Internal financial controls

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Synopsis

- Refresh on IFC
- Snapshot from revised ICAI guidance note
- Approach for ICFR implementation

IFC, as per Companies Act, 2013

As per Section 134 of the Companies Act 2013, the term 'Internal Financial Controls' means the policies and procedures adopted by the company for ensuring:

- orderly and efficient conduct of its business, including adherence to company's policies,
- safeguarding of its assets,
- prevention and detection of frauds and errors,
- accuracy and completeness of the accounting records, and
- timely preparation of reliable financial information.

Determining IFC/ ICFR applicability across entities

	Requirements		Listed	Public unlisted: Specified class of companies*	Public unlisted: Others	Private
1	Director's Responsibility Statement (134)	IFC	●			
2	Auditor Report (143)	ICFR	●	●	●	●
3	Audit Committee (177)	ICFR	●	●		
4	Independent Directors (Schedule IV)	ICFR	●	●		
5	Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 – BOD report – Financial Statements only (ICFR only)	ICFR		●	●	●

**** Specified class of companies***

(a) Public companies with a paid-up share capital >= INR 10 Cr

(b) Public companies having turnover >= INR 100 Cr

(c) Public companies having, in aggregate, outstanding loans or borrowings or debentures or deposits >= INR 50 Cr

Amendments - Revised guidance note

What remains the same?

Auditor should use the same materiality considerations defined in *SA 320* for ICFR and financial statements

Auditor may adopt integrated audit (testing of controls to accomplish audit of ICFR and financial statements)

Auditor should report if the company has adequate internal controls system in place and whether they were operating effectively at the balance sheet date

Reporting on ICFR will not be applicable for interim financial statements

What is modified?

Auditor is required to report on ICFR, on Consolidated financial statements (CFS) for components incorporated under CA 2013

Reference to COSO framework is replaced with *SA 315 issued by ICAI*

- Control environment
- Entity’s risk assessment
- Control Activities
- Information system and Communication
- Monitoring of controls

Tests of design

Tests of design

Objective

- to determine if a deficiency in design exists

Deficiency in design exists when:

- Control is missing
- Existing control is not properly designed

How to test design effectiveness of controls?

Auditor should test the design effectiveness of controls by determining whether the company's controls:

- satisfy the company's control objectives
- can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements

Evaluation of design of relevant controls

Factors to be considered by auditor:

- Nature and significance of risks of material misstatement addressed by the control
- Characteristics or details of the control
- Factors to determine whether the control is appropriately designed

Professional judgement is necessary to evaluate the design of relevant controls.

Factors to consider when determining whether control is appropriately designed

- Appropriateness of the purpose of the control and its correlation to individual risk/ assertion
- Appropriateness of the control considering the nature and significance of the risk
- Competence and authority of the person(s) performing the control
- Frequency and consistency with which the control is performed
- Level of aggregation and predictability
- Criteria for investigation and process for follow-up
- Dependency on other controls or information

Tests of operating effectiveness

Tests of operating effectiveness

How to test operating effectiveness of controls?

Auditor should test the design effectiveness of a control by determining:

- whether the control is operating as designed
- whether the person performing the control possesses the necessary authority and competence to perform the control effectively

Consider the following:

- There is no need to test the operating effectiveness of controls that are improperly designed
- If the control does not operate effectively, then it is a ‘deficiency in operating effectiveness’

Approach to Financial reporting controls

Phase 1 Assess and plan

1a Assess materiality and define coverage

1b Develop documentation standards

Phase 2 Document

2a ELC documentation

2b ITGC documentation

2c Risk identification and mapping of controls

2d Conduct walkthroughs to identify operating gaps

2d Develop testing strategy

Phase 3 Testing

3a Self testing

3b Independent testing

Phase 4 Reporting

4a Reporting considerations

4b Auditor's reporting

Work products

Phase 1

a) Prioritized processes and coverage
b) Financial reporting controls roadmap
c) Documentation standards / templates

Phase 2

a) Entity level documentation and SoD
b) Risk & Control Matrix and gap report
c) Walkthrough documents, deficiency logs and remediation
d) Testing strategy

Phase 3

a) Test results
b) Management reports

Phase 4

a) Impact assessment
b) Auditor's report

Detailed approach

Assess and plan | Document | Testing | Reporting

Accounts	Amount	Significant account
Cash & cash equivalents		
Cash in hand	600,000	✓ Susceptibility to fraud/error
Cash at bank	980,123,000	✓ Materiality
Accounts Receivable		
Accounts receivable	502,405	✖ Not a significant account
Accrued revenue	55,550,400	✓ Susceptibility to fraud/error
Allowance for bad debt	(1,940,305)	✓ Subjectivity in estimation
Fixed Assets		
Property and Equipment, Leased	59,204,240	✓ Materiality
Property and Equipment, Owned	490,420	✖ Not a significant account
Goodwill and Intangibles	189,204,000	✓ Materiality + Subjectivity
Capital Work-in-progress	45,603,000	✓ Susceptibility to fraud & error
Investments	1,000,000	✖ Not a significant account
Other current assets		
Current portion of deferred taxes	78,802,840	✓ Subjectivity in estimation
Employee receivables	43,789,900	✓ Susceptibility to fraud/error
Advances to vendors	8,794,000	✓ Susceptibility to fraud/error

Parameters considered

Quantitative factors
- % of revenue
- % of pre-tax income

Qualitative factors
- Transaction complexity
- Subjectivity and estimates
- Susceptibility to fraud and error
- Unresolved external and internal audit issues

Identification of significant accounts

Mapping significant accounts to processes

Accounts	PTP	Production	Sales	Payroll	Accounting	Taxation	Treasury
Cash and cash equivalents							
Cash in hand	✓		✓	✓	✓		✓
Cash at bank	✓		✓	✓	✓	✓	✓
Accounts Receivable							
Accounts receivable			✓		✓		
Accrued revenue			✓		✓		
Allowance for bad debt			✓		✓		
Inventories							
Raw-materials	✓	✓			✓		
Work-in-progress		✓			✓		
Finished goods		✓			✓		
Goods-in-transit	✓	✓			✓		
Provision for obsolescence					✓		
Other current assets							
Current portion of deferred tax					✓	✓	
Prepaid expenses	✓				✓		
Employee receivables				✓	✓		
Advances to vendors	✓				✓		

ILLUSTRATIVE

Detailed approach

Assess and plan | Document | Testing | Reporting

Procurement to pay process

	Risk details		Financial assertions				
Sub process process	Risk # #	Risk	Complete-ness	Existence/ Occurrence e	Valuation /Measurement t	Rights and obligations	Presentation on and disclosure
Balance confirmation on	BP.01 1	Differences between vendor accounts and vendor and vendor statements are not investigated and investigated and resolved timely which may lead may lead to misstatement of financial information information		✓		✓	
Accounting g	BP.02 2	Incorrect/ unauthorized processing of invoices invoices resulting in incorrect/ excess payment to payment to vendors	✓	✓	✓	✓	

Control description						
Control # #	Existing control	Key control control	Evidence	Frequency	Type	Nature
BP.01.01	Vendor balance statements are are requested from vendors on pre- on pre-defined periodicity for confirmation as per policy	Y	1. Policy for vendor balance balance confirmation 2. Vendor balance confirmation	Quarterly	Manual	Detective
BP.02.02	System is configured to perform perform three way match between between vendor invoice, GRN and and PO to validate rate and quantity and highlight exceptions exceptions	Y	System report	Ongoing	IT dependent dependent	Preventive e

Detailed approach

Assess and plan | Document | Testing | Reporting

Financial statement close process

Illustrative FSCP process self certification			
Sub- process	Control ref #	Existing control	Control evidence
Cut off procedures	FSCP.02.03	Manual journal entries (MJE's) are approved in ERP as per DOA and are accounted post approvals	1. JV documents 2. JV Policy

New MJE WORKFLOW Request # 136343305	
Workflow Status	Closed [Approved] Click to view workflow status Current Step(s) : Auto Close
Community	India MJE Portal
Requestor	M, Ramkumar
Requestor SSO ID	105063486
Requestor Phone	+914449680265
Requestor Business Name	Global Ops-ASIA-Finance
Requestor Department Name	Global Ops-Asia-Fin-R2R IN-BLR-F-D
Business Segment	Global Ops-Asia
Industry Focus Group	GE Global Operations
Legal Entity ID	I00162
Requestor Location	Thru Vi Ka Industrial Estate Ekkaduthangal, Ramnath Towers No. 29A, Guindy,, Chennai, TN, 600 032, IN
Manager Name	P G, Pradeepa
Manager's SSO	212424901

Audit Trail (Workflow History)	
July 02, 2015 10:45:57 AM	Request has been approved through automatic approval.
July 02, 2015 10:45:56 AM	Request approved by ~Corp Support Central, Distribution Lis
July 02, 2015 10:10:26 AM	Request submitted by Bagaria, Vishwas [Process Leader].
July 02, 2015 2:40:59 AM	Request submitted by M, Ramkumar [Requestor].

MJE policy

MJE DoA

Testing and documentation

Control Statistics

Control summary					
Sub process	# Total controls	# key controls passed	# key controls failed	# non key controls passed	# non key controls failed
Cut off procedures	2	1	0	1	0
Reconciliation	1	0	1	0	0
Foreign exchange fluctuations	3	1	-	1	1

Test summary and remediation

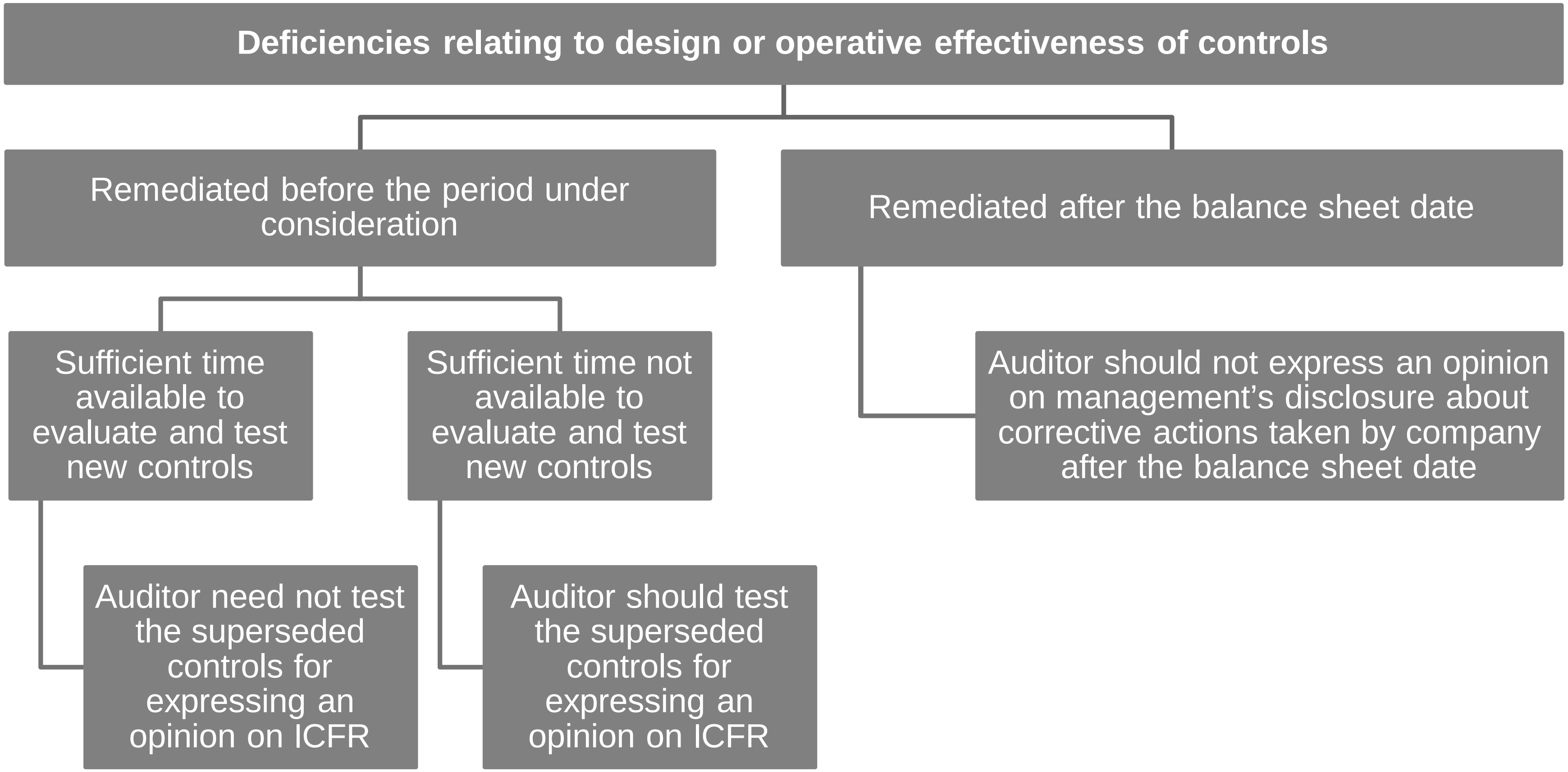
Exception reporting					
Control Ref #	Existing control	Control evidence	Reason of failure	Remediation plan	Timeline
RV.01.03	Provision entries for doubtful debts are approved by finance manager	Email approval for entries	Provision entries are not approved	All provision entries will be approved by finance manager	Oct'15
R2R.02.01	All reconciliations are approved	Approved reconciliation reports	Reconciliation reports are not approved	Reconciliation reports will be approved	Oct'15

Detailed approach

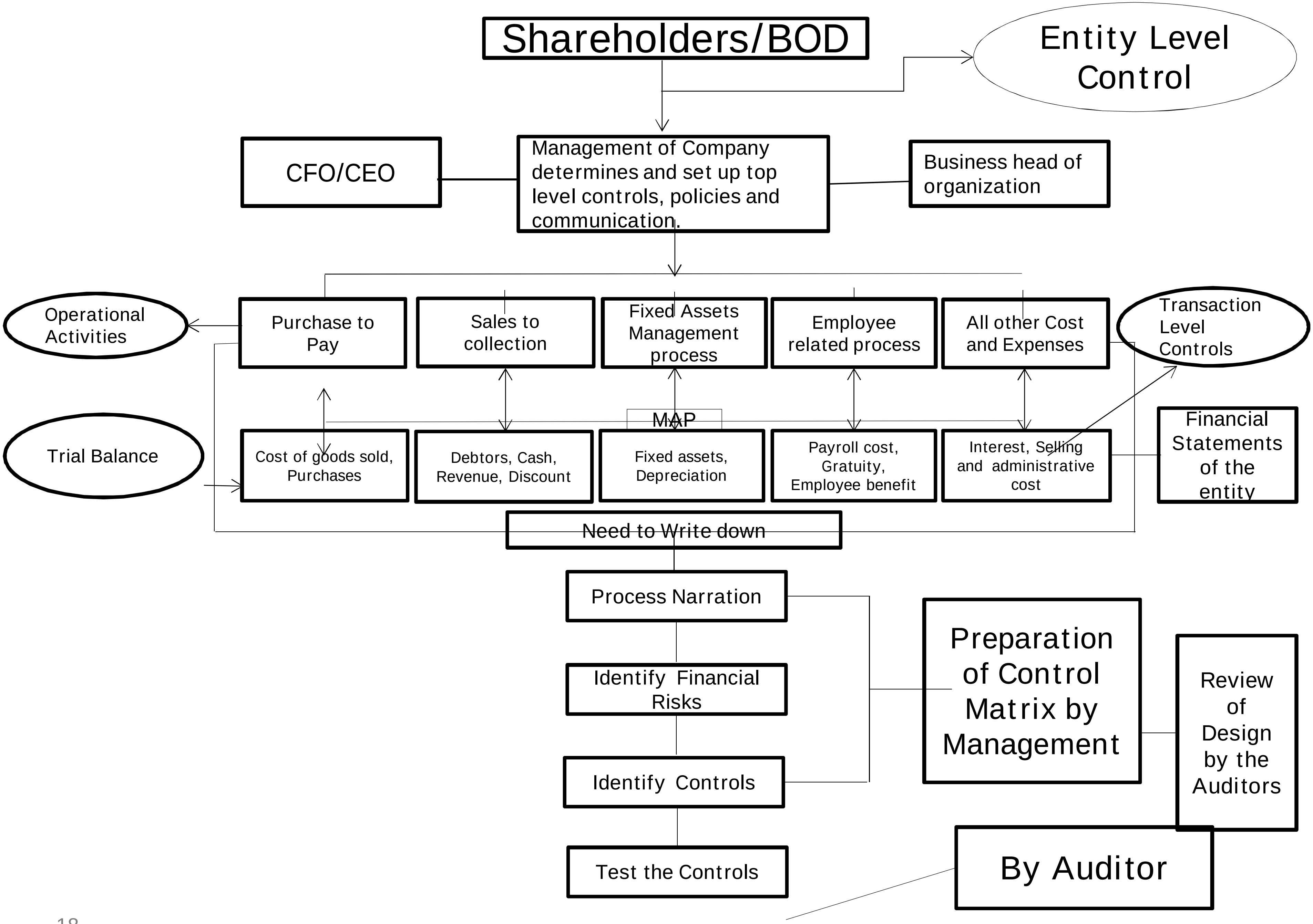
Frequency of control activity	Minimum sample size Risk of failure	
	Lower	Higher
Annual	1	1
Quarterly (including period- end, i.e., +1)	1+1	1+1
Monthly	2	3
Weekly	5	8
Daily	15	25
Recurring manual control (multiple times per day)	25	40

Remediation testing

Remediation testing



- Amount of time that a control should be in place and operating effectively depends on the nature of the control and how frequently it operates.
- Amount of time a remediation control should be existence for placing reliance on the control by the auditor is a matter of professional judgement.

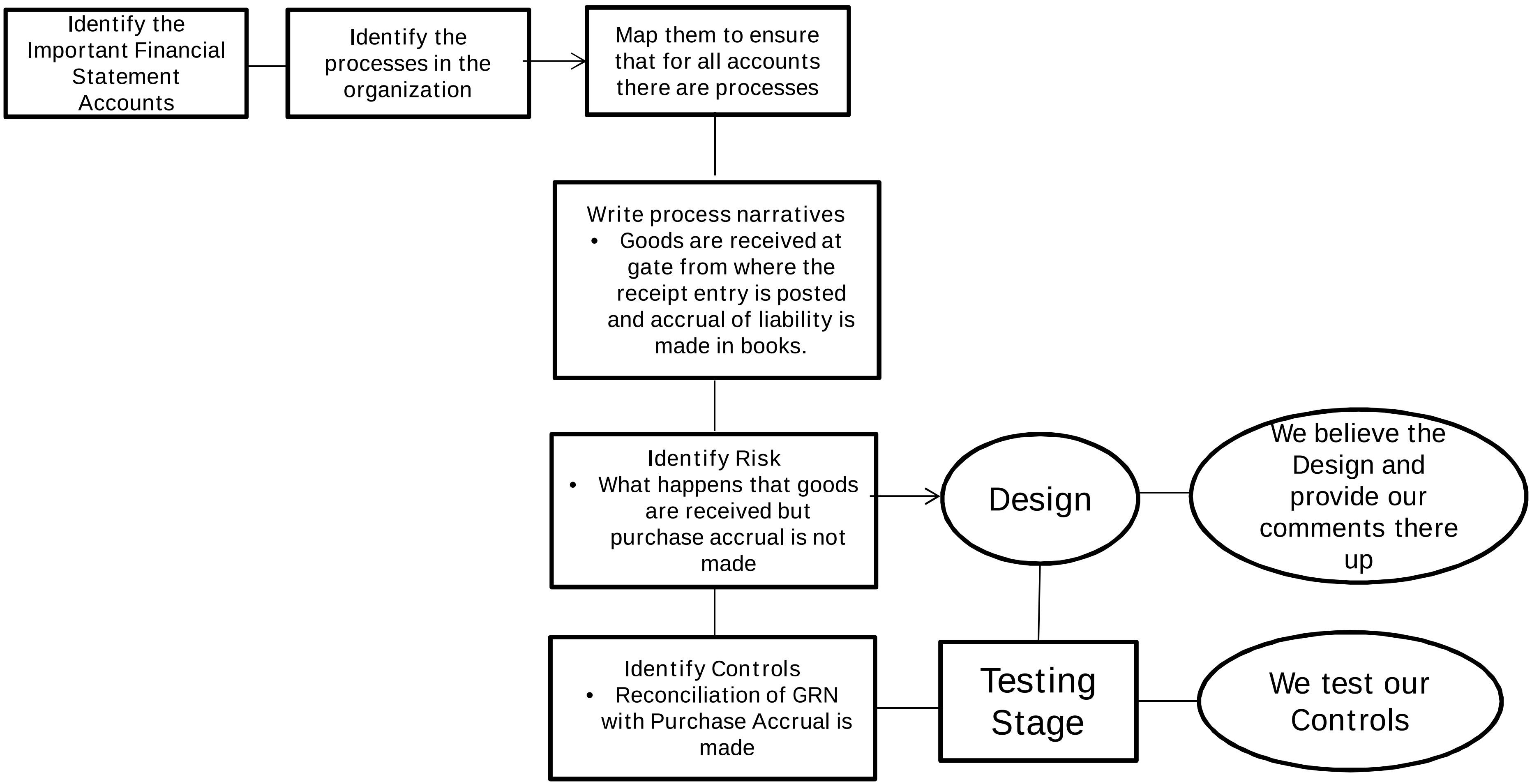

Shareholders/BOD
Entity Level Control
CFO/CEO
Management of Company determines and set up top level controls, policies and communication.
Business head of organization
Operational Activities
Purchase to Pay
Sales to collection
Fixed Assets Management process
Employee related process
All other Cost and Expenses
Transaction Level Controls
MAP
Trial Balance
Cost of goods sold, Purchases
Debtors, Cash, Revenue, Discount
Fixed assets, Depreciation
Payroll cost, Gratuity, Employee benefit
Interest, Selling and administrative cost
Financial Statements of the entity
Need to Write down
Process Narration
Identify Financial Risks
Identify Controls
Test the Controls
Preparation of Control Matrix by Management
Review of Design by the Auditors
By Auditor

What Needs to be done?

A. Entity level controls:

Identify the management level entity controls, document them and ensure that they are adhered to.

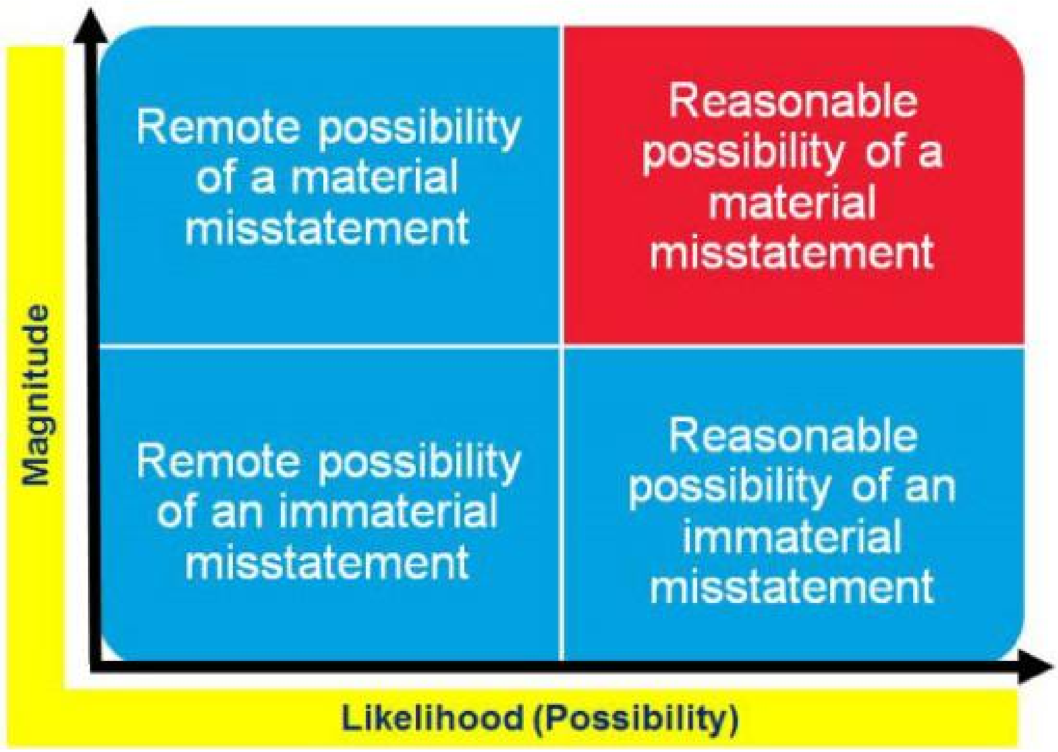
B. For operational activities



Evaluation of deficiencies

For evaluation of the severity of a deficiency in IFC, auditor should primarily consider two factors:

- Likelihood that the deficiency will result in a financial



- This process is, in essence, an exercise of risk analysis
- There are no bright-line tests based solely on quantitative measures
  - Qualitative measures must also be considered
  - Professional judgement is required

Reporting Considerations

- Auditor should express a qualified opinion on ICFR:
  - when the auditor, having obtained sufficient appropriate audit evidence, concludes that:
    - such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis, or the control is missing, and
    - effects/ possible effects of the material weakness in such internal controls are material but not pervasive to the financial statements

Qualified opinion

Examples

- Company not having 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.
- Company's internal financial controls over customer acceptance, credit evaluation and establishing customer credit limits for sales, not operating effectively which could potentially result in the company recognising revenue without establishing reasonable certainty of ultimate collection.

Adverse opinion

- Auditor should express an adverse opinion on ICFR:
  - when the auditor, having obtained sufficient appropriate audit evidence, concludes that:
    - such controls are designed, implemented or operated in such a way that it is unable to prevent, or detect and correct material misstatements in the financial statements on a timely basis, or the control is missing, and
    - effects/ possible effects of the material weakness in such internal controls are both material and pervasive to the financial statements, even if the audit opinion on the financial statements is unmodified

Examples

- Company not having 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 also not adequate. These could potentially result in material misstatements in the company's trade payables, consumption, inventory and expense account balances.
- Company's internal control system for inventory with regard to receipts, issue for production and physical verification not operating effectively. Further, the internal control system for identification and allocation of overheads to inventory also not operating effectively. These could potentially result in material misstatements in the company's trade payables, consumption, inventory and expense account balances.

Thank you

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