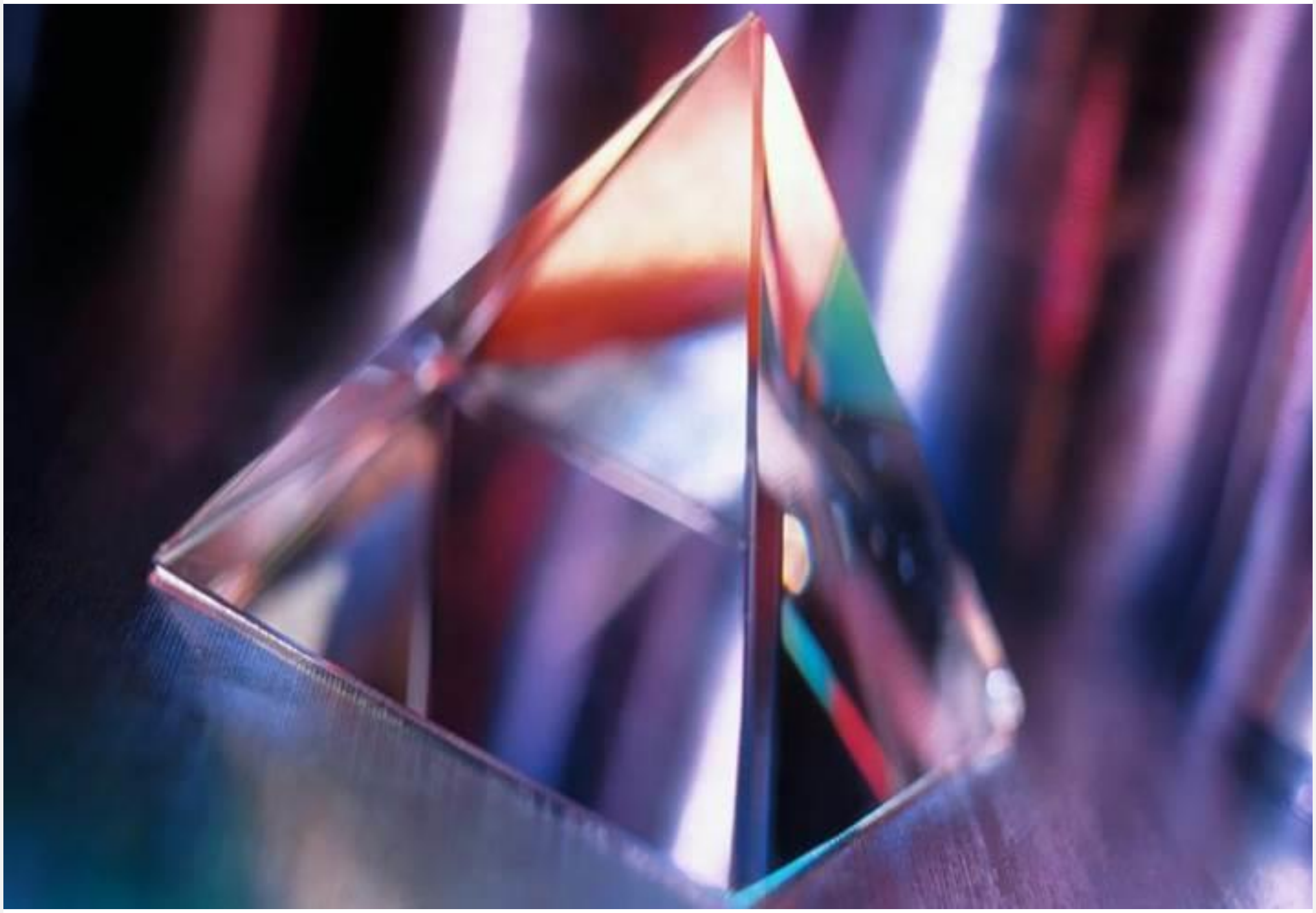


D'Prism

A series on the Companies Act, 2013

Internal financial controls

Global scenario

In June 2003, the Securities and Exchange Commission (SEC) of the United States of America adopted Rules for the implementation of Sarbanes – Oxley Act (SOX) that required certification of the Internal Controls over Financial Reporting (ICFR) by the management and by the auditors.

The Public Company Accounting Oversight Board (PCAOB) has issued its Auditing Standard (AS) 5 on: "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements". This standard establishes requirements and provides direction that applies when an auditor is engaged to also perform an audit of the internal controls over financial reporting in addition to the audit of the financial statements.

In June 2006, the Financial Instruments and Exchange Act (J-SOX) was passed by the Diet, the National Legislature of Japan. The requirements of this legislation are similar to the requirements of internal controls over financial reporting under SOX.

In the United Kingdom, the UK Corporate Governance Code specifies the corporate governance requirements for the board of directors of listed companies, which, *inter alia,* includes matters relating to oversight and review of internal controls in the company.

Issue 5[1]: Internal financial controls

January 2015

In this issue:

Scenario in India[2]

As per sub-clause IV.D of Clause 49 of the Equity Listing Agreement (the "ELA"), the role of the Audit Committee (the "AC") of companies whose equity shares are listed includes evaluation of internal financial controls and risk management systems. Further, sub-clause IX.C of Clause 49 requires the CEO and CFO of such companies, to certify to the board of directors (the "board") that they accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting.

[1] Includes updates up to 14 January 2015.

[2] Auditor's reporting on internal financial controls made voluntary for the year ending 31 March 2015 and made mandatory for financial years beginning on or after 1 April 2015. No deferment has been provided to reporting by the directors of a company in the board report.

The Companies Act, 2013 (the “2013 Act”) has stated specific responsibilities on the board of listed companies towards the company’s internal financial controls and, *inter alia,* requires the board to state that they have laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. These changes are effective from the financial years beginning on or after 1 April 2014. Currently, many companies are assessing the impact these new requirements will have on the operations and processes of the company, including the financial reporting process.

Statutory auditors are also required to report on the adequacy and operating effectiveness of the company’s internal financial control system. The reporting by the auditors is voluntary for the year ending 31 March 2015 and mandatory for financial years beginning on or after 1 April 2015.

In this issue, we shall discuss the following with respect to internal financial controls:

1. Responsibility on the board and board reporting requirements relating to internal financial controls as introduced by the 2013 Act and the Companies (Accounts) Rules, 2014.
2. Some considerations to be factored in by the board and the AC in fulfilling their duties.
3. Implication to companies on auditor’s reporting under section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of controls.

Responsibility on the board and its reporting requirements

Section 134(5)(e) of the 2013 Act requires the board of listed companies to assume responsibility of laying down “internal financial controls” and ensuring that such controls are not only adequate but are also operating effectively.

As per the explanation provided to this clause, the term “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 the accounting records**, and the timely preparation of reliable financial information.

The Code for Independent Directors provided in Schedule IV to the 2013 Act also emphasises that the independent directors have to satisfy themselves on the strength of financial controls, thereby placing specific responsibility on independent directors.

As per section 177 of the 2013 Act, the AC is required to evaluate the internal financial controls and risk management systems in the company.

Rule 8(1) of the Companies (Accounts) Rules, 2014 states the matters to be included in the board’s report. This Rule states that the board’s report shall be prepared based on the stand alone financial statements of the company. It further states that with respect to the subsidiaries, associates and joint ventures, the board report shall contain a separate section reporting the performance and the financial position for each such entity.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of **all companies** to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

What constitutes internal financial controls? The explanation of the term ‘internal financial control’ has been provided only in the context of section 134(5)(e). It includes policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, thereby covering not only the controls pertaining to financial statements (more commonly known as Internal Controls over Financial Reporting (“ICFR”), but also include strategic and operational controls pervasive across the entire business. For example, controls relating to strategic and operational controls could relate to those that may not have a significant impact on financial reporting objectives such as those relating to productivity, quality, environmental practices, innovation, customer and employee satisfaction, etc. The controls pertaining to information technology (IT) also fall within the definition of internal financial controls. IT includes both the IT applications used as well as IT infrastructure (e.g., network, operating system) used in supporting the applications. Accordingly, management is expected to consider the use of IT in the company’s operational and financial transactions.

The aforesaid explanation provided in section 134(5)(e) may not be applicable to the auditors reporting on internal financial controls under section 143(3)(i). For example, orderly and efficient conduct of its business is proprietary in nature and auditors may not be able to comment on it.

Applicability to entities where only debt securities are listed: The responsibility of the board of listed companies to establish and maintain adequate internal financial control system that is operating effectively will be applicable even if only the debt securities of the company are listed.

Applicability to unlisted companies: Whilst section 134(5)(e) requires directors to state their responsibility on internal financial controls only in case of listed companies, auditors are required to report on the adequacy and operating effectiveness of such controls in case of all companies. Further, Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements, though the said Rule appears to limit the board’s statement to ICFR and also does not require the board to state the operating effectiveness of such controls. In view of the above, and since the primary responsibility for safeguarding the assets of the company, preventing and detecting fraud or other irregularities and maintaining proper books of account continues to be with the board, laying down adequate ICFR and ensuring that such ICFR operates effectively will be the responsibility of the board even in case of unlisted companies.

Board responsibility in case of consolidated financial statements: Whilst Rule 8(1) of the Companies (Accounts) Rules, 2014 does not specify the reporting by the board of the parent company on internal financial controls in the subsidiaries and joint ventures considered in the consolidated financial statements, it would still be relevant for the board of the parent company to consider internal controls limited to the preparation of the consolidated financial statements, since such financial statements are required to be prepared and presented by the parent company.

Controls to be effective throughout the year: Given the spirit of the 2013 Act and taking cues from the similar such requirements under other acts (e.g., SOX), it appears that the board and AC of the company should ensure that the controls are adequate and operating effectively throughout the year. Controls could be tested for the year with increased emphasis as at the year end and ensuring that adequate time is available prior to the year-end for remediating and retesting controls which failed in earlier testing cycles.

Some of the common misconceptions that companies have with respect to internal financial controls are as follows:

Management's view	Matters to be considered
• Under the Companies Act, 1956, statutory auditors have reported that the company's internal controls were adequate and therefore nothing additional needs to be done in relation to internal financial controls.	Statutory auditors reporting under the Companies Act, 1956 was limited only to adequacy of internal controls and did not extend to its operating effectiveness. Further, the internal controls reported upon were limited to purchase of goods, inventory and fixed assets and sale of goods and services. As such it did not include other processes such as payroll, treasury, financial reporting, etc.
• Internal controls are very important and the company needs to have controls in place for every process and account balance. We do not need to link risks with controls.	The company needs to carry out a risk assessment to determine the risks in each process and then design controls to mitigate the risk. Establishing internal controls without identification of risk could result in certain risks not being addressed/mitigated or in having redundant controls. In identifying the risks that need to be mitigated, it is necessary to consider the likelihood of the occurrence of the risk and the possible magnitude of its impact on the company's operations and financial position. This analysis would also enable the company to assess the cost – benefit of establishing internal controls for the risks identified.
• If the company has an ERP, the internal controls are automatically in place.	An ERP environment in itself does not ensure adequate internal controls. The company will need to establish internal controls around the ERP environment such as access controls, segregation of duties, etc. Further, assessment of those controls that reside within the ERP and those that are manually effected will also need to be considered when evaluating the adequacy and operating effectiveness of internal financial controls.
• Testing of controls and remediation of deficiencies is the responsibility of auditors.	The primary responsibility for establishing an adequate internal financial control system that operates effectively is with the board of the company.
• We understand controls. There is no need for training and development of our people.	To enable the board and auditors to report on internal controls, it is essential that the company personnel are able to demonstrate the existence of the controls as established. Further, the internal controls may need revisions due to changes in the company's business and operations. This would then require training of company personnel periodically to enable the company maintain a robust internal controls system.

Some considerations for the board and AC to address the internal financial control related requirements and breaking these common myths are provided in the following section.

Matters for consideration by the board and AC

Framework:

The 2013 Act does not specify or recommend any framework that may be considered by companies when they establish their internal financial control system.

> To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with a framework and the generally accepted accounting principles under which it is prepared. For example, the accounting standards specified under the 2013 Act is the framework on which companies prepare and present their financial statements and is the framework on which auditors evaluate if the financial statements present a true and fair view of the state of affairs and operations of the company in an audit of the financial statements carried out under the Companies Act. Different financial results would be obtained if different accounting frameworks were used, such as IFRS, US GAAP, etc. It is, therefore, important for users of financial statements to understand the framework used in the preparation of financial statements, and this is typically identified in both the financial statements prepared by the management and in the report of the auditors. Similarly, to assess and report on adequacy and compliance of the system of internal control, it is essential that the management adopts any one or a combination of benchmark frameworks of internal controls. Both the assessing and reporting cannot be in a vacuum without identifying a reporting framework.

In order to effectively and efficiently develop systems of internal control that also adapt to changing business and operating environments, mitigate risks to acceptable levels, and support sound decision-making and governance of the organisation, it is essential to adopt an appropriate internal control framework.

There are many frameworks that provide guidance to entities for developing and establishing their internal control systems. Some of the commonly applied internal control frameworks are as follows:

- Internal Control - Integrated Framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework). The original COSO Framework issued in 1992 was available for use until 14 December 2014. Thereafter this has been superseded by the 2013 COSO Framework. The 2013 COSO Framework, *inter alia,* has been issued to enable organisations to also achieve operational control objectives rather than just the financial reporting objectives.
- Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (CICA).
- Report published by the Institute of Chartered Accountants in England & Wales “Internal Control: Guidance for Directors on the Combined Code” (known as the Turnbull Report).
- In India, a “Guide to Internal Controls over Financial Reporting” was issued by the Committee on Internal Audit of the ICAI (now the Internal Audit Standards Board) in the context of the requirements of Clause 49 of the ELA. This Guide, along with any amendments thereto could also provide the necessary framework for companies.

Accordingly, a company may adopt any of the above frameworks or establish a framework of its own. Pending issuance or recommendation of a framework by the Ministry of Corporate Affairs (MCA), in case a company chooses to establish an internal control framework of its own, it should ensure that the framework addresses the following essential components of internal control:

- Control environment: The control conscience of an organisation - the “tone at the top”
- Risk assessment: The evaluation of internal and external factors that impact an organisation’s performance
- Control activities: The policies and procedures that help ensure that actions identified to manage risk are executed and timely
- Information and communication: The process that ensures relevant information is identified and communicated in a timely manner
- Monitoring activities: The process to determine whether internal control is adequately designed, executed, effective and adaptive

Role of the AC

Section 177 of the 2013 Act requires the AC to evaluate the internal financial control systems while performing its duties. This can be achieved by the AC through increased involvement in the company’s internal controls assessment process. For e.g., the AC may:

- actively participate in the risk assessment process
- understand major risks faced by the company and key controls
- define the role of internal audit and actively participate in the annual internal audit planning
- meet with the internal audit head on a regular basis
- seek test results and other relevant information on internal financial control on a more real time basis
- understand how management addresses the risks highlighted by test of internal controls

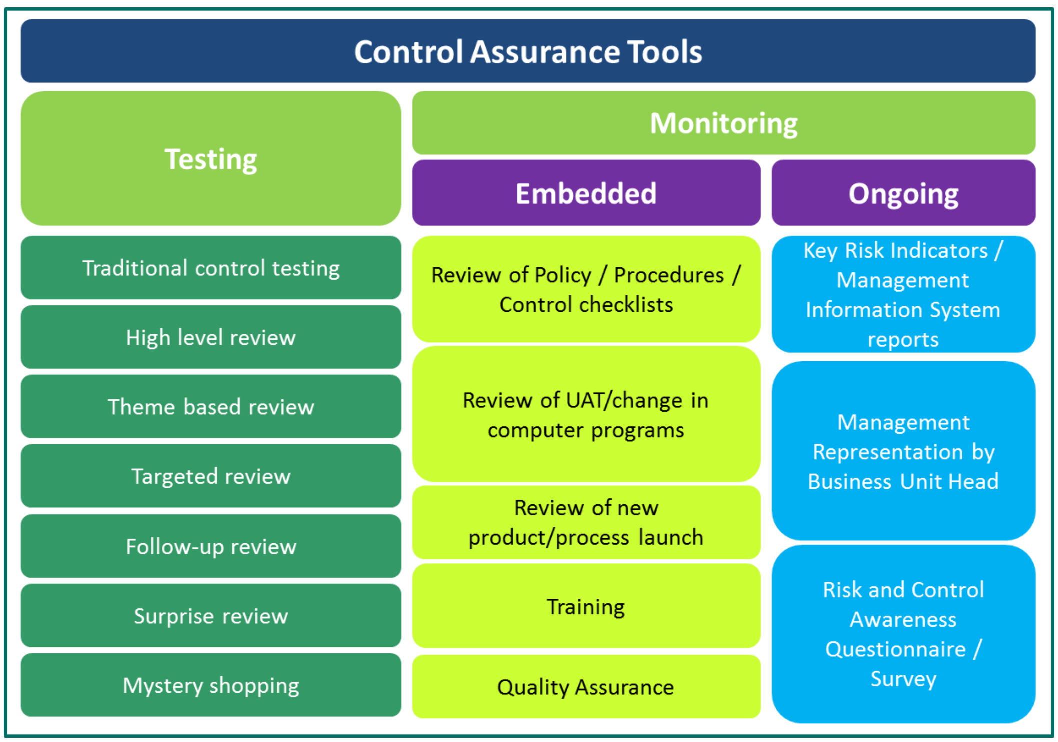
For the AC to demonstrate that it has taken necessary steps to evaluate the internal financial control systems, it may call for the comments of the internal auditors and the statutory auditors about the company’s internal control systems, scope of audits, etc., as this would give them additional insights on the assessment of such controls. The AC may, if required, also seek external help or expert advice and guidance for the evaluation of internal financial controls.

Controls assurance: In the Three Lines of Defense model, management control is the first line of defense in risk management, the various risk control and compliance oversight functions established by management are the second line of defense, and independent assurance (i.e., internal audit) is the third. The AC would need to introduce a robust control assurance program to be collectively performed by the first and second lines of defense to assess and ensure that:

- Identified controls adequately mitigate potential risks that need to be managed
- The controls are appropriately designed to mitigate the risks
- The controls are operating as designed
- The controls are periodically tested and monitored for design and operating effectiveness
- Control gaps where identified are remediated in a timely manner
- Adequate oversight processes exist

Controls assurance enables continuous improvement of the existing control environment, through the identification of inefficient practices and a renewed assessment of current and changed practices.

Control assurance methods: Boards and ACs may introduce control assurance methods like testing and monitoring to assess the design and operating effectiveness of controls. Some of the control testing and monitoring methods are given below:



Control maturity scale: The AC may adopt or design a control maturity scale based on their business objectives and risk assessment to be able to assess the overall health of their business control environment. Once the scale is put in place, the AC may implement leading globally accepted control practices to be able to move up on the control maturity scale, e.g., implementing preventive and automated controls as against having detective and manual controls. An illustrative control maturity scale is given below:

Control Maturity Scale		Unreliable	Insufficient	Reliable	Optimal
Characteristics	Documented controls, policies and procedures	○	◑	◕	●
	Disclosure creation process	○	◑	◕	●
	Formal responsibility for control activities	○	◑	◕	●
	Assessment of controls	○	◑	◕	●
	Identification and remediation of control deficiencies	○	◑	◕	●

○ Does not exist ◑ Exists but not fully documented ◕ Exists and adequately documented ● Use of technology, existence of preventive controls, and adequate documentation

Advantages of a robust internal financial control system: By placing more accountability and responsibility on the board and AC with respect to internal financial controls, the 2013 Act is attempting to align the corporate governance and financial reporting standards with global best practices. With adequate and effective internal financial controls, some of the benefits that the companies would experience include:

- Senior Management Accountability
- Improved controls over financial reporting process
- Improved investor confidence in entity's operations and financial reporting process
- Promotes culture of openness and transparency within the entity
- Trickling down of accountability to operational management
- Improvements in board, AC and senior management engagement in financial reporting and financial controls
- More accurate, reliable financial statements
- Making audits more comprehensive

Internal financial controls also become important as they help derive values in the form of:

- Fresh independent look at key business processes
- Identification of potential operating process opportunities
- Updated formal, centralised, and managed financial internal controls documentation for the company
- Enhanced support to CEO/CFO certifications
- Enhanced control environment thereby mitigating risk
- Better understanding of internal controls

Auditor’s reporting on internal financial controls

Responsibility of statutory auditors

The 2013 Act requires the statutory auditors to state in their reports whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The reporting by the auditors is voluntary for the year ending 31 March 2015 and mandatory for financial years beginning on or after 1 April 2015.

However, unlike in section 134(5)(e), where internal financial controls have been specifically explained for purposes of that section, there is no such explanation provided in section 143(3)(i).

For example, the explanation of the term ‘internal financial control’ provided in the context of section 134(5)(e) includes *policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business.* Orderly and efficient conduct of its business is proprietary in nature and auditors may not be able to comment on the same. SA 200 specifically excludes this as an objective of the auditor. Paragraph A1 of SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing” states “The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor’s opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.”

Considering the overall objectives of an audit and the Companies (Accounts) Rules, 2014, it appears that the auditors responsibility with respect to reporting on the adequacy and operating effectiveness of internal financial controls is only limited to those pertaining to financial statements i.e., ICFR.

Impact of modified opinion by the auditors on internal financial controls over financial reporting in subsequent interim period financial reporting: Whilst the auditors apply both test of controls and substantive testing to gain assurance on the financial statements, the management relies solely on its internal financial controls when preparing financial statements. The ability of a company to accurately describe its own financial condition when it discloses unaudited financial information, as in quarterly results filed with the Stock Exchanges, is significantly dependent on the adequacy and operating effectiveness of ICFR.

Thus, while the audit opinion on a company’s financial statements may be “clean”, this would provide little information on the adequacy and operating effectiveness of ICFR, unless separately reported upon. Specifically, the audit report on internal financial controls would provide the users of the financial statements with one of the criteria against which to evaluate the reliability of a company’s disclosed financial information even when they are not audited.

Role of internal auditors

Section 138 of the 2013 Act read with Rule 13 of the Companies (Accounts) Rules, 2014 requires every listed company and other specified class of companies to appoint an internal auditor.

Internal audit can be made part of the AC's oversight mechanism on internal financial controls, *inter alia*, by engaging them in evaluating the adequacy and operating effectiveness of internal financial controls.

Conclusion

The scope and responsibilities of the board, AC, and auditors can be summarised separately as below:

Board	AC	Auditors
Scope: • Listed companies – Adequacy and operating effectiveness of internal financial controls • Unlisted companies – Adequacy of internal financial controls over financial reporting		• Report on adequacy and operating effectiveness of internal financial controls system over financial reporting
Responsibilities: • Lay down adequate and effective internal financial controls and include it in Directors' Responsibility Statement • Independent directors to satisfy themselves on the strength of financial controls	Responsibilities: • Evaluate internal financial control systems • Review Auditors' comments/ observations on internal financial controls before submission to the Board • Discuss issues with management or internal/ statutory auditors • Investigate and seek external professional advice	

Based on experiences globally where reporting on ICFR has been mandated, it is not unreasonable to expect that significant efforts will be required to establish robust internal financial control systems to meet the new reporting requirements. Companies in consultation with the board and AC must act expeditiously on this requirement and complete the process of bringing in the necessary changes by 31 March 2015 so that the board can report on the adequacy and the operating effectiveness of such internal financial controls.