



Internal Financial Control

A New Era of Compliance Reporting

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Internal Financial Control

Preamble

The Introduction of Internal Financial Controls (“IFC”) in The Companies Act 2013 (“Act”) indicates the intention of the Regulators to reflect the international trend of Reporting. Various sections stipulates the compliance requirement by the Company’s Management and the reporting requirement by the Independent Auditor.

IFC - Appearance in Companies Act 2013

- Section 134(5)(e)
- Section 143(3)(i)
- Section 177(4)(vii)
- Section 177(5)
- Schedule IV
- Rule 8(5)(viii)

Meaning – Explanation to Section 134(5)(e)

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.

Some key terminologies dealt with as part of the definition are:

- Policies and Procedures adopted by the company
- Orderly and efficient conduct of business
- Adherence to company’s policies
- Safeguarding of its assets
- Prevention and detection of Fraud and errors
- Accuracy and completeness of accounting records
- Timely preparation of reliable financial information

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IFC – Appearance in the Act

Reference	Details
Section 134(5)(e)	The Directors' Responsibility Statement shall state that the directors, in the case of a listed company, had laid down Internal Financial Controls to be followed by the company and that such Internal Financial Controls are adequate and are operating effectively.
Section 143(3)(i)	The Auditor's Report shall also state whether the company has adequate Internal Financial Controls system in place and the operating effectiveness of such controls
Section 177(4)(vii)	Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include evaluation of Internal Financial Controls and risk management systems.
Section 177(5)	The Audit Committee may call for the comments of the auditors about Internal Control systems, the scope of audit, including the observations of the auditors and review of financial statement 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	The Independent Directors shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.
Rule 8(5)(viii)	The Board Report of all companies to state the details of adequacy of Internal Financial Controls with reference to financial statements

Listed Vs. Unlisted Companies Vs. Terms of Engagement

Section 134(5) of the Act applies only to listed companies which gives rise to a peculiar situation in case of unlisted companies where the auditors would be expected to express opinion on matters of a company for which even the Directors have not taken the responsibility. This is contrary to the concepts in Standard on Auditing (SA) 210, **Agreeing the Terms of Audit Engagement**, which requires the management to acknowledge its responsibility in relation to matters including design, implementation and effective operation of a system on internal controls.

Section 177(4)(vii) of the Act specifies that every Audit Committee shall act in accordance with the terms of

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reference specified in writing by the Board which shall, inter alia, include evaluation of internal financial controls and risk management systems, which implies that the Management should have laid down internal financial controls and risk management systems.

However, Rule 8(5)(viii) specifies that the Board Report of **all companies** should state the details of adequacy of Internal Financial Controls with reference to financial statements

In conclusion, establishment of such internal controls is the fundamental duty of the Directors of any company whether or not stated so explicitly in the Act.

Standards on Auditing (SA)

Establishing adequacy of IFC and review of its compliance is not a new concept. Standards on Auditing that deal with evaluation of IFC's are:

- SA 200 (R) - Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
 - SA 210 (R) - Agreeing the Terms of Audit Engagements
 - SA 250 (R) - Consideration of Laws and Regulations in an Audit of Financial Statements
 - SA 300 (R) - Planning an Audit of Financial Statements
 - SA 402 (R) - Audit Considerations Relating to an Entity Using a Service Organisation
 - SA 450 - Evaluation of Misstatements Identified During Audit
 - SA 500 (R) - Audit Evidence
 - SA 530 (R) - Audit Sampling
 - SA 580 (R) - Written Representations
 - SA 610 (R) - Using the Work of Internal Auditors
 - SA 620 (R) - Using the Work of an Auditor's Expert
- Specific standards that deal with IFC's in greater detail are:
- SA 265 - Communicating deficiencies in Internal Control to those with Governance and Management
 - SA 315 - Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment
 - SA 330 - The Auditor's Response to Assessed Risk

Clause 49 of the Listing Agreement – Role of the Audit Committee

The Audit Committee shall:

- Review with the management, adequacy of internal control systems.
- Review the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
- Review the Management letters / letters of internal control weaknesses issued by the statutory Auditors.
- Review internal audit reports relating to internal control weaknesses.

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Clause 49 of the Listing Agreement – CEO/CFO Certification

The CEO, i.e. the Managing Director or Manager appointed and the CFO i.e. the Whole-time Finance Director or any other person heading the finance function discharging that function shall certify to 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 and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- they have indicated to the Auditors and Audit Committee, significant changes in internal control over financial reporting during the year.
- they have indicated to the Auditors and Audit Committee, instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

Matters for consideration by the Auditor

Amendment to Appendix to SA 700 - Forming an Opinion and Reporting on Financial Statements

Originally, the Auditor's Responsibility Para specified in the Illustrative Format of the Independent Auditor's Report required the auditor to comment that:

"In making risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control."

However, owing to the new reporting requirements, the Institute of Chartered Accountants of India (ICAI) has issued the Illustrative format of the Independent Auditor's Report under the Companies Act 2013 and the Rules thereunder to be added to the Appendix to SA 700. This new format requires the auditor to comment that:

"In making risk assessments, the auditor considers internal financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

The Ministry of Corporate Affairs (MCA) has issued a notification on 14th October 2014, whereby the following insertion was made in the Companies (Audit and Auditors) Rules, 2014 after Rule 10:

"10A. For the purpose of clause (i) of sub-section (3) of section 143, for the financial years commencing on or after 1st April 2015, the report of the auditor shall state about the existence of adequate internal financial

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control system and its operating effectiveness:

Provided that auditor of a company may voluntarily include the statement referred to in this rule for the financial year commencing on or after 1st April 2014 and ending on or before 31st March 2015."

Accordingly, the auditor may consider the following comment which is also specified as part of the illustrative format issued by the ICAI:

"In making those risk assessments, the auditor considers internal financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on whether the Company has in place an adequate internal financial controls system over financial reporting and the operating effectiveness of such controls."

"As on Date" or "For the Period"

The Manner and Timing would vary if the requirement to report on adequacy and operating effectiveness would be "As on Date" or "For the Period". The identification of Control Related issues and related strengthening by the management is a perpetual process.

The Auditor may come across some IFC deficiencies during the period, which may have been rectified by the management before the reporting date. In such situations, the Auditor is not bound to report his findings as per Section 143(3)(i).

However, the Auditor may report the deficiencies identified and reported to those charged with governance and Management as specified in SA 265 issued by the ICAI.

Consolidated Financial Statements

Rule 8(1) of the Companies (Accounts) Rules, 2014 states that the Board's Report shall be prepared based on the stand alone financial statements of the company and the report shall contain a separate section wherein a report on the "performance and financial position" of each of the subsidiaries, associates and joint venture companies included in the consolidated financial statement is presented.

The Rules do not specify the Board reporting on internal financial controls for the subsidiaries, associates and joint ventures considered in the consolidated financial statements. Therefore, it could be inferred that the requirements relating to reporting on internal financial controls are not intended to apply in the case of the consolidated financial statements.

Matters for consideration by the Board & Audit Committee

Framework

In order to comply with the requirements of Rule 8(5)(viii), every company shall necessarily adopt a framework to establish their internal financial control system. However, currently the Act does not specify

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or recommend any framework. Some common international frameworks that provide guidance to entities for developing and establishing the internal control system are:

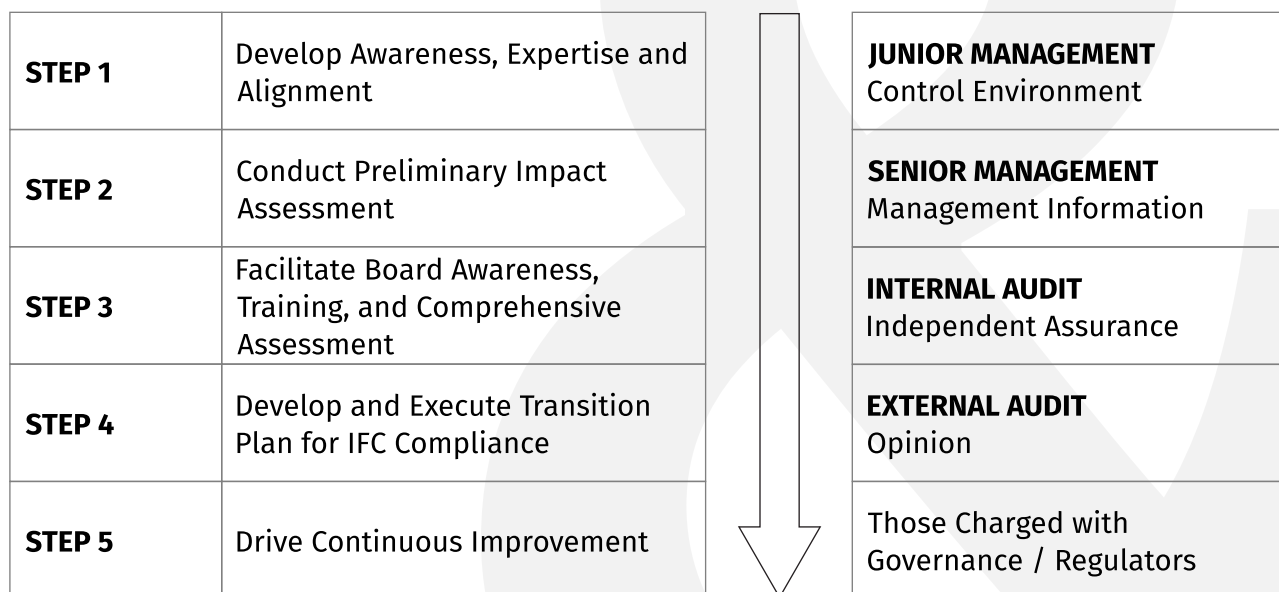
- Internal Control - Integrated Framework issued by Committee of the Sponsoring Organizations of the Treadway Commission (**COSO**).
- Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (**CoCo**)
- Internal Control: Guidance for Directors on the Combined Code, published by the Institute of Chartered Accountants in England & Wales (**Turnbull Report**)
- Guide to Internal Controls over Financial Reporting issued by the Internal Audit Standards Board of the ICAI
- Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the Audit and Assurance Standards Board of the ICAI.

Role of Audit Committee

Audit Committee's involvement has to be increased multifold to comply with requirements of Section 177 and Clause 49 of the Listing Agreement. In order to evaluate the Internal Financial Controls and risk management systems, the Audit committee should:

- Understand the risks and related controls surrounding the business environment
- Understand the risk assessment procedures of the management
- Understand the risk mitigation procedures of the management
- Define role of the internal audit function and assess results on a timely basis
- Meet the internal auditor and external on a regular basis
- Regularly test management's monitoring of internal control assessment tools.

Management's Measures



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Conclusion

With increasingly complex business models evolving it becomes highly important for the promoters, management, directors to implement strong internal controls within the organization. That being said, the importance of such internal controls reflect on the audit procedures to be implemented and ultimately the reliance for the sake of the stakeholders. Strong framework coupled with user understanding of technology is the need of the hour. Companies in discussion with the relevant experts should gear up for ensuring such compliance by 31st March 2015.

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