INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING

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CONTROLS

Group Level	Entity Level	Functional/Process Level
	Organizational Structure	
Policies Including Risk Management Policy	Statutory Compliance Mechanism	Delegation of Authority Matrix
	Code of Conduct/ Ethics Policy	Segregation of Duty
MIS Reporting	Internal Audit Mechanism	Risk Control Matrix
	Whistleblower Mechanism	Standard Operating Procedures (SOP)*
KPI/ Compensation Policy*	Disaster Recovery *	
	Business Continuity *	IT General Control including Access Rights

Combines PLC & ELC. ELC to be mapped to group control as needed

*All are not mandatory for IFC Compliance but a "must have" for operating business efficiently be it listed or unlisted

Fraud and IT controls needs to be addressed while designing both ELC, PLC

PROCESS Vs CONTROL

Process

Action of taking transaction or event through an established and usually a routine set of procedures or steps

Control

Control is an action or activity taken to prevent or detect misstatement within process.

Example

Process - Receipt of purchase order and entry as sales order in the system by sales staff.

Control – Verification and approval of sales order by head of sales department.

TYPES OF CONTROL

Preventive	➢ Prevent errors initially before recording in the books. Example - verification of accounting entry computation prior to recording, approvals before action.
Detective	➢ Expose the errors after their initial recording. Example - Review of BRS/ reconciliation of subsidiary ledger balances with G.L. control A/c balances.
Manual	➢ People perform manual controls Example – Authorization of purchase orders.
Automated	➢ The Operating system or application software performs automated controls. Example – Recording and monitoring attendance through biometric machine.

TYPES OF CONTROL – ENTITY LEVEL CONTROLS

Illustrative Entity Level Controls

1. Code Of Conduct
2. Whistleblower Policy
3. Risk Management Policy (ERM)
4. HR Policy
5. Policy related to related party transactions
6. Business Continuity plan
7. Organization Structure, Roles and Responsibilities including job descriptions, delegation of power
8. Disaster Recovery Plan
9. MIS & Reporting

TYPES OF CONTROL – OPERATING CONTROLS

Illustrative List

Human Resources

- KPIs are defined, aligned with business objectives, communicated and monitored
- Job descriptions exist, at least for key positions and are understood

Procurement

- Service levels have been formally agreed with vendors and are used for vendor performance evaluation
- There is a formal process of demand forecasting and supply planning, with clear inter departmental service levels

Sales

- Sales orders are tracked, monitored and analyzed regularly
- Sales scheme designs are formally reviewed and approved prior to launch, and post scheme analysis done to measure effectiveness

Production

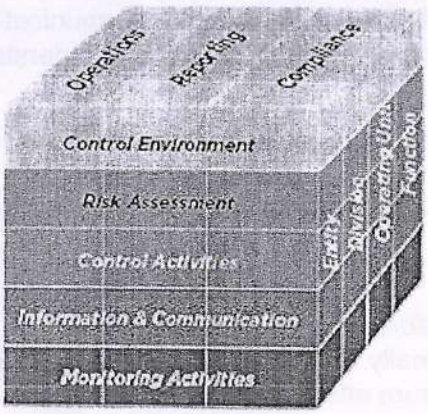
- Input-Output ratios are defined, measured and monitored periodically
- A formal preventive maintenance program exists and breakdown Vs Preventive Maintenance data is monitored

Inventory

- Inventory levels are fixed and actual inventory is measured against the levels and corrective action taken for excess inventory
- Procedure is established for identifying slow/obsolete inventory items
- Procedure for physical verification at regular interval is designed

COMPONENTS OF INTERNAL CONTROLS

The 2013 COSO framework has come out with revised cube



The Internal Control environment comprises of 5 components

COMPONENTS OF INTERNAL CONTROLS

Control Environment	1. Demonstrates commitment to integrity and ethical values 2. Exercises oversight responsibility 3. Establishes structure, authority and responsibility 4. Demonstrates commitment to competence 5. Enforces accountability
Risk Assessment Process	6. Specifies suitable objectives 7. Identifies and analyzes risk 8. Assesses fraud risk 9. Identifies and analyzes significant change
Control Activities	10. Selects and develops control activities 11. Selects and develops general controls over technology 12. Controls deployed through policies and procedures
Information System & Communication	13. Uses relevant information 14. Communicates policies internally 15. Communicates policies externally
Monitoring of Controls	16. Conducts ongoing and/or separate evaluations 17. Evaluates and communicates deficiencies to appropriate authority

COMPONENTS OF INTERNAL CONTROLS

Control Environment

1. The organization demonstrates a commitment to integrity and ethical values. The enforcement of integrity and ethical values includes for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal or unethical acts.
2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with oversight of BOD, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

COMPONENTS OF INTERNAL CONTROLS

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COMPONENTS OF INTERNAL CONTROLS

Risk Assessment Process

6. The organization specifies objectives with sufficient clarity to objectives.

7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.

8. The organization considers the potential for fraud in assessing risks to the achievement of objectives.

9. The organization identifies and assesses changes that could significantly impact the system of internal control.

Changes can be due to circumstances such as

- Change in operating environment
- New personnel
- Rapid growth
- New or improved IT system
- New accounting pronouncement

COMPONENTS OF INTERNAL CONTROLS

Control Activities

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

11. The organization selects and develops general control activities over technology to support the achievement of objectives.

12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into place.

Control activities will include

- **Policies regarding performance reviews**
- **Policies in respect of information processing**
- **Physical controls**
- **Segregation of duties**

COMPONENTS OF INTERNAL CONTROLS

Information System & Communication

↓

Infrastructure
Software
People
procedure

13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.

14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.

15. The organization communicates with external parties regarding matters affecting the functioning of internal control.

The Information system relevant to financial reporting objectives encompasses methods and records

- Identify and record all valid transactions
- Describe the transaction in sufficient detail to permit proper classification for financial reporting
- Determine the time period in which transactions occurred
- Present properly the transaction and related disclosure in FS

COMPONENTS OF INTERNAL CONTROLS

Monitoring Of Control	16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. For example - Timely preparation of BRS- Role of Internal Auditor 17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

LIMITATION OF INTERNAL CONTROLS

Internal Control can provide only reasonable assurance and not absolute assurance about entity's financial reporting, operating and compliance objective.

Some inherent limitations of internal control are

- Management consideration of cost vis-as-vis benefits
- Possibility of collusion with employees
- Person abusing the responsibility for exercising internal control
- Manipulation by management in preparation of FS

INTERNAL CONTROL ENVIRONMENT IT CONTROL

- o User Access
- o Access Log
- o Password Policy
- o Custom Programme
- o Change Management
- o Back up and restoration
- o Infrastructure security

AUDIT METHODOLOGY FOR INTERNAL CONTROLS

For auditors to comment on the adequacy and operating effectiveness of internal financial controls, they will have to follow a 4 stage methodology.

1) Planning

2) Design & Implementation

3) Operating Effectiveness and

4) Reporting

Prepare and control audit documentation
Continuous focus on audit quality

Audit engagement formalities to be completed – Format of engagement letter given in Appendix-1 of GN

AUDIT METHODOLOGY - AUDIT OBJECTIVE

Combining the audits

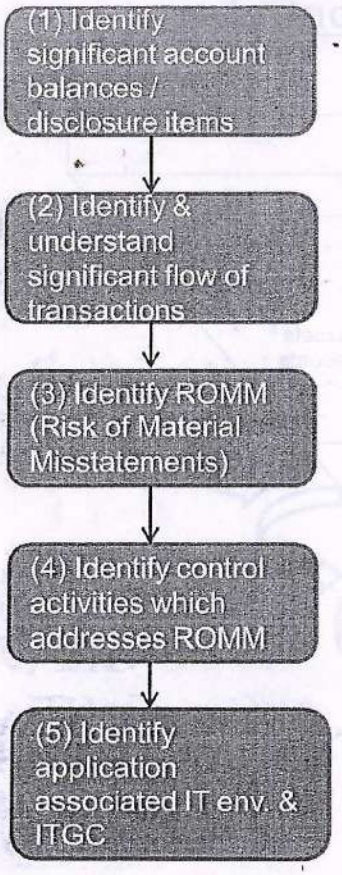
The audit of IFCFR should be combined with audit of FS.

The objectives of both the audits are not identical. However the auditor should design tests of control to accomplish the objectives of both the audits simultaneously.

Audit objectives of both the audits are

- To obtain sufficient evidence to support the auditor's opinion on IFCFR as of year end, and
- To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of FS

AUDIT METHODOLOGY – PLANNING STAGE



(1) - Identify relevant Assertions (existence/ occurrence, completeness, valuations/ allocation, rights & obligations, presentation and disclosure)
- Basis of identification of account balances – volume, complexity, recurring/ one time, materiality, contingency nature, related party txn

(2) - Inquire and Verify evidence to understand the activities performed for processing particular type of transaction (initiated, recorded, authorised and processed)

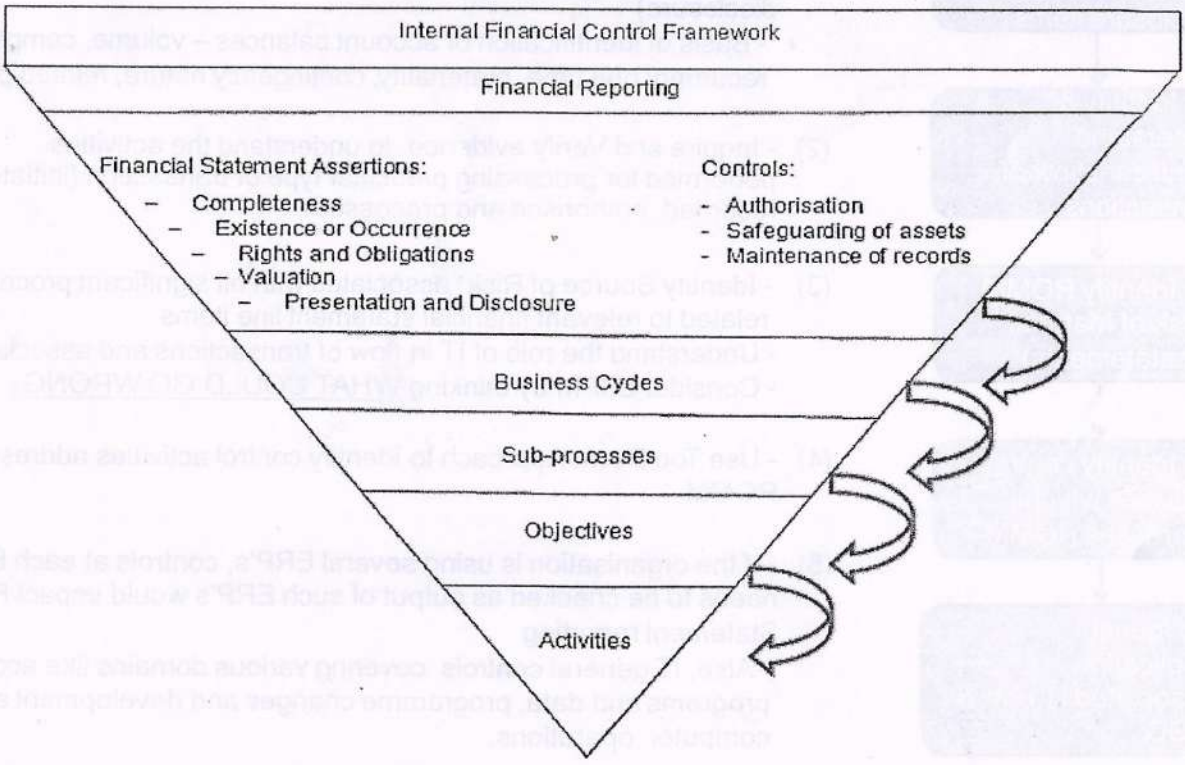
(3) - Identify Source of Risk associated with all significant processes related to relevant financial statement line items
- Understand the role of IT in flow of transactions and associated risk
- Consider LSPM by thinking WHAT COULD GO WRONG

(4) - Use Top Down Approach to identify control activities addressing ROMM

(5) - If the organisation is using several ERP's, controls at each ERP needs to be checked as output of such ERP's would impact Financial Statement reporting
- Also, IT general controls covering various domains like access to programs and data, programme changes and development and computer operations.

AUDIT METHODOLOGY – PLANNING STAGE

Top-Down Approach to Internal Financial Control over Financial Reporting :



AUDIT METHODOLOGY - SELECTING CONTROLS TO TEST

The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled.

Eg. Entity-level control, transaction-level control, control activity, monitoring control, preventive control, detective control

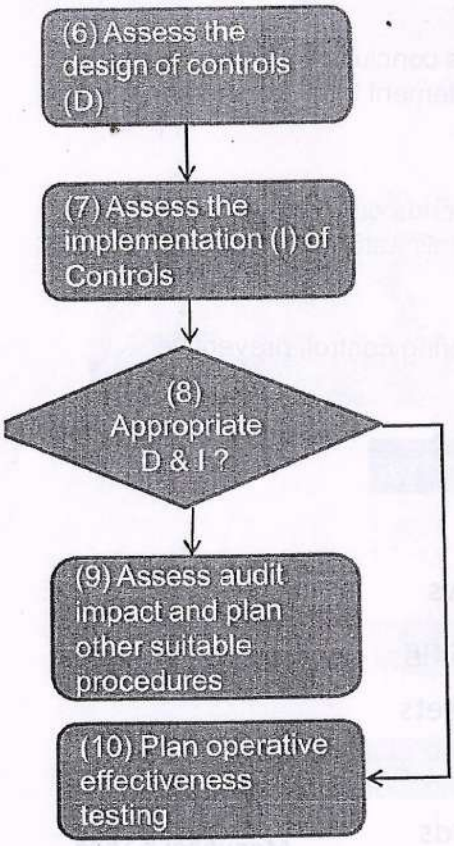
Financial Statement Assertions

- Completeness
- Existence or Occurrence
- Rights and Obligations
- Valuation
- Presentation and Disclosure

Control Activities

- Authorization
- Performance Reviews
- Information processing
- Physical Control of assets
- Segregation of duties
- Maintenance of records

AUDIT METHODOLOGY – DESIGN AND IMPLEMENTAION (DI) STAGE



(6) - Control designed should address the ROMM at set assertion level.
- Control designed should reduce the possibility of fraud at individual level, through collusion or through management override of controls.

Technique of control testing enquiry, discussion, observation, IPE

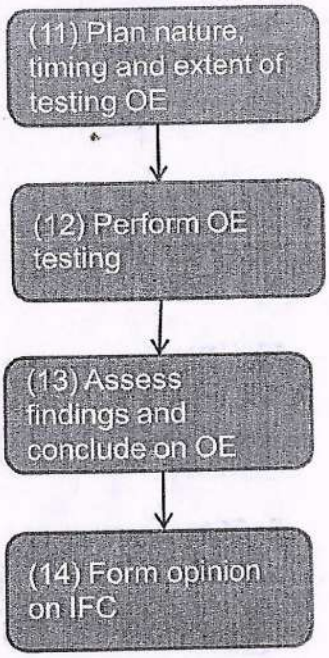
(7) - Based on ***Walkthrough performed*** and evidences collected, ensure whether above designed controls are implemented. Testing is done by selecting once sample for each homogenous nature of transaction

Answer to (8) ?
- Note Gaps (eg: no maker checker concept, Change of Sale price without authorised approval etc)

(9) NO: Assess the impact of lack of control design or implementation on financial statements

(10) YES: The next step is to test the operating effectiveness of internal controls.

AUDIT METHODOLOGY – OPERATING EFFECTIVENESS (OE) STAGE



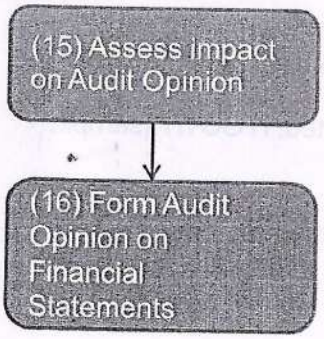
(11) Nature: Inquiry, observation, inspection and re-performance
Timing: Samples selected should represent the period to be covered by audit.
Extent: Frequency of control, manual or automated, ITGC /IT (sample size is prescribed by GN)

(12) - Perform and document the testing at focus points

(13) - Analyse the combination of findings (favourable and un-favourable) and conclude on the OE of the controls for the period covered by audit.

(14) Form appropriate opinion on IFC .

AUDIT METHODOLOGY – REPORTING STAGE



(15) - The auditor needs to assess whether the conclusion on IFC will have any impact on audit opinion on financial statements as a whole

(16) - Form appropriate audit opinion. Format of reports given in Appendix III of GN.

AUDITOR'S REPORT – MODIFIED OPINION

Based on evaluation of deficiencies if auditor concludes that deficiencies individually or in common result in one or more material weaknesses he need to consider to give a modified opinion that is qualified or adverse on company's IFCFR

Qualified Opinion

A Qualified Opinion shall be given when 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 misstatement in FS on timely basis or control is missing but, the effects /possible effects of material weaknesses in such internal controls are material but not pervasive to FS. (Example - scenario 1 and 3 in Example 2 of Appendix III of GN)

Adverse Opinion

An Adverse Opinion shall be given when 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 misstatement in FS on timely basis or control is missing but, the effects /possible effects of material weaknesses in such internal controls are both material and pervasive to FS, even if audit opinion on FS is unmodified. (Example - scenario 2 and 4 in Example 2 of Appendix III of GN)
- The system of IFCFR adopted by the company does not consider the essential components of internal control as stated in section III of Part B of GN (Example - scenario 5 Example 2 of Appendix III of GN) or
- Audit Opinion on FS is required to be modified and such modification is also consequent to material weaknesses in company's IFCFR (Example 4 of Appendix III of GN)

AUDIT REPORT

Auditor to issue separate reports on company's FS and on IFCFR

Auditor's report on IFCFR to include

- Title
- Management responsibility
- Identification of benchmark criteria used by management for establishing IFCFR
- Auditor's responsibility
- Statement that audit was conducted in accordance with GN on audit of IFCFR and Standards on Auditing to the extent applicable, both issued by ICAI
- A statement that GN on audit of IFCFR and SA required that auditor plan and perform the audit to obtain reasonable assurance about whether adequate and effective IFCFR were maintained in all material respects
- A statement that audit includes obtaining understanding of IFCFR, assessing the risk that material weakness exist, testing and evaluating the adequacy and operating effectiveness of IFCFR based on assessed risk and performing such other procedure as considered necessary
- A statement that auditor believes the audit provides reasonable basis for his opinion
- A paragraph stating that because of inherent limitations, IFCFR may not detect or prevent misstatement and that projections of any evaluation of effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in condition or that degree of compliance with policies and procedures may deteriorate
- Auditor's opinion
- Signature with firm name, the place and date of report
- Example 1

REPORTING CONSIDERATION – SEVERITY OF DEFICIENCY – INDICATORS OF MATERIAL WEAKNESS

Severity of deficiency depends on

- Whether there is reasonable possibility that company's controls will fail to prevent or detect a misstatement of an account balance or disclosure and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies

Indicators of material weakness include

- Identification of fraud whether or not material, on the part of senior management
- Errors observed in previously issued FS in current FY
- Identification by the auditor of material misstatement of FS in current period in the circumstances that indicate that misstatement would not have been detected by company's IFCFR and
- Ineffective oversight of company's external financial reporting and internal financial control over financial reporting by company's audit committee

REPORTING CONSIDERATION – COMMUNICATING CERTAIN MATTERS

Communication to	Matter to be communicated
Management	**All deficiencies in IFCFR that are of a lesser magnitude than significant deficiency, identified during audit**
Audit Committee	• All material weaknesses and significant deficiencies identified during audit • All deficiencies reported to the management along with their response
Those charged with the governance	• All material weaknesses and significant deficiencies identified during audit

In case of auditor becoming aware of fraud reporting responsibility under Companies Act, 2013 to be considered.

REPORTING CONSIDERATION - SOME EXAMPLES OF CONTROL DEFICIENCES

Design deficiency	• Inadequate documentation of components of internal controls. • Absence or inadequate SOP within a significant account or process. • Inadequate design of ITGC and application controls. • Absence of process to report deficiency on Internal controls to management.
Operating deficiency	• Failure of control of dual authorization. • Management override of controls. • Failure of application controls. • Failure to perform reconciliations of significant accounts.
Significant deficiency	• Deficiency in control over selection and application of accounting principles. • Deficiency in antifraud programs and controls. • Deficiency in non-routine /manual transactions. • Deficiency in period end financial reporting process.
Material Weakness	• Ineffective oversight on financial reporting and internal controls. • Ineffective Internal Audit or risk assessment function for large /high complex entity. • Identification of fraud of any magnitude on part of senior management.

REPORTING CONSIDERATION – EVALUATING IDENTIFIED DEFICIENCIES

The auditor to evaluate the severity of each control deficiency that comes to his attention to determine whether the deficiencies individually or in combination are significant deficiencies or material weaknesses.

As per GN

- A `deficiency' in IFCFR exists when design or operation of a control does not allow management or employees in normal course of performing their assigned functions, to prevent or detect misstatements on timely basis.

- A `Significant Deficiency' is a deficiency or combination of deficiencies, in IFCFR that is important enough to merit attention of those charge with governance since there is a reasonable possibility that a misstatement of company's annual or interim FS will not be prevented or detected on timely basis.

- A `Material Weakness' is a deficiency or combination of deficiencies, in IFCFR, such that there is a reasonable possibility that a material misstatement of the company's annual or interim FS will not be prevented or detected on a timely basis.

3. Lack of segregation of duties	• Evaluation of alternative controls designed and implemented by the management • When external parties are used, auditor to evaluate the controls performed by external party and used by the management for mitigating the risks
4. Financial reporting incompetency	• Evaluating the company's policies and procedures for assessing the skill and abilities of persons prior to hiring/ training of employees and performance evaluation • When assistance from outside professional is taken, the auditor should consider the process followed by the management for identifying the professional, overseeing the work of professional and evaluating the performance of professional
5. Less formal documentation	• Test of operating effectiveness of controls would include combination of inquiry, observation, document inspection and re-performance of the controls • Auditor to prepare his own documents in respect of process followed for testing of controls

Obtaining Information about process and control as well as operating effectiveness of control

Example:

Scenario:

- Small manufacturer not developed detailed policies and procedures for purchases
- Process followed- Preparing a form describing product requirement, name of supplier and payment terms. Form prepared by an assistant and reviewed by supervisor/manager
- On receipt of goods comparison made with the purchase form and approved by senior management personnel

Audit Approach:

- To verify copy of completed purchase form and related documents to obtain initial understanding of flow of transaction
- Inquiring the personnel involved in the process
- Tracing of transaction in the accounting system
- Summarizing the understanding of transaction flow in audit note and also including copy of purchase form as part of working paper
- Verification of transactions by sample selection to confirm that process as understood is followed
- To prepare a document showing the methodology of sample selection, samples verified, review of sample results, deviations noticed and explanations obtained thereon

1. Management override of controls	Evaluating mitigating controls addressing risk of management override: • Maintaining integrity and ethical value • Active over-sight by AC/BOD • Control over Journal Entries
2. Ineffective IT controls or information system	Evaluation of IT controls: • Test of security and access control by evaluating system security settings/ password parameters, access capabilities of users • Test of operational controls by evaluating back-up and recovery process and reviewing process of identifying and handling operational problems • Test of controls over system developments and system changes to include examining processes for selecting, acquiring and installing new software, evaluating process for implementing software upgrade, etc. • Test of application control would include combination of inquiry, observation, document inspection and re-performance of the controls

AUDITING SMALLER, LESS COMPLEX COMPANIES

Characteristics of small companies

- Fewer Business lines
- Fewer employees in accounting functions and centralized accounting system
- Segregation of duties not done
- Direct involvement, supervision and monitoring of the owner/senior management over processes
- Use of package software without modification
- Less complex business processes and financial reporting system

Control Deficiencies

- Lack of formal documentation for purchase of inventory and assets
- Inadequate documents in support of transactions entered
- Inadequate records relating to receipt/production, consumption/dispatch and stock of inventory/finished goods
- Incompetent staff not understanding accounting issues
- No formal system of financial reporting at periodic intervals
- Absence of control over cut-off operations and closing journal entries

AUDITOR'S REPORT – DISCLAIMER OF OPINION

The auditor shall give disclaimer of opinion on company's IFCFR

- **If** company has not established system of IFCFR considering the essential components of internal control stated in GN (Example – Scenario 1 in Example 3 of Appendix III of GN) or

- The auditor is unable to obtain sufficient appropriate audit evidence to express an opinion on IFCFR but is able to perform appropriate substantive procedures to express an opinion on FS (Example – Scenario 2 in Example 3 of Appendix III of GN) or

- When auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion on company's IFCFR and/or the auditor concludes that consequent to material weakness in such internal control the possible effects on FS of undetected misstatement, if any, could be both material and pervasive (Example – Scenario 3 in Example 3 of Appendix III of GN)

APPLICABILITY OF SAs FOR AUDIT OF IFCFR

ISSUES

1. Company has prepared document of SOP describing process of operation /activity. During Audit of IFCFR it was found that some activities actually being carried out by the employees are not included in SOP. How to deal with such situation?

2. The company does not have any document evidencing internal financial control. What should be audit methodology for review of IFCFR in this situation?

3. Whether any qualification or adverse comment in separate report IFCFR would also require auditor to qualify or give adverse opinion in report on FS?

4. Whether any qualification or adverse comment in audit report on FS would also require auditor to qualify or give adverse opinion in separate report on IFCFR?

5. In the report on IFCFR the auditor has given adverse opinion on account of material weakness in IFC. However in the Directors' Report it is stated that the company has laid down IFC which are adequate and were operating effectively. How the auditor should deal with the situation?

6. Whether documentation prepared for audit of IFCFR can be used as documentation for control risk assessment in connection with audit of FS ?

THANK YOU!