# INTERNAL FINANCIAL CONTROLS


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CHARTERED ACCOUNTANTS

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## 01 New Provisions in Law?

**Section 134(5) (e)***

Director's Responsibility Statement of a **listed company** to include **laying down of Internal Financial Controls (IFC)** and that such controls are **adequate & operating effectively.**

**Section 177(4) (vii)***

The terms of reference of Audit Committee shall include **evaluation of Internal Financial Controls (IFC).**

**Essence of new Compliance Requirements**

The **Board of Directors** and **Audit Committees** (wherever applicable) of **all companies,** listed as well as unlisted, are required **to ensure laying down of Internal Financial Controls (IFC) over financial reporting and adequacy and operating effectiveness** of such controls. **The auditors are required to opine** on the adequacy and operating effectiveness of IFC on Financial Reporting (FR) **as on 31st Mar'16.**

**Company (Account) Rules, 2014 Rule 8(5) (viii)**

Board's report shall contain details in respect of **adequacy of Internal Financial Controls (IFC)** with reference to the **Financial Statements.**

**Section 143(3) (i)***

The auditor's report shall state whether the company has **adequate internal financial controls system** in place and the **operating effectiveness** of such controls.

**Standard on Auditing (SA) 200**

Para A1 states regarding auditor's **opinion on the financial statements** being prepared in accordance with the **applicable financial reporting framework.**

* Companies Act, 2013

## 02 What was the status of IFC before Companies Act, 2013?

- **Company's (Auditor's Report) Order:** Reporting on internal controls limited to adequacy of controls over purchase of inventory and fixed assets and sale of goods and services. **No requirement of reporting adequacy of all controls and operating effectiveness of any controls.**
- **Clause 49 of the Equity Listing Agreement:** Certification by **CEO** / **CFO** stating acceptance of responsibility, evaluation and disclosure in relation to internal controls for financial reporting.

**Applicability**

The reporting related to internal controls was limited to listed companies (clause 49) or large corporates falling under CARO, whereas under the new law BOD and Auditors of all the companies are required to report on IFC on FR.

**Role of Directors**

There was no specific role of BOD or Independent Directors in relation to Internal Controls whereas under the new law the Directors are responsible for laying down the IFC and commenting upon adequacy and effectiveness of IFC.

## 03 Difference in compliance requirements?

No opinion was required from Statutory Auditors whereas in new law statutory auditors have a dual role of providing an opinion of Financial Statements as well as IFC on FR.

**Opinion**

Even the scope of reporting was very limited whereas under the new law the scope includes all transactions impacting financial reporting.

**Scope**

## 04 What is 'Internal Financial Controls' over Financial Reporting?

Definition as per Explanation to Section 134(5) (e), "internal financial controls" means that 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.

As per the definition there are 5 major components of IFC, these are:

**The Companies Act 2013 coined a new term "Internal Financial Control" (IFC) which is a bit of "Internal Control for Financial Reporting" (ICFR) used in the US after the Sarbanes Oxley (SOX) Act and "Internal Control" (IC) as defined in COSO Framework.**

- Policies & Procedures to ensure orderly & efficient conduct of business
- Controls over safeguarding of assets
- Mechanism of prevention & detection of frauds
- Controls to ensure accuracy & completeness of accounting records
- Process for timely preparation of reliable financial information

## 05 All the components of IFC as stated above already exist in some form or the other

### So what really has changed?

### In principle there are two major changes:

**Control Framework Required**
No benchmark framework was suggested and compliance requirements were not specific. These were left to management to execute and report. However, the new requirements are more specific in terms of execution and responsibilities. Also, ICAI under its recent Guidance Note has suggested a framework on lines of globally accepted frameworks like COSO.

**Demonstration Through Documentation**
Since BOD are responsible and Statutory Auditors are required to provide an opinion, the demonstration of the existing controls framework through documented policies, procedures, responsibility matrix, delegation of authority, segregation of duties, risk and controls matrix etc. is very crucial.

## 06 Suggested strategy for implementation of IFC to ensure compliance as well as to extract benefits of IFC framework?

In order to comply with the provisions and to extract benefits, the suggested strategy implementation is to establish three lines of action. These are:

**1st LINE OF ACTION**

Tone setting from the top, putting in places the required **policies & procedures,** identification of risks and defining controls to mitigate the risks by Management.

**2nd LINE OF ACTION**

Fixing up clear responsibility among various team to ensure compliance to the laid down policies & procedures like **Control Self-Assessment.**

**3rd LINE OF ACTION**

Independent assurance to the Management, BODs & Independent Directors that the required controls are being defined adequately and operating effectively.

The suggested strategy will equip the BOD and Audit Committee to ensure compliance as well as provide insights to the Management and Independent Director on the business risks and control effectiveness.

Also, the strategy will enable Statutory Auditors to assess and provide opinion on the controls framework of the organization.

## 07 Why Internal Auditor function is most suitably positioned to implement IFC framework?

i. Structured to enable the maintenance of independence and objectivity, as well as proximity to the business, to establish and maintain relationships with an in-depth understanding of the business.

ii. Sound understanding of business strategy and the associated risks along with ability to challenge and strengthen the control environment.

iii. More than a compliance function; Internal Audit is recognised by business leaders as a function providing quality, value add recommendations and assurance on risk an controls.

iv. Having visibility across the various functional areas / units and dynamic processes through integrated quality assurance and learning programs.

v. Plays an integral role in the governance structure while being aligned with the stakeholders

vi. Capable to build a strategic (two to three years) plan developed in collaboration with the management and aligned to the organisation's risk profile.

## 08 Approach for implementing IFC framework?

Based on RAMA's experience as Internal Auditors of large and mid-size corporates and assisting organizations in effectively implementing Internal Financial Controls over Financial Reporting (ICFR), we believe that for implementing ICFR the underlying risks should be identified for material (significant) accounts. For mitigating / reducing the possibility of occurrence and impact of the identified risks, controls should be designed and a testing strategy should be developed for ensuring that the controls are operating.

A broad structure for implementing ICFR includes:

### 01 Scoping:

Identification of significant accounts, processes and locations, defining materiality, finalizing templates, documenting standards and alignment with External Auditors, Audit Committee and Boards

### 02 AS-IS Assessment:

Performing process walkthroughs, documenting process flows and controls (Entity Level, Transactions Level and IT) and identification of design gaps

### 03 Resolution of Design Gaps:

Developing plan for resolution of design gaps (preferably through automation) prioritized based on the financial impact, Discussion with process owners for buy-in, Implementation timelines, Regular follow-ups and Monitoring

### 04 Continuous Testing:

Finalization of sampling strategy, testing plans and frequency in alignment with Statutory Auditors, perform tests as per plan to identify material risks and plan for resolution

### 05 Reporting:

Highlighting material risks along with mitigation plan to Management & Board

"Complying to the regulations defined in the new Companies Act , IFC would contribute in creating organizations with a solid foundation of transparency and accuracy in financial reporting through robust processes, controls and governance framework.  Management should work with Board of Directors in attaining a right balance between compliance and related costs to take concrete steps resulting in greater confidence of all stakeholders"

CA Narayan R. Pasari - Independent Director, {Hon. Advisor to RAMA}

**Ram Agarwal** - Founder Partner

**Kapil Bansal** - Partner Leading Assignments on ICFR / IFC Frameworks

**Vishal Mandani** - Partner Leading Fraud Risk Management Practice

Ram Agarwal & Associates (RAMA), a Chartered Accountant firm, having its Head Office at Mumbai, carries a quality professional experience of varied services. Partners, Directors and Senior Professionals have in-depth combined experience of more than 50 years in delivering high quality professional services acknowledged by the clients.

RAMA offers services in the areas of Internal Audits, Management Audits, Business Process Review & Re-engineering, SOP, ICFR, Fixed Assets Review, Production Facility – Efficiency Audits, Audit of Retail Locations, Pre-payment Audits and Corporate Fraud Investigations including Forensic Audits and Whistle Blower Management.

RAMA also works on "Greenfield" ERP Implementations, Corporate Finance & Business Advisory.

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