objectives of both audits simultaneously
- ❧ In such a combined audit the auditor expresses opinion on:
 - ❧ Opinion on ICFR which requires independent evaluating effectiveness of IFC over FR;
 - ❧ Opinion on FS (True and fair view)
- ❧ Though final objectives of the above are not identical, the auditor needs to plan and perform work to achieve both objectives in an integrated manner.

Important aspects in designing and implementing IFC framework



- ❧ Establishing a governance framework for implementation,
- ❧ managing and monitoring internal controls
- ❧ Involvement of Board and audit committee from the beginning
- ❧ Formalization of processes, standard operating procedures, workflows and authority matrix

Important aspects in designing and implementing IFC framework



- ❧ Segregation of duties and access controls, automation of controls through ERP
- ❧ Redeployment of work routines to enable audit trails, evidencing the reviews etc.
- ❧ Maker - Checker control or the 4-eye principle
- ❧ Regular Systems or IT audit to ensure effectiveness of controls

Reporting on ICFR in SMEs

Such companies typically  have the following qualitative characteristics:

- ❧ Concentration of ownership and management in small number of individuals
- ❧ Straightforward or uncomplicated transactions;
- ❧ Simple record-keeping;
- ❧ Few lines of business and few products;

Reporting on ICFR in SMEs



- ❧ Few internal controls;
- ❧ Few levels of management with responsibility for a broad range of controls or
- ❧ Few personnel, many having wide range of duties.

Evaluation of ICFR needs to be done in light of the above factors

Reporting Format by Auditors for ICFR



- ❧ ICAI GN lays down recommended format of reporting on ICFR
- ❧ Can be given as an Annexure to main report
- ❧ In such cases, there will be 2 Annexures to the Audit Report
– one for ICFR and another for CARO 2016

Reporting Format by Auditors for ICFR



- ❧ For unlisted / smaller companies also possible to include paragraph in the main report as under:
- ❧ *In our opinion, the Company has, in all material respects, an adequate internal financial control system over financial reporting and such internal financial controls over financial reporting were operating effectively as at 31 March 2016, 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;*

How IFC help the Organisation



- ❧ Helps in standardisation of policies and procedures
- ❧ Rationalisation of number of controls across the Organisation-
Smart controls
- ❧ Fosters control conscious work environment at various levels
- ❧ Business process re-designing thereby plugging revenue leakages and Cost containment opportunities.
- ❧ Provides assurance to the stakeholders

Role of Internal Auditors

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- ☞ Regulations have not defined any specific role / responsibility for internal auditors for IFC/ICFR. Internal Auditors can play a pivotal role in:
- Providing consultative assistance in developing ERM, IFC and /or ICFR Framework
 - Assisting in documenting process walkthroughs and Risk Control Matrices
 - Assisting in testing existence and adequacy of controls on behalf of the management

Role of Internal Auditors



- Assistance in testing operational effectiveness of controls on behalf of the management
- Sharing evidence of testing with statutory auditors, if asked for.
- The Audit Committee may ask the Internal Auditors to provide assurance, based on their evaluation, on the adequacy and effectiveness of ICFR – for this, a specific mandate needs to be given. This is not considered to be a part of the regular internal audit function.



THANK YOU