Walker Chandiok & Co LLP

Internal Financial Controls over Financial Reporting - IFCoFR

Presented by: **KHUSHROO B. PANTHAKY**

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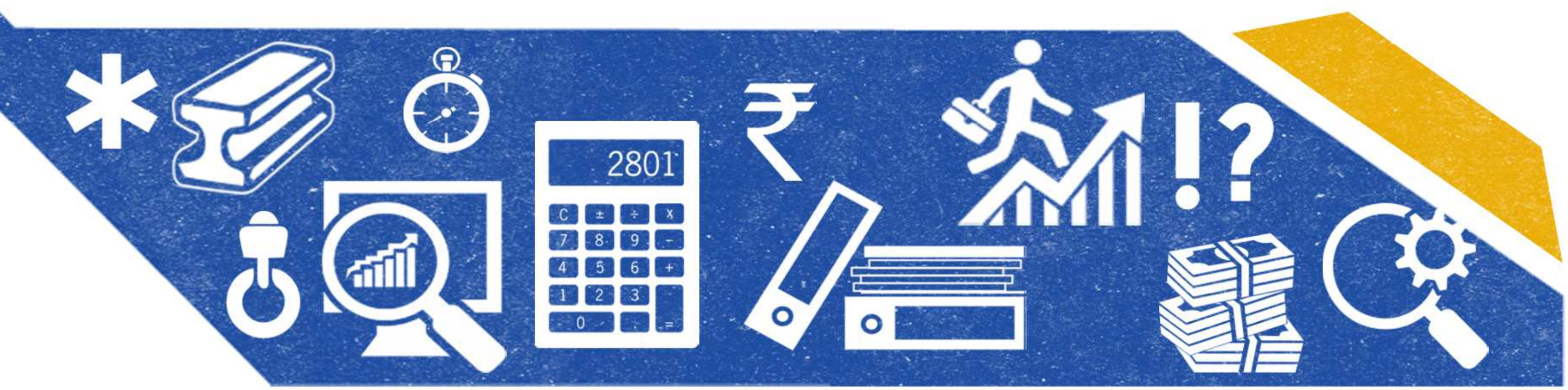


Content

Background

Scenario in India: what's changed?

- Coverage enhances to '**orderly and efficiently conduct of business, safeguarding of assets, Prevention and detection of frauds and errors**.
- Responsibility for ensuring adequacy in IFCs and reporting responsibility has moved from CEO/ CFO to **Board of Directors**
- Applicability to both **listed and unlisted** companies – a significant difference compared to applicability of codes in various other countries – which is mainly applicable to listed companies

Scenario in India: Board's responsibility

Section 134 → Board of Directors

- State in Director's responsibility statement that directors had laid down "**internal financial controls**" to be followed by the Company and that such internal financial controls were **adequate and operating effectively**
- Applicable only in case of **listed entity**

Companies (Accounts) Rules, 2014 → Board of Directors

- Include the details in respect of **adequacy** of "**internal financial controls**" with reference to the **financial statements** in Board's report
- Applicable to **all companies**

Scenario in India: AC’s and ID’s role

Section 177 → Audit Committee

- Evaluation of **internal financial controls** and risk management systems;
- Call for and discuss auditor's comments on internal control systems and their audit observations and discuss those with management, if considered necessary.

Schedule IV → Independent Directors

- Satisfy themselves on the integrity of financial information and that **financial controls** and the systems of risk management are robust and defensible

Scenario in India: Auditor's responsibilities

Section 143 → Auditor

- Report on whether the company has **adequate** internal financial controls system and **operating effectiveness** of such controls
- Applicable to **all companies** (standalone as well as consolidated).

CARO, 2015 → Auditor

- Report if there are **adequate** internal control procedures for **purchase of inventory** and **fixed assets** and for **sale of goods and services**

Scenario in India: IFC applicability snapshot

Requirements	Listed companies	Specific class of companies*	Other companies
Director's Responsibility Statement (Section 134)	✔		
The Companies (Accounts) Rules, 2014 (Rule 8)		✔	✔
Audit Committee (Section 177)	✔	✔	
Independent Directors (Schedule IV)	✔	✔	
Auditor Report (Section 143)	✔	✔	✔

* Specified class of companies:

- public companies with a paid up capital of Rs.10 Crores or more;
- public companies having turnover of Rs.100 Crores or more;
- public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs.50 Crores or more.

The above thresholds as existing on the date of last audited Financial Statements shall be taken into account.

Scenario in India: IFC scoping spectrum

IFC Set for Board (section 134) and Statutory Auditors (section 143)

- Key and moderate financial controls +
- Key and moderate reporting controls +
- Key anti-fraud controls +
- Key entity level controls

Management Set for CSA (Controls Self Assessment) **and CEO/ CFO certification**

- IFC set +
- Key and moderate operating controls +
- Moderate anti-fraud controls

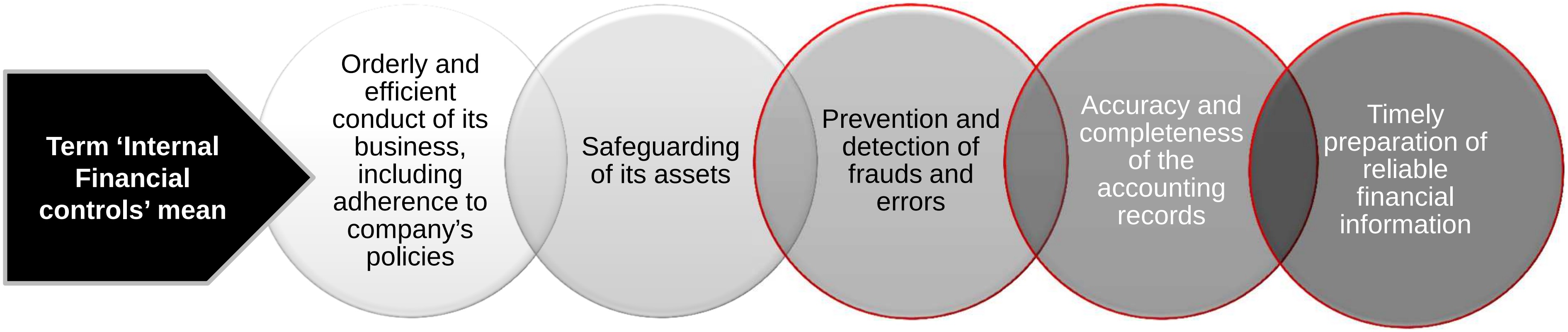
Application guidance

Guidance note: Overview

- On 14 September 2015, ICAI has issued the **Guidance Note** on Audit of Internal Financial Controls Over Financial Reporting (the 'Guidance Note')
- Substantially similar to **US PCAOB Auditing Standard (AS) 5**, *An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements.*
- The Guidance Note clarifies that the Act specifies the **auditor's reporting on internal financial controls only in the context of audit of financial statements,** and thus, consistent with the practice prevailing internationally, the term '**internal financial controls system**' stated in Section 143(3)(i) would relate to 'internal financial controls over financial reporting'.
- The Guidance Note covers aspects such as **scope of reporting on internal financial controls** under the Companies Act 2013, **essential components of internal controls**, **technical guidance** on audit of Internal Financial Controls, **implementation guidance** on audit of Internal Financial Controls
- The Guidance Note contains **illustrative list** of risk of material misstatement, related control objectives and control activities for several processes and standard template for testing controls

Guidance note: Key definitions

Internal financial controls ('IFC') (for the purpose of director's reporting – as defined under Companies Act, 2013) is wider which includes policies and procedures adopted by the company to ensure orderly and efficient conduct of company's business, including adherence to company's polices, 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.**



Internal financial controls over financial reporting ('IFCOFR') (for the purpose of auditor's reporting– as defined in the Guidance Note) – 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 the generally accepted accounting principles.

Guidance note: Key definitions

Deficiency

Deficiency in internal financial controls 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.**

Significant deficiency

A significant deficiency is a **deficiency, or a combination of deficiencies,** in internal financial controls 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.**

Material weakness

A 'material weakness' is a **deficiency, or a combination of deficiencies,** in internal financial controls over financial reporting, such that there is a r**easonable possibility that a material misstatement** of the company's annual or interim financial statements will not be prevented or detected on a timely basis**.**

Guidance note: Key highlights

Framework

- The Guidance Note have not prescribed a particular framework, instead the Guidance Note states that a benchmark system of internal control, based on suitable criteria, is essential to enable the management and auditors to assess and state the adequacy and compliance of the system of internal controls. Further, the Guidance Note refers to Appendix 1 of *Standards on Auditing (SA) 315*, *Identifying and Assessing the Risk of Material Misstatement through Understanding an Entity and Its Environment* which provides necessary criteria for internal financial controls over financial reporting for companies.

- The internal controls components referred to in Appendix 1 of SA 315 are similar to the internal controls components and its 17 principles enunciated in COSO framework.

- Auditor should make an assessment using the same framework as has been adopted by management

Materiality

- Based on quantitative and qualitative risk factors – similar to materiality used for financial reporting purposes

Guidance note: Key highlights

Top-down approach

Identifying significant financial reporting elements (accounts or disclosures) basis materiality determined

Identifying material financial statement risk within these accounts or disclosures

Identifying and observing the design effectiveness of the entity level controls which would address these risks

Identifying and observing the design effectiveness of the activity level controls which would address these risks

Testing the operating effectiveness of these entity and activity level controls

Guidance note: Key highlights

Timing of testing

- The **auditor's reporting** on the **adequacy and operating effectiveness** of company's internal financial control systems has to be **as at the balance sheet date**. Although, the extent of testing at or near the balance sheet date may be higher, the auditor should test the internal financial controls during the financial year under audit.

Extent of testing

- **number of samples** to test the design and operating effectiveness of internal financial controls

Control frequency	Lower risk	Higher risk
Annual	1	1
Quarterly (Including period end)	2	2
Monthly	2	3
Weekly	5	8
Daily	15	25
Recurring manual control	25	40

Guidance note: Key highlights

Reporting on management assessment

- Auditors are not required to report on the management's assessment of effectiveness on internal financial controls. **As a result, reporting by auditors will be an independent assessment on the adequacy and effectiveness of the company's internal financial controls.** Further an auditor is required to **communicate significant deficiency and material weakness in internal financial controls system** with those charged with governance.

Reporting on Interim financial statements

- The Guidance Note also clarifies that **reporting on internal financial controls will not be applicable with respect to interim financial statements,** such as quarterly or half-yearly financial statement, as reporting requirement is for financial statements prepared under the Act and for **audit reports issued under Section 143 of the Act**, unless such reporting is required under any other law or regulation

Guidance note: Key highlights

Reporting on consolidated financial statements

- The Guidance Note has clarified by stating that reporting on the adequacy and operating effectiveness of IFC **would apply even in the case of CFS, for the respective components included in the CFS, only if it is a company under the Companies Act 2013** and illustrative audit report for different circumstances in case of Consolidated Financial Statements is given in the Guidance Note. The Guidance Note provides **that the auditors can rely on the work of other auditor's and include reference of such reliance in its Auditor's Report** while reporting on internal financial controls over financial reporting, similar to reporting on the audit of financial statements.

IFC audit plan

IFC: Audit plan

Planning the audit

- Determine materiality
- Identify significant account balances and disclosures and their relevant assertions
- Multiple location scoping decisions
- Understand process flow of transaction
- Identify risk of material misstatement ("what could go wrong")
- Use work of others
- Use of specialist
- Service organization

IFC: Understand process flow of transaction

Step 1 - Identify and understand key processes relevant to the financial reporting (including how these transactions are initiated, authorised, processed, and recorded)

Step 2 - Identify points of material misstatement including one due to fraud

Step 3 - Identify the controls that management has implemented to address these potential misstatements

Step 4 - Select key controls to test to mitigate the risk

Note: Understanding process flow of a transaction provides foundation for the top-down, risk based evaluation of internal financial control over financial reporting.

Example processes:

Significant account balance **– Revenue and Receivable** →

Processes:
1. Customer master creation and updating
2. Invoicing
3. Revenue recognition
4. Collection

IFC: Identify ‘What could go wrong?’

Sl. No.	Cycle	Process	Relevant Assertions	Risk of Material Misstatement (“What Could Go Wrong”)
1.	Revenue/ Receivables	Revenue Recognition	Existence/Occurrence	i. Sales and accounts receivable are recorded that **do not relate to valid sales/ shipments** ii. Sales are **recorded prior to** all necessary revenue recognition criteria being met **iii.** **Credit notes are issued** or committed to the customer but **not recorded**
2.	Revenue	Revenue Recognition	Completeness	Goods are **shipped to** customers and **no invoice is generated** and recorded.
3.	Revenue	Revenue Recognition	Occurrence	Contract accounting **not consistent** with the terms

IFC: Identify 'What could go wrong?'

Sl. No.	Cycle	Process	Relevant Assertions	Risk of Material Misstatement ("What Could Go Wrong")
4.	Revenue/ Receivables	Revenue Recognition	Valuation gross	i. Revenue or **receivables are recorded at an incorrect amount.** ii. Existence of **side agreement not considered** to record revenue or receivables.
5.	Revenue	Revenue Recognition	Valuation net	Receivables included in the allowance for doubtful accounts calculation: • **Do not exist or the entity no longer has rights** to such receivables • **Do not include all** receivables.
6.	Revenue	Revenue Recognition	Cut off and Completeness	Revenue **not recorded in correct period**

IFC: Difference between process v controls

- **Processes <u>involve initiating,</u>** capturing, calculating, processing or recording transactions

- **Controls <u>prevent / detect errors</u>** in initiating, capturing, calculating, processing or recording of transactions

<u>Process</u>	**<u>Controls</u>**
1. Capturing a sales order in the order entry module	1. Requiring an authorization based on approved authorization matrix for a customer who has exceeded their credit limit.
2. Preparing a bank reconciliation statement	2. Investigating reconciling items above a threshold and resolving on timely basis.

IFC: Board categorization of controls

Entity Level controls

- Controls that **management relies on to establish "tone at the top"** relative to financial reporting.
- Often have **pervasive impact on effectiveness of controls** at the process, transaction or application level.
- Entity level controls are **in nature of governance controls**.

Activity Level controls

- Activities-level controls are **controls performed at the process level** within a transaction cycle.
- Pervasive on a company's internal control covering one uniquely identifiable process with in the organization to support the assertion relating to financial reporting

Information Technology Controls

- **Involves establishing controls relating to IT risks**. They are classified in two categories viz. **General Controls** and **Business Process Application Controls**.
- IT controls **protect the data integrity** and are **significant component of entity's IFCOFR**

IFC: Board characteristics of controls

Preventive v Detective controls

- Preventive control – Focuses on **preventing errors or exceptions**
- Detective control – Identifies an error or exception **after it has occurred**
- Because of the inherent limitations of internal control, **an entity should have an appropriate mix of preventive and detective controls**

Manual v Automated controls

- **People perform manual controls** and the reliability is affected by the possibility of human errors
- Operating system / Application software performs automated controls. They function **systematically and work with higher degree of consistency**

Foundational, Operational and Monitoring Controls

- Ensures appropriate controls **across the spectrum of the internal controls components** – an entity should have an **appropriate mix of** foundational (entity level), operational and monitoring controls.

IFC: Assessing design effectiveness of controls

Auditor should determine whether the company's controls:

- operated as prescribed by persons
- possessing the necessary authority and competence
- to perform the control effectively and satisfy the company's control objectives
- effectively prevent or detect errors or fraud that result in material misstatements in the financial statements.

- Management may **assess the design** of the control by performing **Walkthrough**.

- **Walkthrough can be performed by:**
  - Inquiry of appropriate personnel
  - Observation of Company's operations
  - Inspection of relevant documents
  - Re-performance of controls

IFC: Assessing design effectiveness of controls

- Ask probing questions

- Important to note that **inquiry alone ordinarily is not sufficient** to support design effectiveness

- Document the result of assessment of design in a memorandum that includes:
  - Name and designation of person interviewed
  - Description of item selected for assessment
  - Result of the assessment.

- Extent of testing – **One sample** should be selected for **each process** and should follow the **transaction from origination through company's processes, including information system, until it is reflected on company's records**

IFC: Design effectiveness of controls - Example

Particulars	**Description**
Significant Account balance	Accounts receivable
Relevant assertion	Valuations
Reasonably possible risk identified	Allowances for doubtful accounts not adequate
Control identified	Central Revenue team provides an ageing analysis report to GM Finance who reviews and approves provision for doubtful debts for non-collectible debtors based on provision policy. In case of write off approval is obtained as per the Provisions for Doubtful Debts and write off policy. The provision entry is created in the CRT by Central Revenue team for all entities.

IFC: Design effectiveness of controls - Example

Particulars	Description
Control tested through	Inspection
Testing performed	Sample selected: April 2013 Document No: 1313601127 Control: Central Revenue team extracted Invoice report. This report provides information on outstanding invoices as at April 30, 2013. Central revenue team member (Mr. XYZ) manually computed the ageing report based on the invoice due date. Once the ageing report is completed, provision was computed in accordance with Company policy as follows: 1. Invoice outstanding for 180 -365 days – 40% 2. Invoice outstanding for more than 365 days – 100% Sr. Group Manager (Mr. ABC) reviewed the ageing report and noted no exceptions. This is evident by signoff on Revenue SOx checklist. The file was then sent to Senior GM Finance (Mr. DEF) for review. Sr. GM Finance reviewed the completeness and accuracy of ageing report and computation of provision amount. He did not note any exception. Sr. GM Finance inquired with Corporate Revenue Head (Mr. GHI) to identify if revenue team/sales team have identified any loss event to determine requirement of specific provision. No such event was identified. The file was then approved by Sr. GM Finance. Subsequent to the approval, ensured that the appropriate entry was recorded in Oracle (reversal of provision – USD 44,467)

IFC: Test of operating effectiveness of controls

- **Testing** operating effectiveness involves following steps:
  - Identify controls to test (key controls)
  - Determine a testing strategy
  - Design testing procedures
  - Perform control tests and evaluating the impact of any deviations found
  - Aggregate such deficiencies and evaluate the impact
  - Communicate the deficiencies to those charged with governance and management as applicable

- **Nature** of test of controls

- **Timing** of test of controls

- **Extent** of test of controls

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IFC: Use of work of others

- Engagement teams may decide to use the work of others like:
  - Internal auditors
  - Company personnel; and
  - Third parties working under the direction of management.

- **Determine testing strategies:**
  - Evaluate the **nature of controls tested by others**
  - Evaluate **competence and objectivity of the person** who performed the work
  - Test and **evaluate the quality of their work**

IFC: Use of specialist

- The auditor **<u>may use the expert</u>** to assist him in obtaining sufficient and appropriate audit evidence.

- The expert may be **<u>internal specialist</u>** or **<u>external specialist</u>**.

- The extent of use of work performed by the expert **<u>depends on the risk associated with the controls being tested</u>** and also various factors as enumerated by the guidance note.

IFC implementation plan

IFC: Activities and Deliverables

	Phase I Design	Phase II Management Testing	Phase III Operating Effectiveness
Activities	- Identify key processes - Identify key financial and operational risks - Identify design gaps - Document risks and controls	- Create test sheets - Workshops to process owners - Templates for capturing exceptions - Co-develop remediation measures	- Receive self reporting from process owners - Test operating effectiveness
Deliverables	- Risk and Control Matrix - Process Flowchart - Exception report on design gaps	- Test Sheets - Management reporting template	- Exception Report on operating effectiveness

IFC: Design phase

	1 Scoping	2 Current State Analysis – "AS IS" processes	3 Conduct gap analysis	4 Design and validate 'To be' processes
Key Activities	• Identify financial reporting controls elements, critical processes, supporting systems and locations • Account level materiality and chart of accounts analysis • Confirm the methodology for the engagement • Prepare a detailed project plan • Identify process owners • Devise communication and reporting protocols	• Understand the 'as-is' process and sub-processes by interviewing key operating personnel • Review entity level controls • Conduct process / system walk-through including all the process steps where finance has an interface. • Review ITGC Controls on the accounting systems being used at 3M	• Map risk factors and dependencies • Identify 'gaps' and 'what can go wrong' in existing processes • Identify control points with improvement opportunities • Identify anti-fraud controls w.r.t. segregation of duties, safeguarding and authorization controls • Test one sample for each control to establish test of design	• Suggest remedial action for gaps identified, in line with leading practices, and to ensure compliance • Prepare 'To-be' process maps • Update the risk control matrix and obtain buy-in from the process owners • Constant interaction with statutory auditor • Develop and institutionalise a frame-work to make a continuous assessment on internal controls
Deliverables	• Detailed project plan	• 'As-is' process documentation	• Gap Analysis Report	• 'To-be' process maps • Risk control matrix • Control Dashboard for the Leadership Team

Focus on significant risks and controls having an interface with finance function for each in-scope process

IFC: Testing phase

	Testing	Exception	Remediation
Activities	- **Provide simple, clear and detailed templates to process owners for testing** - **Workshops with process owners covering methodology, RCMs, and information required for testing** - **Management will perform testing of key internal financial controls**	- **Self certification on controls tested** - **Process owners will identify exceptions, if any** - **Develop a remediation testing plan**	- **Remediate exceptions in a timely manner before test of operating effectiveness**
Deliverables	- **Test Sheet Templates**	- **Completed Test Sheets** - **Management reporting template**	

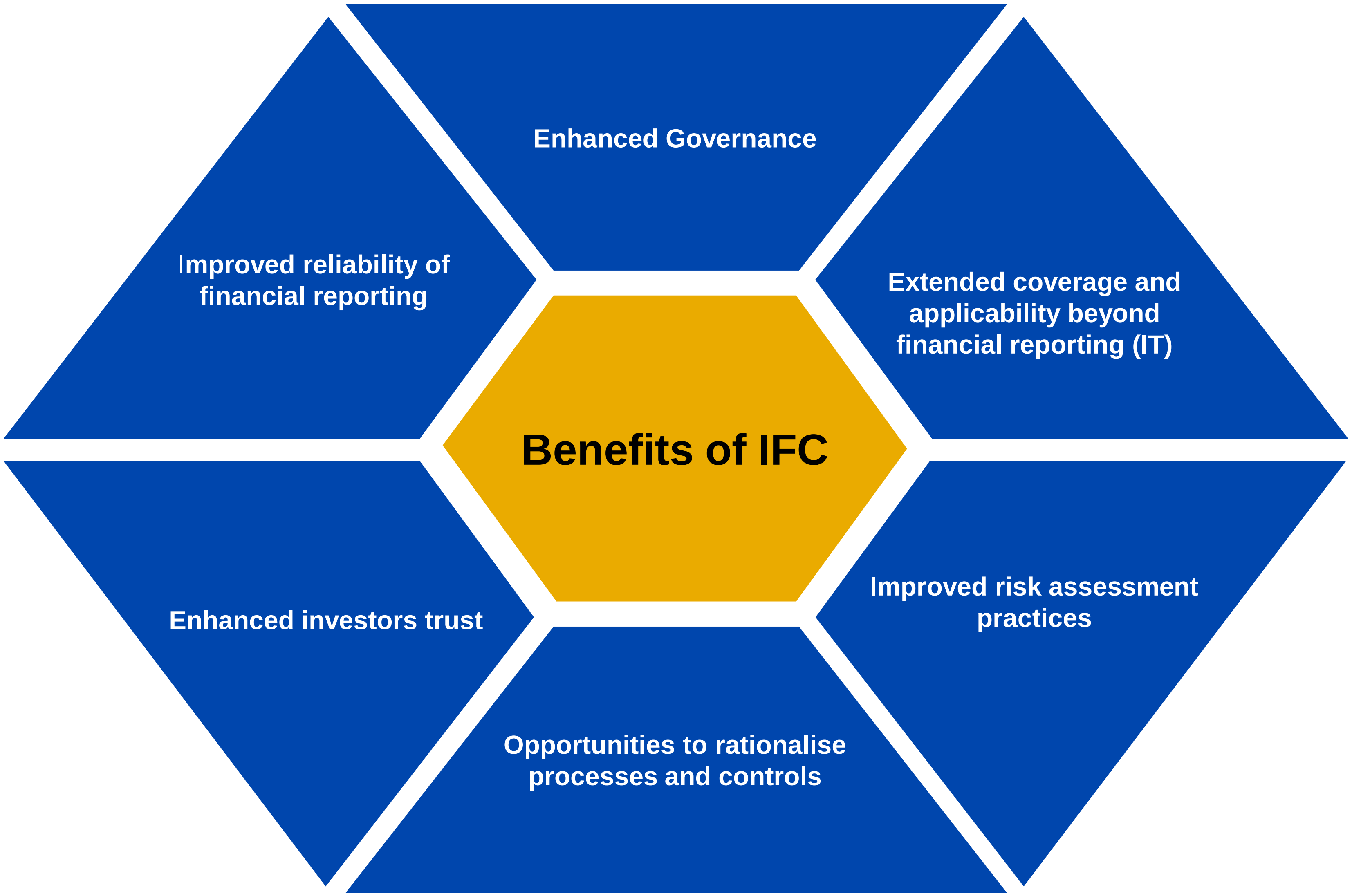
IFC: Operating effectiveness phase

Steps	1 Re-test	2 Remediate	3 Co-ordinate with Statutory Auditors	4 Evaluate
Key Activities	• Re-perform test of operating effectiveness • Identify additional gaps, if any	• Work with process owner to remediate gaps • Gaps to be remediated as of year end date	• Match management test results with test results as per auditor • Reconcile any differences in test results • Perform any additional testing, as needed	• Identify population of deficiencies, compensating controls • Jointly assess impact across locations– deficiency, significant deficiency, material weakness
Deliverables	• Final GAP analysis report			• Final exception report

Focus on significant risks and controls having an interface with finance function for each in-scope process

IFC: Benefit and Nuances

IFC: Benefits



…but, these can be managed

Board

- Start early
- Allocate adequate budget
- Understand impact of IFC reporting
- Educate stakeholders
- Establish key timelines and define milestones

IT Systems

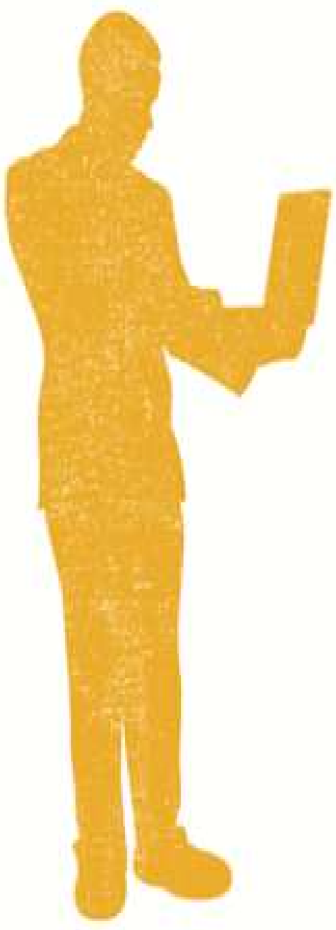
- Plan both ‘quick fixes’ and major system modifications to enable sustained adequate control environment
- Involve IT specialist for testing of ITGCs and automated controls

Management

- Understand IFC principles and provide training
- Define roles and responsibilities for project team well in advance
- Prepare revised standard operating policies and practices
- Manage overall process of establishing adequate control environment
- Obtain agreement from external auditor on the approach and reporting requirements
- Communicate the progress of the project to Board

Reporting

Evaluating deficiencies



- Management must **<u>evaluate the severity of each control deficiencies</u>** that comes to their attention.

- Determine whether **<u>deficiencies, individually or in combination, are material weakness.</u>** Factors to be considered include

  - Likelihood that the deficiency will result in a financial misstatement

  - Magnitude of such outcome

- **<u>Evaluate the effect of compensating controls</u>** when determining whether a control deficiency or **<u>combination of deficiencies is a material weakness</u>**

- Attempt to **<u>remedy deficiencies</u>** and **<u>test remediated controls</u>**

- Control deficiencies that are determined to be a **<u>material weakness must be disclosed in management's annual repor</u>**t on its assessment of the effectiveness of IFCOFR.

Compensating v complimentary controls

Compensating controls

- Balancing of weak controls in a process with the strong controls within the same process.
- reduce the severity of the deficiency but not eliminate the deficiency.
- Example: Weak manual controls are compensated by strong automated controls or vice versa

Complimentary controls

- These controls enhance the effectiveness of two or more controls
- Example: Manual controls are complimented by automated controls and vice versa.

Communicating deficiencies

- Auditor's responsibility is to communicate, in writing,
  - all material weaknesses;
  - significant deficiencies; and
  - combination of deficiencies resulting into a significant deficiency

- To management and those charged with governance

- As and when they occur but before the issuance of audit opinion on internal control over financial reporting.

Reporting

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

- **Auditors may issue separate or combined report/s on internal financial controls over financial reporting and financial statement audits.** The date of the audit report on internal financial control over financial reporting should be the same as that of the date of the audit report on the financial statements where separate reports are issued.

- **Single period for the internal control audit** (never comparative).

Particulars	Effect on Financial Statements	
	Material and Pervasive	Material but not Pervasive
Material weakness identified	Adverse	Qualified
Scope limitation	Disclaimer	Qualified

- **The modified audit opinion on internal financial controls over financial reporting may or may not affect the type of audit opinion on financial statement audit.**