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## ***How well you are prepared to deal with IFC***



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## ***Internal Financial Controls over Financial Reporting (IFCFR)***

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# Background

Companies Act 2013 has **significantly enhanced** focus on Internal Financial Controls (IFCs)

The act requires the directors to report on the adequacy, existence and operating effectiveness of the IFCs (As applicable).

External Auditors are required to provide a **separate and distinct opinion** on adequacy and operating effectiveness of entity's internal controls over financial reporting.

The guidance note draws on concepts that exist in US PCAOB auditing standards.

ICAI has issued guidance note and implementation guide to provide guidance to members. The Guidance note and the Implementation Guide has also clarified certain ambiguities.



# Overview of Internal Financial Controls ('IFC')

Definition of IFC as per Section 134(5)(e)	Key constituents
<p>The <b>policies and procedures</b> adopted by the company for <b>ensuring</b></p> <ul style="list-style-type: none"><li>• orderly and efficient <b>conduct of its business</b>,</li><li>• adherence to company's policies, safeguarding of its assets,</li><li>• <b>accuracy</b> and <b>completeness</b> of the accounting records,</li><li>• Timely preparation of <b>reliable</b> financial information</li></ul>	<p>An adequately 'designed' and 'effective' framework for:</p> <ul style="list-style-type: none"><li>• <b>Financial Reporting Controls</b> (<i>All Companies</i>)</li><li>• <b>Operating Controls</b> (<i>Listed Companies only</i>)</li></ul>
<ul style="list-style-type: none"><li>• <b>prevention</b> and <b>detection</b> of frauds and errors.</li></ul>	<p><b>Fraud Risk Management</b> (<i>All Companies</i>)</p>



- ❖ This definition of IFC is all encompassing and *does not restrict itself* to financial reporting.
- ❖ **Guidance note has clarified** that Internal Financial Controls in context of reporting responsibility of auditors u/s 143(3)(i) implies and relates to 'Internal financial controls over financial reporting' i.e. IFCFR.

## IFCFR – Regulatory mandate as per Companies Act'2013

Relevant Clauses in	Requirement	Applicability
Directors' Responsibility Statement - <b>Sec 134(5)(e)</b>	Board to confirm that IFCs are adequate and operating effectively	Listed Companies
Board Report ( <b>Rule 8 (5) (viii) of Companies (Accounts) Rules</b> )	Board report to state the details in respect of adequacy of IFC with reference to the financial statements	All Companies
Code for Independent Directors (IDs) - <b>Section 149(8) and Schedule IV</b>	Independent Directors shall satisfy themselves on integrity of financial information and that financial controls are robust & defensible.	All companies having Independent Directors
Audit Committee (AC) terms of reference - <b>Sec 177(7)</b>	Evaluation of internal financial controls and risk management system.	All companies having Audit committee
Auditor's report - <b>Sec 143(3) (i)</b>	Auditors to report if the company has adequate IFC systems & that they are operating effectively <b>( from 2015 -16 )</b>	All Companies

- ❑ In case of components included in Consolidated Financial Statement , reporting for IFCFR would apply for respective components only if it's an Indian company registered under the Companies Act 2013.

## Applicability

Following is the broad applicability of reporting on IFCFR by external auditors:



#	Situation	Applicability
1.	Interim Financial Statements	Not applicable
2.	Consolidated Financial statements	Applicable (Indian Components)
3.	Listed Company	Applicable
4.	Private Company	Applicable
5	One person Company	Applicable

- The reporting requirements for auditors are applicable from fin. year **2015-16 onwards**.
- There are **no thresholds / cutoff limits** for applicability like turnover, net worth etc. and therefore even a small private company is covered under the ambit of IFCFR.
- In case of components included in CFS, reporting for IFCFR would apply for respective components only if it's a company under the Companies Act 2013. Auditors of parent company should apply concept of materiality on matters related to IFCFR reported by component auditors.

# Reporting framework for Auditors

Following are the broad requirements as per Guidance note on Audit of IFCFR issued by ICAI



- ❑ Auditor needs to obtain **reasonable assurance** to state whether an adequate internal financial controls system exists.
- ❑ Auditor to comment that Internal financial controls systems are **designed & operate effectively** in the company in all material respects with **respect to financial reporting only**.
- ❑ Auditors to adopt **SA 315**– “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment “ as framework. Similar to ISA 315.
- ❑ Standards on Auditing (SA) do not fully address requirements for reporting on IFCFR. Guidance Note provides supplementary procedures to plan, execute & report on IFCFR.
- ❑ The auditor should report on design and operating effectiveness **as at the balance sheet date**. (though testing needs to be spread throughout the period).
- ❑ Reporting on **management assertion is not required**. Auditors to give independent assessment and distinct opinion.
- ❑ Examples of separate report on internal financial controls over financial reporting are given in the Guidance note.

## What changes – Key differentiators from CARO

Until now, reporting on internal controls by auditors was restricted to a few select areas mandated under the Companies (Auditor’s Report) Order, 2003 “CARO” (as amended).

However, under the Companies Act, 2013, the scope for reporting on internal financial controls is **significantly larger and wider than CARO**.

Coverage	Cos. Act	CARO	What changes
Financial Reporting Controls	✓	✗	CARO had no direct mention about reporting on all financial reporting controls.
Coverage to all significant Business Processes	✓	✗	CARO limited to the adequacy of controls over purchase of inventory and fixed assets and sale of goods and services.
Reporting on Operating effectiveness	✓	✗	CARO does not require reporting on the “operating effectiveness” of such controls.
Separate opinion	✓	✗	CARO required disclosure in audit report and not a separate opinion as required by Companies Act.

- ❖ Earlier internal controls were assessed to determine audit strategy for a financial statements only audit.
- ❖ Now controls will have to be assessed for a separate audit opinion to be issued on internal financial controls.



# *IFC – Around the World*



## **SOX Reporting in US**

- SOX is applicable only to listed companies whereas IFCFR requirements are applicable to all companies (Listed / Unlisted / Private)
- SOX casts reporting responsibility on CEO/CFO whereas under IFC the responsibility is cast on Board of Directors to report on adequacy and operating effectiveness
- The audit opinion to be issued on Design and Operating effectiveness of Internal Financial Controls Over Financial Reporting similar to SOX

## **Financial Instruments and Exchange Act (J-SOX) – Japan**

- Applicable to certain listed entities including their significant subsidiaries and affiliates.
- Management assumes the role and the responsibility to develop and operate internal controls, and is required to evaluate the effectiveness of internal control for financial reports, and report the results in the form of an internal control report to the public.
- The external auditor is required only to issue an opinion on management's evaluation of the effectiveness of internal controls.

## **Chinese SOX**

- Applicable to listed entities.
- Requires management to undertake an annual self-assessment of internal control Effectiveness and disclose the conclusion in annual report

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# ***IFCFR – Smaller, Less Complex Companies***

***ICAI issued the “Implementation Guide on Audit of Internal Controls over Financial Reporting with Specific Reference to Smaller, Less Complex Companies” [IG] on August 22, 2016***

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## *IFCFR – Audit of Smaller, Less Complex Companies*

- ❑ What are ‘Smaller, Less Complex Companies’ [SLC]?
  - No linkage to ‘Small Company’ as defined under Sec. 2(85) of the Companies Act, 2013
  - Indicator to assess SLC given in IG
    - **Concentration of ownership** and management in a small number of individuals;
    - Straightforward or **uncomplicated** transactions;
    - **Few** lines of business and few **products** within business lines;
    - Few internal controls;
    - Few levels of management with **responsibility** for a **broad** range of controls;
    - **Few personnel**, many having a wide range of duties;
    - Use of **less complex IT systems**;
    - **Extensive involvement** by the owners and senior management in the **day-to-day activities** of the business.

The above list is an indicative one and it is not necessary that each of the companies need to demonstrate all of the above characteristics to be considered as a SLC.

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## *IFCFR – Audit of Smaller, Less Complex Companies*

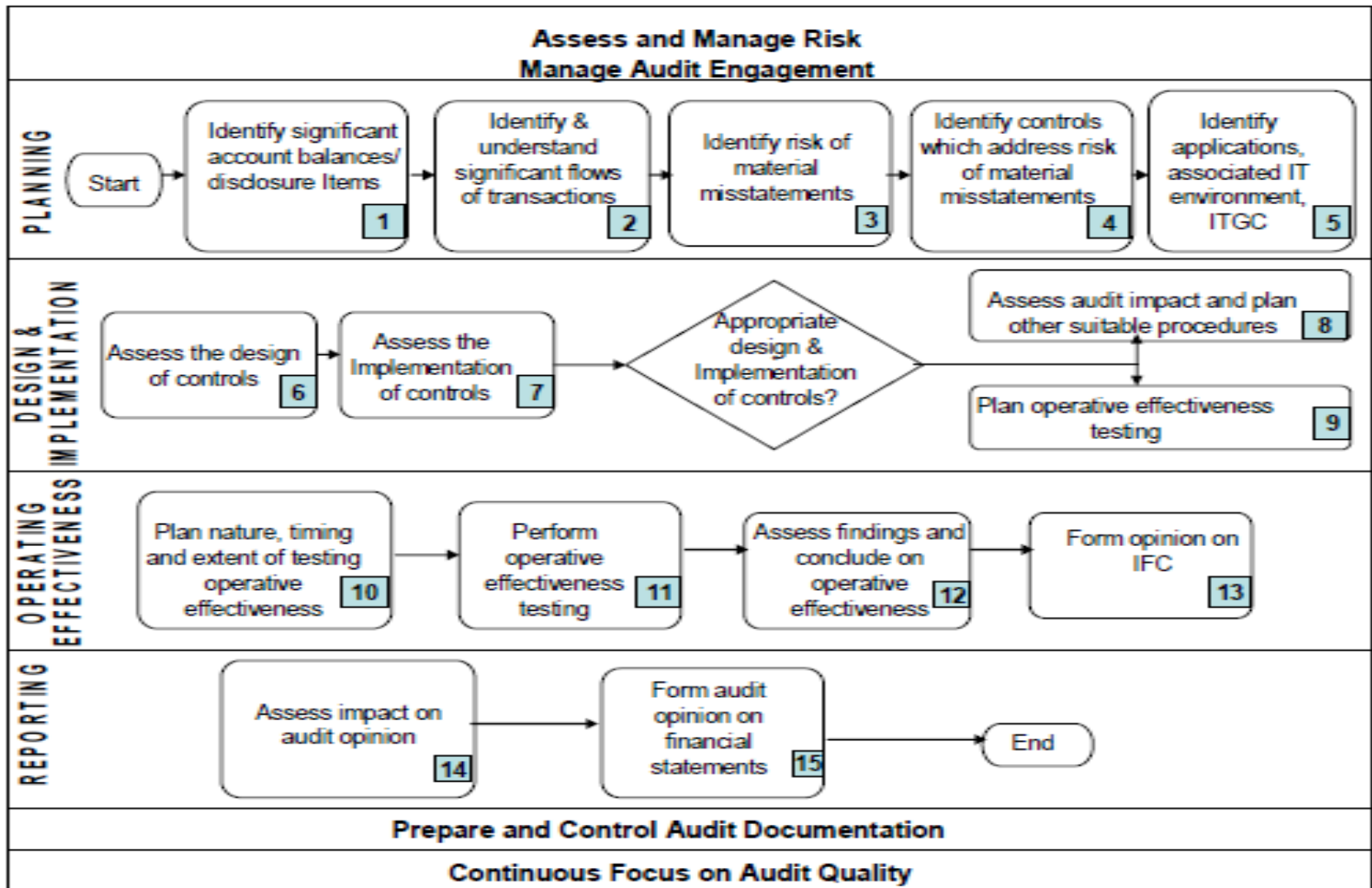
- ❑ IG to be read in conjunction with [Guidance Note \[GN\]](#) on IFCFR issued by ICAI in September 2015
  
- ❑ What does the [IG](#) deal with?
  - discusses how the guidance given in the [GN may be applied](#) to audit of IFCFR in case of SLC. Takes cue from Para 79 of GN on IFCFR regarding [customising](#) the audit taking into [consideration](#) the size, complexity, risks and the means of achieving the control objectives to address the risks
  - IG addresses some of the [practical difficulties](#) that may arise in audit of IFCFR in case of SLC
  - IG assists the auditor to identify ways of obtaining sufficient appropriate audit evidence in case of companies having [limited/formal documentation](#) which is faced most auditors in case of SLCs.
  - [Assists](#) the auditor to design and execute the [audit strategy](#) considerations.
  - Examples of [report](#).

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## *IFCFR – Audit of SLC - Approach*

- ❑ Combined with audit of financial statements [FS]
- ❑ Plan and approach to achieve **objectives of both audits**
  - Audit of FS – opinion on the fairness with which the FS present in all material respects, financial position, results of operations, and its cash flow in conformity with financial reporting framework
  - Audit of IFCFR – opinion on the effectiveness of the Company’s internal control over financial reporting
- ❑ **4 step** approach
  1. Audit Planning
  2. Risk Assessment Procedure
  3. Auditor response, including test of accounts and controls
  4. Completion and Reporting

# IFCFR – Audit of SLCs – 4 Step Approach



## IFCFR – Audit of SLC - General considerations

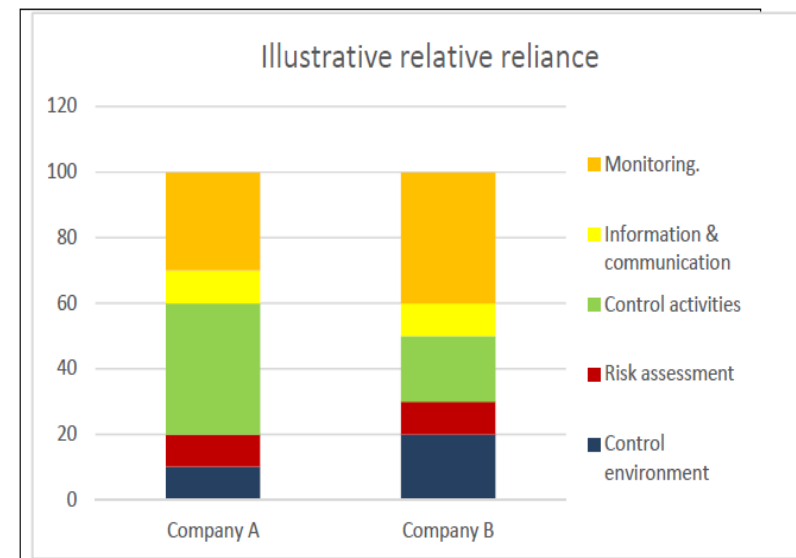
### ☐ Sufficient appropriate audit evidence:

- What **alternative sources** can be considered in absence of formal documentation of controls – Circulars on practices followed, internal departmental documents, extracts of management / internal audit reports, business plans, Board / Committees meeting minutes, agreements etc.

### ☐ Assessing **Entity Level Controls [ELCs]**

- All **5 components** should be present and functioning
  1. Control environment
  2. Risk assessment
  3. Control activities
  4. Information system and communication
  5. Monitoring of controls

*Appendix 1 of IG gives a indicative list of such ELCs*



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## *IFCFR – Audit of SLC - General considerations (Contd.)*

- ❑ Evaluating **risk of management override** and its mitigating actions - Integrity and ethical values, oversight by senior management / Board, compliant mechanism, other controls such as dual authorisations etc.
- ❑ Evaluating controls implemented in lieu of **segregation of duties** – use of external party, oversight and review activities etc.
- ❑ Evaluating financial reporting **competencies** – use of professionals, competencies of other professionals.
- ❑ Reliance of **work of Internal Auditor** – SA 610
- ❑ Considerations related to **discontinued operations**
- ❑ Considerations when certain business processes are **outsourced**
- ❑ Evaluation and test of **Information Technology General Controls**



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## *IFCFR – Audit of SLC - General considerations (Contd.)*

- ❑ **Process level controls** that can be considered for SLCs - [Appendix 2](#) of IG
- ❑ **Compensating controls** that can be considered for SLCs - [Appendix 3](#) of IG
- ❑ **Techniques of testing**
  - Corroborative enquiry
  - Observation
  - Examination of Documentation
  - Re-performance

## *IFCFR – Audit of SLC - General considerations (Contd.)*

- Sample sizes –

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

- **Period of testing** – Samples through out the period, emphasizes on testing closer to year end, interim testing – roll forward procedures
- **Remediation** - to be before period end, to be tested for operating effectiveness

## Illustrative Risk wise controls (Revenue & Receivables)

Following are the risk wise controls that can be considered for a small, less complex entities:

Risks	Control(s)/control activities that can be tested	Procedures to be performed
<p>All goods shipped are not invoiced, therefore revenue is not complete (completeness)</p>	<ul style="list-style-type: none"> <li>The client raises a shipping document for all goods supplied. These shipping documents for the basis for the sales invoice;</li> </ul>	<ul style="list-style-type: none"> <li>Test the <b>sequential numbering</b> of the documents and ensure that the documents are controlled. Re-perform controls document sequence to check that all documents are accounted for in raising invoices.</li> <li><b>Inspect</b> monthly <b>exception report(s)</b> which list un-invoiced shipping documents and obtain explanations from management for any omissions and / or delays in processing.</li> </ul>
<p>Invoices are raised, but the data used (either quantities or price) is inaccurate, therefore revenue is not accurate (accuracy)</p>	<ul style="list-style-type: none"> <li>Client raises invoices based on review and approval of the sales orders.</li> </ul>	<ul style="list-style-type: none"> <li>Test the <b>invoices raised</b> by <b>comparing</b> the same to the approved sales <b>order</b> and obtain <b>explanations</b> from management for any <b>discrepancies</b>.</li> <li><b>Inspect</b> shipping documents to ensure that the <b>correct quantity</b> and stock description has been entered onto the invoice and that the invoice is raised without delay after the dispatch date [only relevant where not automated process]</li> </ul>

## Illustrative Risk wise controls (Revenue & Receivables)

Following are the risk wise controls that can be considered for a small, less complex entities:

Risks	Control(s)/control activities that can be tested	Procedures to be performed
Revenue is recorded For transactions that had not take place (occurrence)	<ul style="list-style-type: none"><li>• There may be a daily or weekly review of sales numbers by management to ensure that the sales recorded are the ones that they were expecting to be shipped in that period, given their understanding of the order book and schedule.</li><li>• Gross margin review may pick up stock shipped but not invoiced</li></ul>	<ul style="list-style-type: none"><li>• Select sales invoices as per the sample size guidance and confirm through inspection of the shipping documents that a sale had taken place.</li></ul>

## Illustrative Risk wise controls (Revenue & Receivables)

Following are the risk wise controls that can be considered for a small, less complex entities:

Risks	Control(s)/control activities that can be tested	Procedures to be performed
<p>Under provision for bad debts (Completeness of provision for doubtful debts; Valuation of Trade debtors; Completeness of expenses)</p>	<ul style="list-style-type: none"> <li>Aged accounts receivable ledger may be used by credit control staff to highlight aged debts, individual payment profiles (to highlight poor/slow payers) and to establish the correct level of bad debt write-offs and provision against bad debts.</li> </ul>	<ul style="list-style-type: none"> <li>Through inquiry and inspection, obtain evidence for a certain number of months that the aged accounts receivable ledger is used by credit control clerks(s) to highlight any errors, establish the correct level of provisioning and to chase aged debts.</li> <li>Discuss any errors identified by the above control, such as missing credit notes, overpayments/credit balances, unallocated cash balances and obtain explanations for each of the errors identified</li> <li>Review report to ensure all of the following items identified in the aged accounts receivable report have been examined, investigated and satisfactorily resolved/in the process of being resolved:               <ul style="list-style-type: none"> <li>overdue/long-outstanding debts</li> <li>unallocated cash balances</li> <li>credit balances</li> </ul> </li> </ul>

## Illustrative Risk wise controls (Inventory)

Following are the risk wise controls that can be considered for a small, less complex entities:

Risks	Control(s)/control activities that can be tested	Procedures to be performed
Inventory received not authorised or not recorded in the inventory system (completeness)	<ul style="list-style-type: none"> <li>All purchase orders are approved by an authorised personnel.</li> <li>Goods receipt note is prepared for quantities received and is verified for an approved purchase order</li> </ul>	<ul style="list-style-type: none"> <li>Verify purchase orders, goods receipt notes and invoices for selected management reviews and approvals.</li> </ul>
Inventory does not exist or belong to the company (Existence, rights/obligation)	<ul style="list-style-type: none"> <li>Physical inventory is counted periodically and discrepancies are investigated and corrected in the inventory records.</li> <li>Inventory records based on the physical inventory are reconciled to the general ledger with any differences being recorded as a book-to-physical inventory adjustment.</li> </ul>	<ul style="list-style-type: none"> <li>Observation management's physical verification of inventory at the year-end.</li> <li>Verify that management has reconciled physical verification to inventory records and necessary adjustments have been made in the books to reconcile the books with physical verification results after appropriate approvals.</li> </ul>

## Illustrative Risk wise controls (Inventory)

Following are the risk wise controls that can be considered for a small, less complex entities:

Risks	Control(s)/control activities that can be tested	Procedures to be performed
Inventory recorded in the general ledger does not reconcile to the inventory records <b>(Completeness, Existence, Rights and Obligations, Valuation and Allocation)</b>	<ul style="list-style-type: none"> <li>Management <b>reviews</b> and approves the <b>reconciliation</b> of the inventory records to the general ledger and any <b>reconciling items</b> are reviewed and addressed on a timely basis.</li> </ul>	<ul style="list-style-type: none"> <li><b>Inspection</b> of evidence for reconciliation performed or through inquiry, reperformance confirm that <b>reviews</b> are performed over the accounts <b>regularly</b>.</li> </ul>
Inventory may not be valued properly <b>(Valuation)</b>	<ul style="list-style-type: none"> <li>Management <b>reviews</b> inventory <b>valuation</b> is appropriate considering <b>obsolescence, NRV, condition, method</b> used for valuation.</li> </ul>	<ul style="list-style-type: none"> <li>Verify that <b>management</b> has <b>reviewed valuation</b> of inventory considering obsolescence, NRV, condition, method used for valuation.</li> </ul>

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## *IFCFR – Audit of SLC – Evaluating Deficiencies*

### ☐ Evaluating Deficiencies –

- Deficiency –that does not allow the management / employee in the normal course of to prevent or detect misstatements on a timely basis
- Significant deficiency - important enough to merit attention of those charged with governance.
- Material Weakness - 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.



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## *IFCFR – Audit of SLC – Reporting Considerations*

- ❑ Unmodified Opinion – generally when able to conclude on existence of design and operating effectiveness of IFCFR
- ❑ Modified Opinion – generally when one or more material weaknesses noted
- ❑ Limitation in Scope / disclaimer of opinion – generally when no system of IFCFR established, lack of evidences

Appendix 4 of IG

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## ***IFCFR – Audit of SLC – Other Matters***

- ❑ Impact of prior year errors
- ❑ Engagement Letter – SA 210 ‘Agreeing the terms of audit engagement’
- ❑ Management Representation Letter – SA 580 ‘Written Representation’
  - Inability to obtain such letter constitutes limitation on the scope

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*Thank  
you*

