

Internal Financial Controls over Financial Reporting

***Planning the Audit – Role of
Risk Assessment***

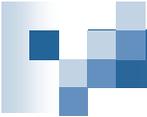
Jyotin Mehta

Mumbai, 20th November 2015

Corporate Governance Timeline

1998	<ul style="list-style-type: none">• CII
1999	<ul style="list-style-type: none">• Kumar Mangalam Birla Committee
2000	<ul style="list-style-type: none">• Clause 49• DCA – Task Force on Corporate Excellence
Enron 2001	
2002	<ul style="list-style-type: none">• Naresh Chandra Committee
2003	<ul style="list-style-type: none">• DCA Report• Narayana Murthy Committee
Lehman 2008 Satyam 2009	
2004	<ul style="list-style-type: none">• Amended Clause 49
2013	<ul style="list-style-type: none">• New Companies Act & IFC

Role of Audit Committee; independence of Internal and Statutory Auditors



Regulatory Mandate

Director's Responsibility Statement

Section 134 (5)(e) of Cos Act 2013

Directors, in the case of a listed company, had laid down internal financial controls & that such internal financial controls are **adequate and were operating effectively**

Only Listed entities

Board of Director's report

Rule 8 (5) of Companies (Accounts) Rules

The details in respect of **adequacy of internal financial controls** with reference to the **financial Statements**

All Entities – Listed or Unlisted

Powers and duties of auditors and auditing standards

Section 143 (3) (i) of Cos Act 2013

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

All Entities – Listed or Unlisted

Code for Independent Directors (ID)

Section 149 (7), Schedule IV of Cos Act 2013

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

Applicable to all companies having ID

Audit Committee (AC) terms of reference

Section 177 of Cos Act 2013

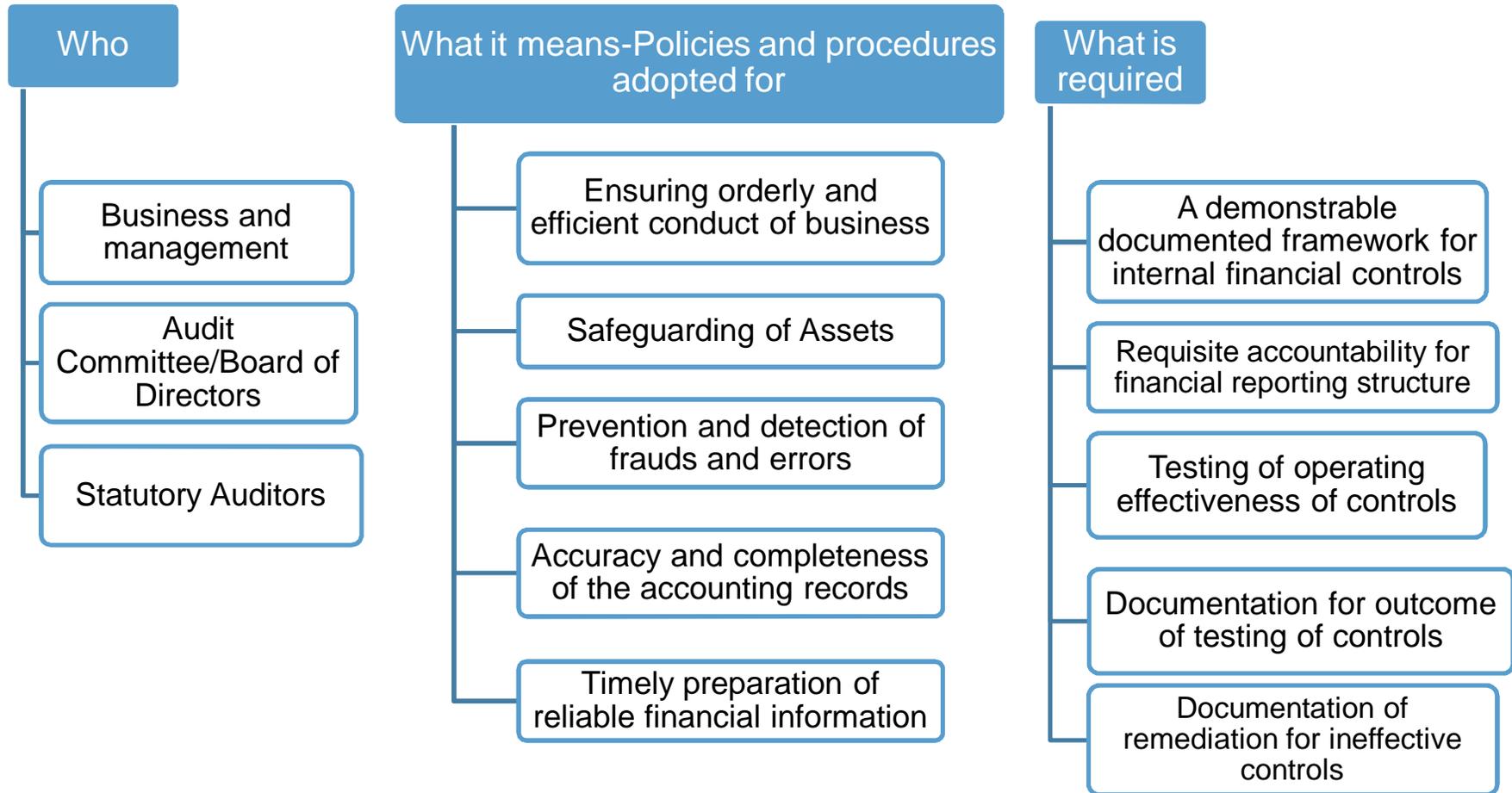
Sub Section (4) - "Evaluation of internal financial controls and risk management systems"

*Sub Section (5) – "Call on auditors to comment in **internal control systems & before their submission of Financial Statements** to the Board, September also discuss any related issues with the internal & statutory auditors and the management"*

Applicable to all companies meeting AC requirements

SEBI Clause 49 of Listing Agreement also has internal control compliance requirements for Listed Entities

Reporting responsibility-Companies Act, 2013





Three lines of defence–Internal Financial Controls (IFC)

Board of Directors/Audit Committee

Senior Management

Responsible for setting up the controls, mitigation of risk and defining policies and procedures to be complied with

Business Units/ Finance

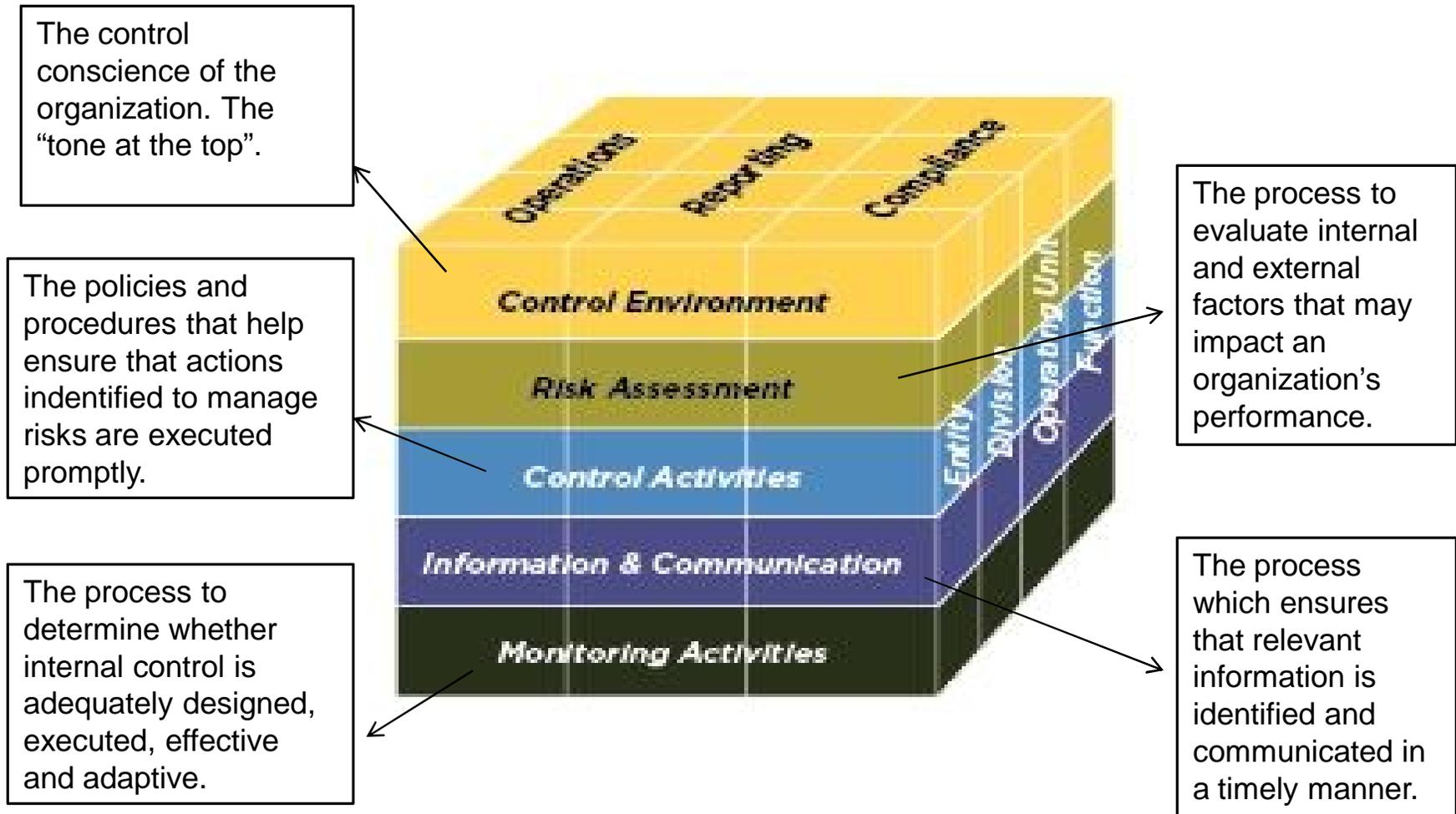
The second line monitors compliance with the laid down controls.

Internal Audit

The third line provides independent assurance on the activities of first and second lines of defence

External Audit

COSO Framework





Risk and Risk Analysis

Risk

Risk indicates potential loss resulting from inadequate or failed internal processes, people and systems, or from external events. It also can be defined as an anticipated event or action that has a chance of occurring, which may result in a negative impact.

Risk Analysis

The process of determining how often specified events may occur (likelihood) and the magnitude of their consequences (impact).



Types of Risks

Types of Risk (External and Internal)

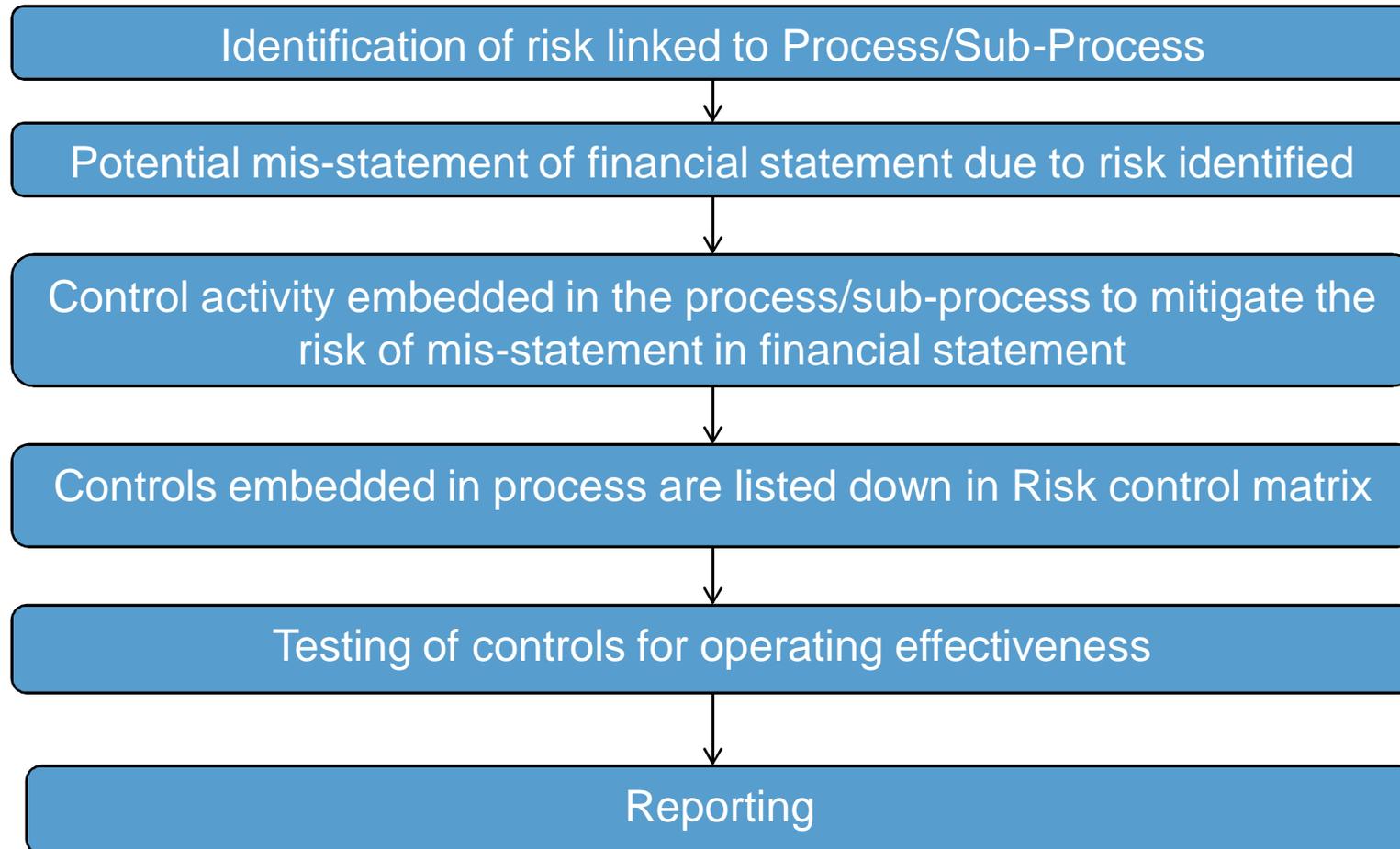
- **Business Risk** - relating to the economy, technology and competition
- **Financial Risk** - relating to liquidity, interest rates, exchange rates and misuse of financial resources.
- **Compliance Risk** - relating to breach of stock exchange regulations, non compliance with accounting standards or company law, non compliance with tax laws or environmental regulations.
- **Operational Risk** - relating to loss of assets, poor service levels, employee related issues or shortage of raw materials.
- **Reputation Risk** – Overriding risk. Reputation risk include ethics, safety, security, sustainability, quality and innovation.



Risks in financial statements

- **All transactions are recorded ?**
- **Recorded transactions are valid ?**
- **Transactions are accurately recorded ?**
- **Transactions are recorded in accounts in the correct period ?**
- **Assets and liabilities are correctly valued ?**
- **Account balances are presented correctly ?**

Risk and Internal Financial Control





Documentation for Internal Control over Financial Reporting – Risk Control Matrix

The Company should maintain documentation that provides reasonable support for its assessment of the effectiveness of Internal Control over Financial Reporting (ICFR) covering:

Risk Control Matrix – It captures controls over relevant assertions related to all significant accounts and disclosures in the financial statements, including

- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties
- Controls over the period end reporting process
- Controls over safeguarding of assets.
- Risk identified to each control activity
- Assertions
- Nature of control (Manual, Combination and Automation)
- Frequency of Control Activity.

Risk Control Matrix is prepared for each process (Example – Revenue, Inventory, Expenditure, etc).

Controls are placed in an organization

Entity Controls

Entity controls set the tone for the organization.

Examples include:

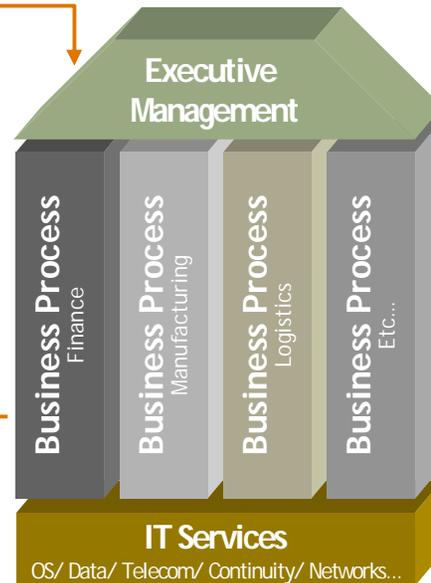
- Systems planning
- Operating style
- Enterprise policies

Anti-fraud Controls

- Governance
- Collaboration
- Information sharing

Examples include:

- Controls over journal entries
- Whistleblower program
- Audit committee oversight
- Prevention of insider trading



General IT Controls

Controls embedded in common services form General IT Controls.

Examples include:

- Systems maintenance
- Disaster recovery
- Physical and logical security
- Data management
- Incident response

Process level Controls

Controls embedded in business process, designed to achieve completeness, accuracy, validity, and recording assertions.

Examples include:

- Authorizations
- Approvals
- Reconciliation

Period-end Controls

Controls that ensure appropriate financial reporting and closing.

Controls as per IFC – Risk Control Matrix

Entity-level Control

Entity-level controls are controls that are common across most departments/units within the Company and therefore, are generally more efficient to test at the entity level.

Example – A Delegation of Authority (DOA) Matrix is maintained by divisions and corporate. Division Heads to establish and communicate the delegation of authority and approval of transactions.

Process-level Control

Process-level controls are controls that specific applicable to a class of transaction and related to business cycles.

Examples : Review of Open Orders is done by Branch Head. The open orders are cancelled centrally, at the end of every quarter and fresh orders are generated, if necessary.

General IT controls

General IT Controls that apply to all systems components, processes, and data for a given organization or information technology (IT) environment.

Examples : Approved Server/Database/net work devices hardening guidelines should be established for hardening the servers, databases and network devices.

Operating Controls

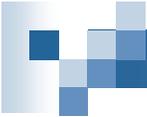
These controls are designed to ensure that day to day actions are consistent with established plans and objectives of the organization.

Examples: Policies and procedures, SOPs, Work instructions, Department procedures, process maps, flow diagrams, forms and format



Internal Financial Control Testing

- Testing of controls should be carried out to determine whether selected internal controls are operating effectively during a relevant period.
- Testing should be carried out for all categories of internal financial controls, viz. entity controls, process controls and IT controls.
- The testing plan should be drawn up to ensure that entity and IT controls are tested prior to testing of the process level controls.
- The testing team should be independent from day to day functioning of the respective controls.
- Testing operating effectiveness: Operating effectiveness refers to whether the control is functioning as expected.
- Techniques for testing Operating Effectiveness (Inquiry, Inspection, Observation and Reperformance).



Outcome of operating effectiveness testing

Types of deficiencies

A *control deficiency* 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. Any control weakness observed during testing may be *first classified as control deficiency*.

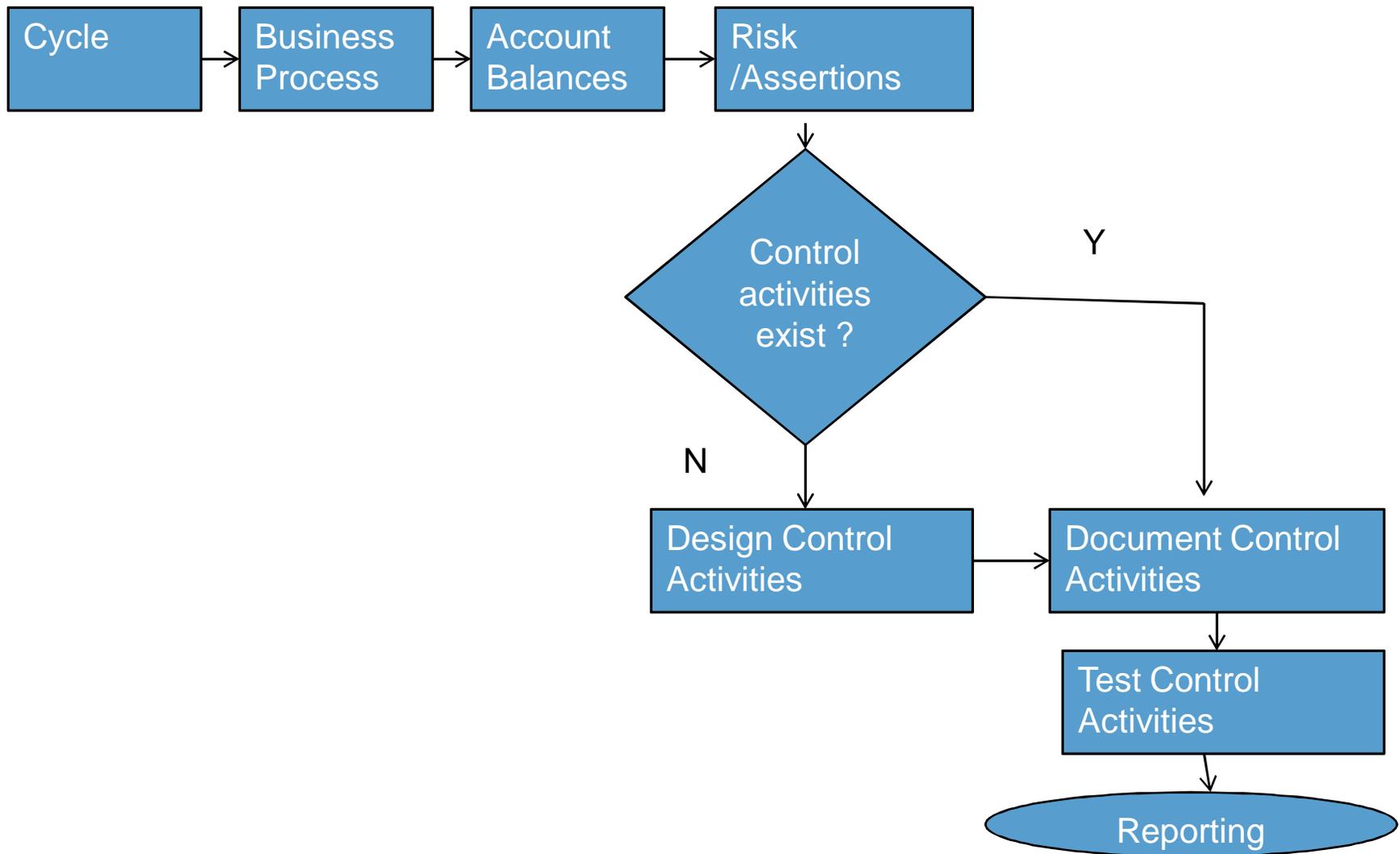
Significant Deficiency

A 'significant deficiency' is a deficiency, or a combination of deficiencies, in internal financial control 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 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.

Approach and methodology - IFC





Internal Audit & Internal Financial Control

- **No formal role definition for internal audit in IFC process under the Act.**
- **Risk based audit approach followed by Internal audit reinforced by documented RCMs**
- **Internal audit can pre-empt the review by statutory auditors and help the organization bridge gaps, if any**
- **Independent reporting to Audit Committee**



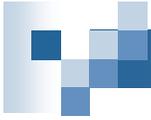
Some thoughts..

- **Keeping RCMs updated for changes in environment, laws, organization, processes.**
- **Defined process for RCM revision in Company's IFC Framework**
- **Internal audit should look at RCMs afresh when planning internal audits**
- **Automation is the key**
- **DOCUMENTATION!!**



IFC and S-Ox

- **Different stages of maturity – IFC yet to evolve**
- **Moving up the curve, process level controls will migrate to entity level controls as has happened in S-Ox**
- **Guidance from ICAI only for statutory auditors as of now – more to follow? (PCAOB has guidance for management as well)**



Thank You!!

20-Nov-2015