Internal Financial Control (IFC)& Internal Financial Controls over Financial Reporting (IFCoFR)

Origin of IFC

The first significant focus on internal control certification related to financial reporting was the ***Sarbanes Oxley Act of 2002 (SOX 404)***

COSO Framework

Publically listed companies in the UK are required to follow the ***"Turnbull Guidance on Internal Control"*** which sets out the best practices for internal controls

The UK Corporate Governance Code

Arrival in India through ICAI Guidance Note issued in November 2014

New Guidance Note released in September 2015 provides the necessary criteria for IFCoFR for companies

Introduction to Internal Financial Control (IFC)

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

- Orderly and efficient conduct of its business
- Safeguarding of its assets
- Prevention and detection of frauds & errors
- Accuracy and completeness of the accounting records
- Timely preparation of reliable financial information

Components:

Internal Financial controls over Financial Reporting (IFCoFR) + Operational Controls + Fraud Prevention → IFC

Example:

Internal Financial controls over Financial Reporting (IFCoFR)	Operational Controls	Fraud Prevention
Realisation of Sales is correctly recorded in Financial Statements	Discounts on sale as per Company Policy	Unauthorised entries/ changes in Books of Accounts/ Price Master

Introduction to Internal Financial Control over Financial Reporting (IFCoFR)

As per Section 143 of the Companies Act, 2013, the term Internal Financial Control over Financial Reporting is a process designed to provide ***reasonable assurance regarding the reliability of financial reporting and the preparation of financial statement***

- Maintenance of Records
- Reasonable assurance that transactions recorded
- Prevention or timely detection of unauthorised acquisition, use or disposition of Company's assets

Components:

Maintenance of Financial records + Authorisation of transactions in accordance with GAAP + Safeguarding of the assets of the Company → IFCoFR

Background

Section 134	Director's Responsibility Statement	In the case of a listed company, the Director's Responsibility states that directors, ***have laid down IFC*** to be followed by the company and that such ***controls are adequate and operating effectively***
Rule 8	Board Report	Every Company to state the details in respect of adequacy of IFC with ***reference to financial statements***
Section 177	Audit Committee	Audit committee ***may call for comments of auditors about internal control systems*** before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company
Schedule IV	Independent Directors	The Independent Directors should satisfy themselves on the integrity of financial information and ***ensure that financial controls*** and systems of risk management ***are robust and defensible***
Section 143	Auditor Report	The Auditor's Report should state whether the company has ***adequate IFC system in place*** and the ***operating effectiveness of such controls***

Applicability Chart



Board of Directors | Audit Committee/ Independent Director | Auditors

Scope:
- ❖ Listed Companies: Adequacy & operating effectiveness of internal financial controls
- ❖ Unlisted Companies: Adequacy of internal financial controls over financial reporting

Board of Directors
- ❖ Lay down adequate and effective IFC
- ❖ Director's Responsibility Statement

Audit Committee/ Independent Director
- ❖ Evaluate internal financial control systems
- ❖ Review Auditor's comments/ observations on IFC
- ❖ Investigate & seek external professional advice

Auditors
- ❖ Focus on Internal Controls
- ❖ Report on adequacy and operating effectiveness of IFCoFR

Common Myths

- Meeting CARO Requirement is sufficient
- Company has SOPs in place
- Controls are automatically in place & hence there is no need to revisit them
- There is no need to document the processes & controls
- There is no need to link the Risks with controls
- The process for IFCoFR Certification is not required since no exceptions are noted by the auditors
- Testing of Controls & remediation of deficiencies is the responsibility of auditors and not of the management
- There is no need to provide training & development to the employees

The Framework

Internal Control Frameworks

- The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) Internal Control–Integrated Framework. COSO is a widely accepted framework and it constitutes:

  Control Environment | Risk Assessment | Control Activities

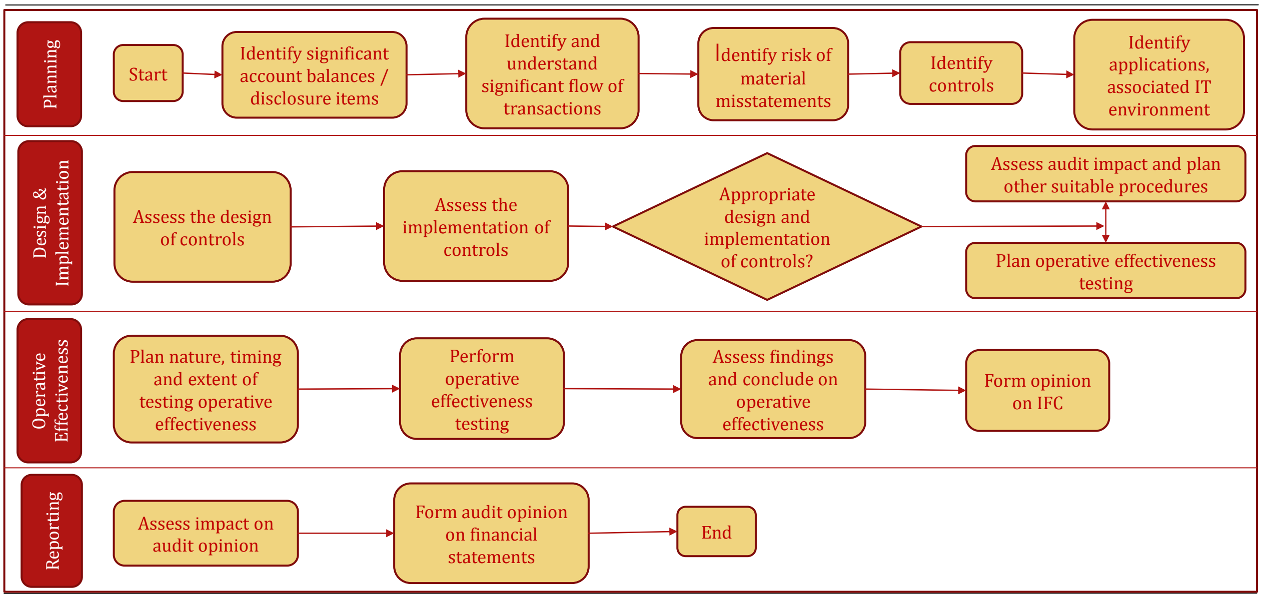
  Information Systems & Communication | Monitoring

- Canadian Institute of Chartered Accountants' (CICA's) - Criteria of Control Framework (CoCo)
- Control Objectives for Information and Related Technology (COBIT)
- International Organization for Standardization (ISO)
- Financial Reporting Council (UK) - Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

Internal Control Components

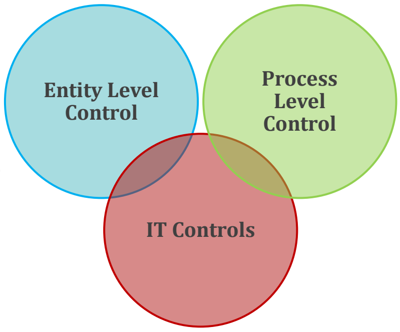
Control Environment	Risk Assessment	Control Activities	Information Systems & Communication	Monitoring
• Established governance processes to demonstrate an ethical organization, e.g. code of conduct, whistle blowing, • Well defined organization structure with established roles and responsibilities • Formal delegation of authority percolating down to functions. • Board and sub committees composition, competence and evaluation. • Periodic refresh, training and affirmation on governance areas	• Identification & assessment of risks to reliable financial reporting • Identification & assessment of fraud risks. • Identification & assessment of risks relating to IT applications/ ERPs used in financial reporting / business processes. • Identification & assessment of risks relating to accuracy, integrity and completeness of reports used in financial reporting / exercising of internal controls	• Documented standard operating procedures for applicable business processes. • Identification & assessment of internal controls relating to all the business processes/ sub processes applicable from a financial reporting perspective. These controls would broadly be, preventive / detective, automated / manual, authorization / segregation of duties related or application configuration related. Also including general IT Controls.	• Identification & assessment of reports used in financial reporting / exercising of internal controls. The assessment would be towards accuracy, integrity and completeness of such reports. • Identification & assessment of Controls over external communication relating financial information. This would include analysts, regulators, taxation authorities etc. • Communication of policies & procedures on a periodic and timely basis.	• At an entity level, presence of a robust internal audit mechanism with adequate coverage of business processes. • At a business process level, presence of adequate monitoring controls like review, reconciliations etc.

Flow of Audit of IFC



Components of Internal Control

- Corporate Governance
  Policies and Procedures
  Organization level controls
- Impact on culture, ethical standards, oversight, responsibility and accountability



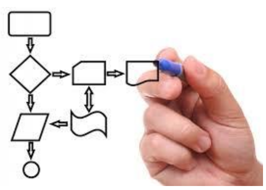
- FA
  Inventory
  Procure to Pay

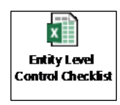
Controls designed to provide reasonable assurance on business operations, process, efficiency & effectiveness.

- Controls which relate to the environment
- Application systems are developed, maintained and operated

Entity Level Controls

- Sets the ***"Tone at the TOP"*** of the organisation
- Provides ***excellent leverage*** to reduce testing at lower levels
- Promotes ***Integrity and Ethical values***
- Assigns ***Authority and responsibility*** within the Organisation





Entity Level Controls

Direct Entity Level Controls

- To detect breakdowns in the application of an organization's policies and procedures.

Indirect Entity Level Controls

- Define the control consciousness of an organization without directly mitigating any one specific financial or operational risk

Entity Level Controls (contd')

Board of Directors	Audit Committee	Key Management Personnel	Auditors	Company Secretary
• to report on existence, adequacy and operating effectiveness of anti fraud/ vigil mechanism	• to monitor end use of funds and evaluate fraud controls	• to design and maintain anti-fraud/vigil mechanism	• to report all frauds	• to report all frauds

Responsibility all across the Organisation

Illustrative Controls:

- Background and reference checks
- Code of conduct
- Job rotation, Forced leave
- Duplicate payment tool
- Whistle blower framework
- Lifestyle checks on sensitive positions
- Fictitious employee/vendor checks

Entity Level Controls- Illustrative

- Organization vision and mission
- Legal and Compliance Framework
- Code of Conduct and Ethics policy
- Organisation Structure and Delegation of Authority
- Enterprise Risk Management Process
- Corporate Communications Functions
- Periodic Business Reviews – Ex COM, BoD etc
- Business Continuity Plan / Disaster Recovery Plan

Process Level Controls

Top down Approach/ Risk Based

- Financial Statements
- Significant Accounts
- What could go wrong analysis
- Residual Financial Reporting Risk
- Transaction Level Controls

- Controls designed to provide ***reasonable assurance***
- Financial statements are reliable & prepared in ***accordance with GAAP***
- Maintenance of records that accurately and fairly reflect the transactions
- Transactions are recorded as necessary to permit preparation of financial statements
- Receipts and expenditures of the company are being made only in accordance with appropriate authorizations
- ***Prevention or timely detection of unauthorized acquisition***, use, or disposition of assets which could materially impact the financial statements

Process Level Controls- Illustrative

Human Resources
- Key Performance Indicators are defined & aligned
- Job descriptions exist

Procurement
- Formal agreements with Vendors
- Vendor Evaluation & Masters
- Demand forecasting & supply planning process

Sales
- Orders tracked, monitored & analyzed
- Sales schemes formally reviewed

Quality
- Quality tests to be conducted defined with quantitative parameters
- Robust program of quality testing

Inventory
- Holding as per benchmarks
- Utilize slow/ non moving inventory of raw materials

IT Controls

Significant Accounts & Disclosures

Relevant Flow of Transactions

General IT Control Areas:
- Data centre
- Access security
- System change control

Identifying relevant application systems:
- Reliance on data
- Relevant automated controls
- Substantial procedures alone not enough

- IT Environment- Relevant Technology Elements
- IT Infrastructure
  - Database
  - Operating System
  - Network

IT Controls (cont'd)

General IT Controls

ERP/ Other Applications

Typical Coverage

- User access management (IFCoFR)
- Change management (IFCoFR)
- Data centre – physical and environmental controls (IFC)
- Information security – logical access to application, database and operating system (IFCoFR)
- Backup and restoration (IFC)
- Job scheduling (IFC)

IT Controls- Illustrative

- Billing System
- Enterprise Resource Planning (ERP)
- Other Applications
- Back- up Process
- Access Controls

Performing Walkthroughs

Objectives

- Primary objective is to understand the process, risks of material misstatements and controls in the process to mitigate the risks
- Can also be used to test the design and implementation of the control
- May be used for testing operating effectiveness in the case of controls that are used infrequently

Evaluation of Controls through Walkthroughs

- Step 1: Following a transaction from origination to financial records
- Step 2: Asking probing questions related to the process steps
- Step 3: Asking probing questions related to the controls
- Step 4: Test design of relevant control (e.g., observation/inspection)
- Step 5: Test operating effectiveness (e.g., re-perform control)

Documentation Required

- Process Flowcharts

RCM_Revenue to Receipt

- Process Narratives
- Risk & Control Matrix

Process
hart- Revenue to R

- Information produced by the entity (IPE) / in scope IT applications
- Key spreadsheets

Evaluation of Design Effectiveness

Assess the design for each control selected for testing → Consider the factors to evaluate the design of the control →

- Purpose of the Control
- Level of aggregation and predictability
- Nature and significance of the risk
- Criteria for investigation and process for follow-up
- Competence and authority of the person(s) performing the control
- Dependency on other controls or information
- Frequency and consistency with which the control is performed

From the Auditor's Perspective

Auditor's Responsibility - Applying SA in Audit of IFCoFR

- According to ***Part A1 of SA 200 "Overall objectives of the Independent Auditor"***
  - the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the **effectiveness of internal control**

- Criteria/ Framework by ***SA 315- Components of Internal Control***
  - Companies that has the components of internal controls as need to adopt a Criteria / Framework stated in the Guidance Note
  - Auditor's IFCoFR report to specify identification of the benchmark criteria used by the management for establishing IFCoFR
  - Failure by the management to establish a system of IFCoFR considering the essential components of internal controls stated in the Guidance Note would ***result in a disclaimer of opinion*** in the IFCoFR reporting by the auditor

- The auditor should consider the requirements of ***SA 230, "Audit Documentation"*** when documenting the work performed on internal financial controls

- ***SA 320 "Materiality in Planning and Performing an Audit"*** should be used to assess the materiality in planning the audit of IFC

Auditor's Responsibility – Applicability & Reporting

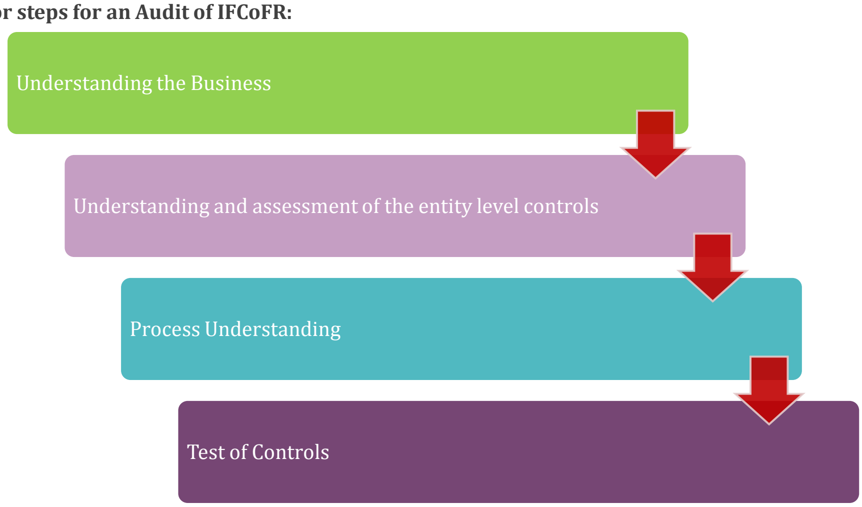
- Reporting on IFCoFR is **applicable to consolidated financial statements**
- IFCoFR is **not applicable to interim financial statements** unless such reporting is required under law or regulation
- **Elaborate Audit Procedures** - Audit of IFC is broader than the audit procedures carried out for reporting under CARO clauses on adequacy of internal controls
- Auditor should report if the company has an adequate internal financial controls system in place and whether the same was **operating effectively as at the balance sheet date**
- When forming the opinion on internal financial controls, the auditor should **test the same during the financial year** under audit and **not just as at the balance sheet date**, though the **extent of testing at or near the balance sheet date may be higher**

Auditor's Responsibility - Point of Focus

- Concepts of **materiality and professional judgment** to apply to matters reported by component auditors
- Audit mind-set to change from ***Only Substantive procedures to Control reliance***
- Mind-set change from ***testing account balances to 'class of transactions'***
- In view of the inherent risk of management override, the auditor will need to identify and ***consider appropriate fraud risk factors*** when testing the control
- Auditors should ***give adequate time, to management*** for remediating deficiencies identified, and to the audit team to test the remediated controls

Audit of IFCoFR

The major steps for an Audit of IFCoFR:



Step 1 – Understanding the business

Understanding the business

- Entity and its environment
- Legal / regulatory framework and key market forces
- Role of IT in the entity
- Preliminary Assessment
- Considering the information obtained in prior periods
- Related party relationships and transactions

Step 2 – Assessment of the entity level controls

- Identifying risks of material misstatement related to internal control at the entity level
- Understanding of the control environment components and its related elements
- Documenting audit evidences obtained
- Conclusion regarding the operating effectiveness of the entity level controls
- Determining the effect on audit strategy

Step 3 – Process understanding

- Understanding of all key relevant business processes
- Critical path for all relevant business processes (through flow charts / diagrammatic representations)
- Identify and document what can go wrongs and relevant controls
- Understanding about controls (includes control description, frequency, nature, overall evaluation of design effectiveness and others)
- Who performed and reviewed the audit work and the such relevant dates

Step 4 – Test of Controls

- Significant class of transactions for which the test of controls is being performed
- Details about the controls which are being tested
- Samples selected for testing the controls
- Population used for sample selection
- Nature, timing and extent of the work being performed
- Documentation regarding the audit evidence gathered
- Conclusion about the operating effectiveness of each control basis the samples tested

Sampling
ethodology- Testi

Step 4 – Test of Controls- Evaluation of Deficiencies

On completing Step 4 – The test of controls, the deficiencies are to be identified.

A deficiency in internal financial control over financial reporting exists when the design or operation of a control ***does not allow*** the management to prevent or detect misstatements on a timely basis, in the normal course of business activity.

The 4 categories of Deficiencies have been provided further.

- Design deficiency
- Operating deficiency
- Significant deficiency
- Material weakness

Evaluation of Deficiencies- Illustrative

Design Deficiency
- Inadequate documentation of components of internal controls
- Inadequate design of IT General Controls 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

Case Study to evaluate Design deficiency

Background	Issue	Conclusion
• ***Risk of material misstatement:*** Inappropriate payments to vendors (validity, accuracy) • ***Relevant control:*** Invoices are reviewed and authorized for payment by the business process owner and the accounts payable manager, based on purchase orders and receiving reports, as applicable; discrepancies are investigated and resolved timely • ***Transaction volume:*** Amount of transactions processed through the control approximates Rs.10,000,000 annually • ***Materiality:*** Rs.1,000,000	• The ***control has not been implemented***, resulting in a missing control and, therefore, a ***design deficiency***. There are no compensating or redundant controls addressing this risk of material misstatement	As a control has not been implemented, all Rs.10,000,000 of transactions ***could have been inappropriate payments*** (i.e., regardless of whether there actually was a misstatement as a result of the control deficiency). Accordingly, given the magnitude of potential misstatement that could have occurred and absent any compensating or redundant controls, ***this deficiency is likely a material weakness***.

Case Study to evaluate Operating deficiency

Background	Issue	Conclusion
• ***Risk of material misstatement:*** Inappropriate payments to vendors (validity, accuracy) • ***Relevant control:*** Invoices are reviewed and authorized for payment by the business process owner and the accounts payable manager, based on purchase orders and receiving reports, as applicable; discrepancies are investigated and resolved timely • ***Transaction volume:*** Amount of transactions processed through the control approximates Rs.10,000,000 annually • ***Materiality:*** Rs.1,000,000	• We selected 25 instances of the control to test (planning for no deviations) and re-performed the control procedure. ***For one selection, the control did not operate as designed***. We investigated the nature of the deviation, noting that it appeared to be ***related to human error***. We therefore cannot conclude that the control is effective because the rate of deviation exceeded what we planned for	As we cannot conclude that this ***control is effective (i.e., a deficiency exists), we cannot conclude that a material misstatement is not reasonably possible***. We may either: • Expand our testing of the deficient control • Identify and test redundant (alternate) or compensating controls • Conclude that the control is deficient, and evaluate the severity of the deficiency

Case Study to evaluate Operating deficiency w.r.t Entity Level Compensating Controls

Background	Issue	Conclusion
• ***Risk of material misstatement:*** Inappropriate payments to vendors (validity, accuracy) • ***Relevant control:*** Invoices are reviewed and authorized for payment by the business process owner and the accounts payable manager, based on purchase orders and receiving reports, as applicable; discrepancies are investigated and resolved timely • ***Transaction volume:*** Amount of transactions processed through the control approximates Rs.10,000,000 annually • ***Materiality:*** Rs.1,000,000	• The control is implemented but we have concluded the ***control is not operating effectively*** based on our tests of the control. ***Compensating controls*** were identified as follows: • ***Quarterly detailed review*** of the key performance indicators to identify changes related to account payable/purchases data; fluctuations greater than Rs.300,000 are identified for follow-up • ***Annual forensic audit of accounts payable***, including searching for indicators such as unusual payment trends or fictitious vendors • ***Purchasing department review*** of purchase history by vendor, quarterly	• We tested the compensating controls and concluded they were ***designed effectively (i.e., the compensating controls are directly related to the risk of material misstatement and sufficiently precise)*** and operating effectively. • We may conclude that the ***deficiency is not a material weakness*** (i.e., a deficiency or significant deficiency), as the compensating controls effectively limit the risk of a misstatement to an amount that would not be material

Reporting on IFCoFR

Qualified Opinion

- The controls are ***unable to*** prevent, or detect and correct material misstatements in the financial statements.
- The effects of the material weakness in such internal controls are ***material but is not pervasive***.

Adverse Opinion

- The effects of the material weakness in such internal controls are both ***material and pervasive***.
- The internal control framework adopted by the company does not consider/ adequately consider the essential components of internal control.

Disclaimer Opinion

- The company has not established its internal financial control over financial reporting on criteria based on any of the recognized internal control framework.
- Unable to obtain sufficient appropriate audit evidence to express an opinion on IFC.

Effect of modified report over IFCoFR

- A modified report on internal financial controls over financial reporting does not in effect/ imply that the audit report on financial statements should also be qualified.
- In an audit of financial statements, the assurance obtained by the auditor is through both internal controls and substantive procedures.
- Hence, substantive procedures are to be performed for all assertions, regardless of the assessed levels of material misstatement or control risk.
- Further, as a result of substantive procedures, if sufficient reliable audit evidence is obtained & if it addresses the risk identified then do not qualify audit opinion on financial statements.

Perspective for Small Companies- Characteristics

Characteristics of Small Companies

- Concentration of ownership and management in a small number of individuals
- Straightforward or uncomplicated transactions
- Simple record-keeping
- Few lines of business and few products within business line
- Few levels of management with responsibility for a broad range of controls
- Few personnel, many having a wide range of duties

Perspective for Small Companies- Challenges

Challenges for Small Companies

- Formal documentation of process and controls
- Achieving segregation of duties
- Limited use of information technology
- Limitations in employing experienced finance and accounting personnel
- Limited Board / Audit Committee governance process
- Increased management attention on business than on processes and controls

Perspective for Small Companies- Approach for IFCoFR

- ***IG 19*** on ICAI Guidance Note on Audit of IFCoFR provides ***implementation guidance*** on audit of internal controls in the case of small companies
- If ***entity's documentation*** on controls is ***lacking***, the auditor may consider using the ***items identified as "What can go wrong" as the risk***
- Auditor will need to ***perform increased level of testing on Entity Level Controls*** such as management philosophy, the quality of review type controls, etc..
- In view of the inherent risk of management override, the auditor will need to ***identify and consider appropriate fraud risk factors*** when testing the controls.

Key Challenges

- A vast majority of the Indian Private / Unlisted clients **will not have sufficient and adequate documentation**
- **Modified controls opinion may be required** for clients lacking adequate and appropriate documentation and evaluation of control components
- **Early commencement of design evaluation** critical to help remediation. In Year 1, timing of audit procedures to allow for remediation will be a challenge for both Auditors and the Clients
- **Short supply of client staff** possessing the skills and competence to develop the Internal Controls framework
- Clients using home grown/ off the shelf accounting applications which do not pass our test of ITGCs will **need to scope in additional manual compensating controls** including where source data from such applications are used to operate manual controls