# Internal Control on Financial Reporting

## Management Evaluation process

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# Background

India

- Clause (i) of Sub-section 3 of Section 143 of the Companies Act, 2013
- Clause (e) of Sub-section 5 of Section 134
- Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014
- Global (US)
  - In addition to certifying the company's financial statements (Section 302), management must also report on the company's internal control over financial reporting (Section 404)

# Understanding what is Internal Controls on Financial Reporting

***A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles***.

# Understanding what is Internal Controls on Financial Reporting Contd…

*includes those policies and procedures that*

*(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;*

*(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and*

*iii) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements*

# Internal Control means..

Systemic measures ( such as review, checks and balances, methods and procedures) instituted by an organization to-

i. conduct its business in an orderly and efficient manner
ii. safeguard its assets and resources
iii. detect errors, fraud and theft
iv. ensure accuracy and completeness of accounting data
v. produce reliable and timely financial and management information and
vi. ensure adherence to its polices and plans

# Benefits of Internal Controls on Financial Reporting

- Reliability of financial reporting,
- Compliance with applicable laws and regulations,
- Effectiveness and efficiency of operations.

# Internal Control- Limitations

- Collusion
- Management override
- Cost/benefit analysis
  - There is often a trade-off between the cost and the effectiveness of internal controls.
  - The concept of **reasonable assurance** recognizes that the cost of an entity's internal control should not exceed the benefits that are expected to be derived

# Management Responsibility

It is the Management responsibility for the effectiveness of internal control in the organisation. They should do the following:

- Evaluate the design and operating effectiveness of its internal control using a suitable, recognized control framework
- Such evaluation should be backed with sufficient evidence, including documentation and testing of controls
- A written assessment of the effectiveness of its internal control over financial reporting as of the end of its fiscal year should be provided based on its evaluation.

# Management Evaluation process

Plan includes-

- Project team should be formed
- Plan and determine the documentation to be produced
- Communicate to the Statutory auditors

# Management Evaluation process contd..

Planning and determining the financial statements reporting controls assessment and validation includes the following steps:

- Assessing materiality the risk of material misstatements
- Analysis of Controls design
- Testing of Controls
- Reporting

# Management Evaluation process contd..

Assessing materiality the risk of material misstatements-

- Materiality assessment includes Identifying significant accounts & disclosures
  - that are individually significant accounts with specific risks that could create a material misstatement
  - that are significant accounts, if aggregated with other locations or business units
  - for those identified significant balances
    - determine financial statement assertions
    - determine significant processes/cycles/transaction types

# Management Evaluation process contd..

Identifying significant accounts & disclosures-

- Generally, financial statement line items and/or accounts that exceed planning materiality should be considered for designation as significant accounts

Qualitative factors also to consider an account or disclosure less than planning materiality to be significant The factors are -

- Susceptibility of loss due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account;
- Accounting and reporting complexities associated with the account;
- Exposures to losses represented by the account;
- Likelihood of significant contingent liabilities arising from the activities represented by the account;
- Existence of related party transactions in the account, and
- Changes in account characteristics from the prior period.

# Management Evaluation process contd..

Identifying significant accounts & disclosures-

- some accounts that are quantitatively significant may not require testing for qualitative reasons

  - Example Fixed Assets in a Service organization

# Management Evaluation process contd..

Financial Statement Assertions-

In preparing financial statements, management is making implicit or explicit claims (i.e. assertions) regarding the recognition, measurement and presentation of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable financial reporting framework. ( eg. IGAAP or IFRS or US GAAP..)

Example-

A balance sheet of an entity shows buildings with carrying amount of Rs 10 Crores, the user shall assume that the management has claimed that:

- The buildings recognized in the balance sheet exist at the period end;
- The entity owns or controls those buildings;
- The buildings are valued accurately in accordance with the measurement basis;
- All buildings owned and controlled by the entity are included within the carrying amount of Rs10 Crores.

# Management Evaluation process contd.. Assertions relating to assets, liabilities and equity balances at the period end

| Assertions | Description | Example |
|---|---|---|
| Existence | Assets, liabilities and equity balances exist at the period end | Inventory recognized in the balance sheet exists at the period end |
| Completeness | All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements. | All inventory units that should have been recorded have been recognized in the financial statements. |
| Rights & obligations | Entity has the right to ownership or use of the recognized assets, and the liabilities recognized in the financial statements represent the obligations of the entity. | Entity owns or controls the inventory recognized in the financial statements. Any inventory held by the entity on account of another entity has not been recognized as part of inventory of the entity. |
| Valuation | Valuation Assets, liabilities and equity balances have been valued appropriately. | Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage has been excluded from the cost of inventory. An acceptable valuation basis has been used to value inventory cost at the period end (e.g. FIFO, Weighted Average etc.) |

# Management Evaluation process

## contd.. Assertions Related to Presentation and Disclosure-

| Assertions | Description | Example |
|---|---|---|
| Occurance | Transactions and events disclosed in the financial statements have occurred and relate to the entity. | Transactions with related parties disclosed in the notes of financial statements have occurred during the period and relate to the entity. |
| Completeness | All transactions, balances, events and other matters that should have been disclosed have been disclosed in the financial statements. | All related parties, related party transactions and balances that should have been disclosed have been disclosed in the notes of financial statements. |
| Classification & Understandability | Disclosed events, transactions, balances and other financial matters have been classified appropriately and presented clearly in a manner that promotes the understandability of information contained in the financial statements. | Users of the financial statements can clearly determine the financial statement captions affected by the related party transactions and balances and can easily ascertain their financial effect. |
| Accuracy & Valuation | Transactions, events, balances and other financial matters have been disclosed accurately at their appropriate amounts. | Related party transactions, balances and events have been disclosed accurately at their appropriate amounts. |

# Management Evaluation process

## contd.. Assertions related to Class of Transactions-

| Assertion | Description | Example |
|---|---|---|
| Occurrence | Transactions recognized in the financial statements have occurred and relate to the entity. | Salaries & wages expense has been incurred during the period in respect of the personnel employed by the entity. |
| Completeness | All transactions that were supposed to be recorded have been recognized in the financial statements. | Salaries and wages cost in respect of all personnel have been fully accounted for. |
| Accuracy | Transactions have been recorded accurately at their appropriate amounts. | Salaries Accuracy Salaries and wages cost has been calculated accurately. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for. |
| Cut-off | Transactions have been recognized in the correct accounting periods | Salaries and wages cost recognized during the period relates to the current accounting period. Any accrued and prepaid expenses have been accounted for correctly in the financial statements. |
| Classification | Transactions have been classified and presented fairly in the financial statements | Salaries and wages cost has been fairly allocated between:<br>-Operating expenses incurred in production activities;<br>-General and administrative expenses; and<br>-Cost of personnel relating to any self-constructed assets other than inventory. |

# Management Evaluation process contd..

## Identifying significant Business Units and locations

- A business unit or location can be defined as any of the following: country, plant, sales region, legal entity, reporting unit, business unit, or segment.
- Categorize business units/locations as following-
  - Individually important.
  - Contain specific risks that by themselves could create a material misstatement in the consolidated financial statements.
  - When aggregated, could represent a level of financial significance that could create a material misstatement in the consolidated financial statements
  - Insignificant Business Units

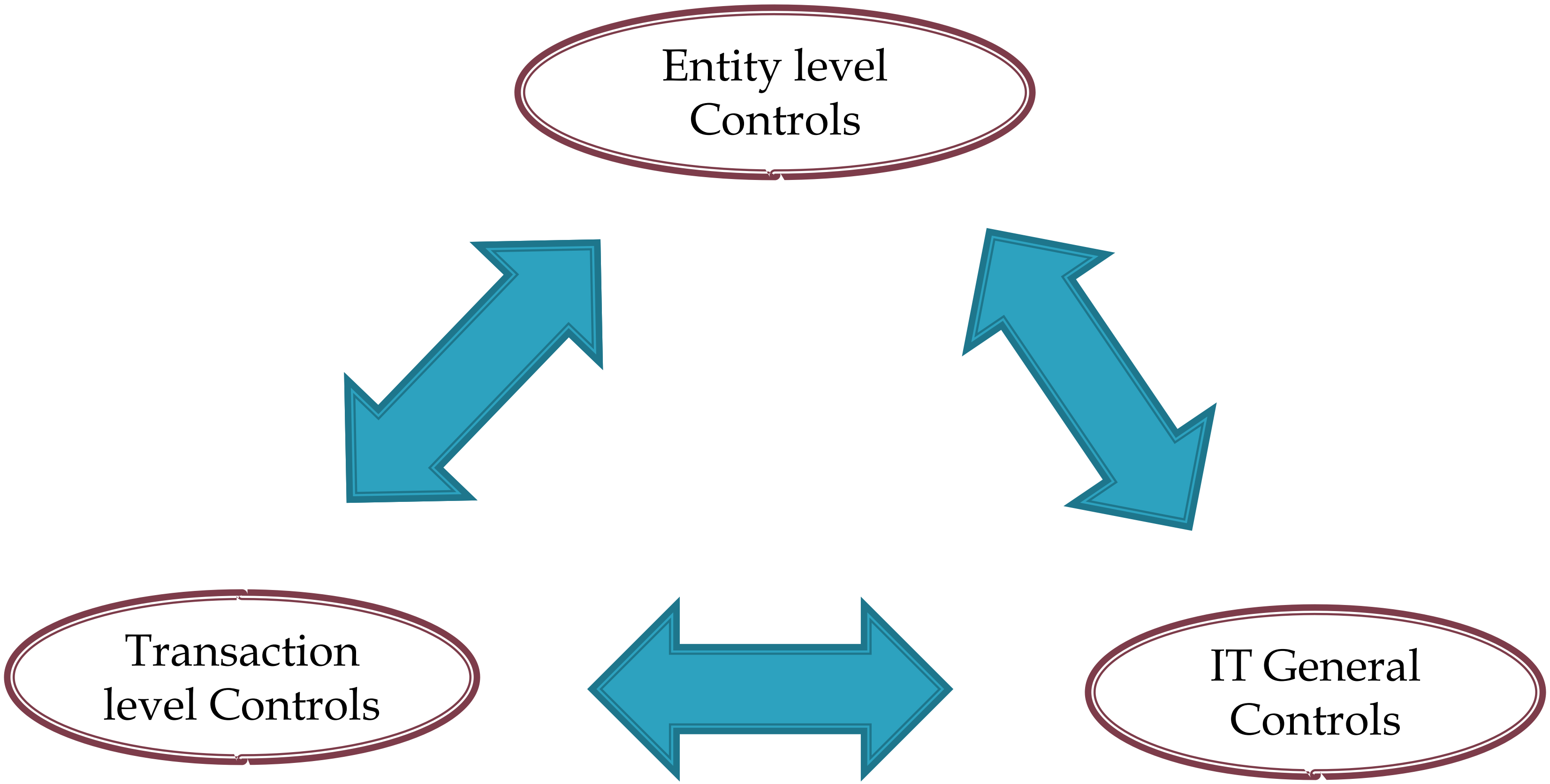
As a general rule of thumb, between our testing of controls over relevant assertions for significant accounts performed at individually important and specific risk locations and evidence obtained from entity-level controls for other locations or other extended procedures, we should typically obtain evidence related to approximately 90 to 95% of consolidated assets and revenue

# Management Evaluation process contd..

Identifying significant Business Units and locations

| Coverage of Total Revenue and Assets | Testing Plan | Location |
|---|---|---|
| 55-70% | Detailed evaluation and tests of controls over significant (or specific risk) accounts and disclosures at the location and testing of entity-level controls. | Individually important locations and specific risk locations |
| 20-35% | Evaluate/test entity-level controls, if applicable, or perform detailed evaluation and tests of controls over significant accounts and disclosures at some locations if adequate entity-level controls do not exist. | Locations considered important when aggregated with others |
| < 5 to 10% | No testing required. | Immaterial locations |

# Management Evaluation process

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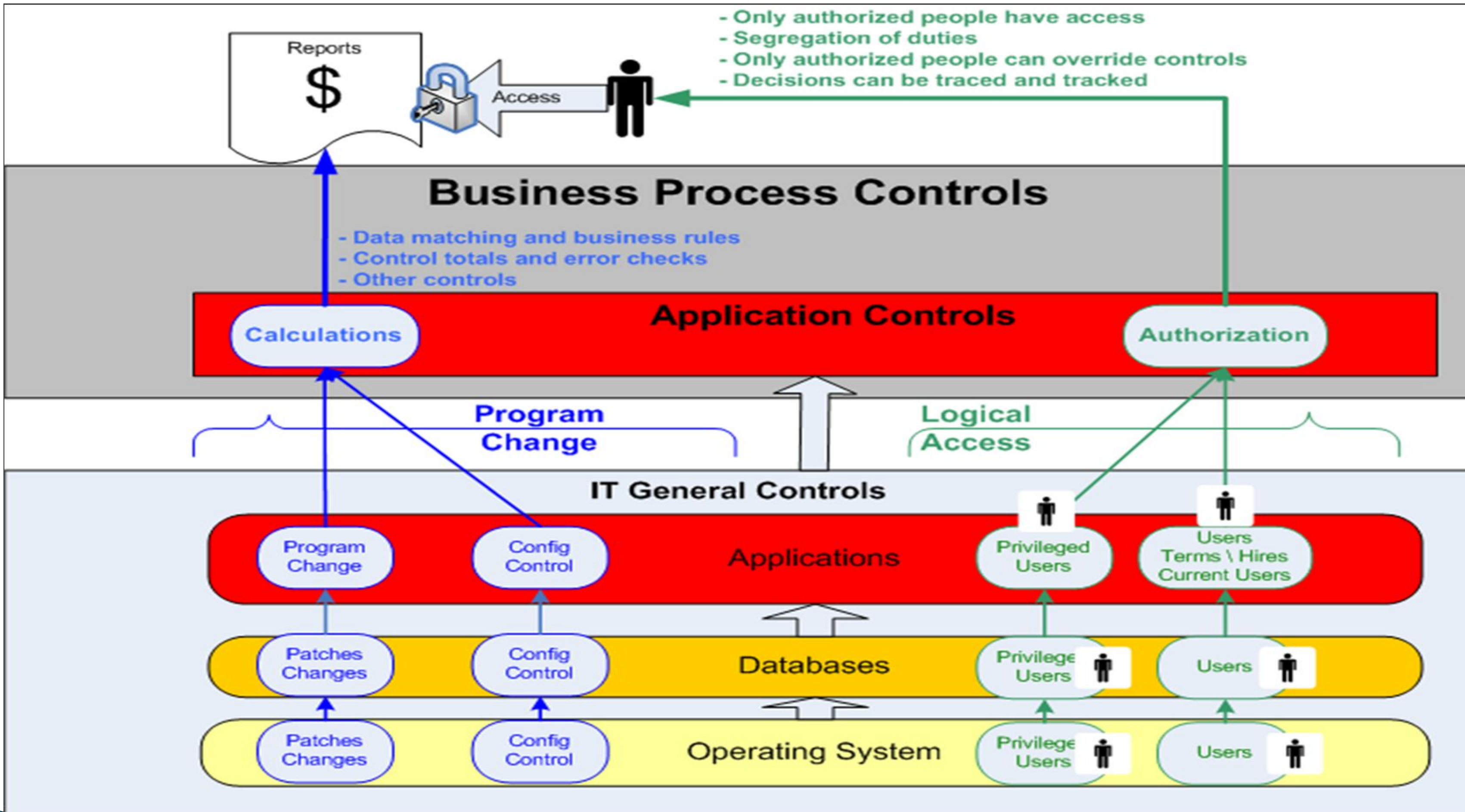
# Management Evaluation process contd..

Entity Level Controls

- the control environment, including tone at the top (Better define and communicate the expectations of management across the organization )
- Management's risk assessment process
- Centralized processing and controls, including shared service environments
- Monitoring results of operations
- Monitoring of controls, including activities of the internal audit function, the audit committee, and self-assessment programs
- The period-end financial reporting process
- Anti-fraud programs

# Management Evaluation process
## IT General Controls

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# Management Evaluation process contd..

Transaction Level Controls and IT Controls

Understand the process flows and Perform Walkthoughs

Walkthroughs provide the management auditor with evidence to:

- Confirm the understanding of the process flow of transactions,
- Confirm the auditors understanding of the design of controls identified for all five components of internal controls over financial reporting, including those related to the prevention or detection of fraud
- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process where misstatements related to each relevant financial statement assertion could occur have been identified
- Evaluate the effectiveness of the design of controls, and
- Confirm whether the controls have been placed in operation

# Management Evaluation process contd..

Analysis of Controls design-

- over relevant assertions related to all significant accounts and disclosures in the financial statements for the identified significant processes and activities, map the understanding of process and activities in Flow charts and determine the risk "what could go wrong" in each process in Risk and Control Matrix.

- Carry walk through of the process to identify
  - Missing controls
  - Missing control objectives
  - Incompatible duties
  - Inappropriate mix of control attributes (lack of monitoring controls, too many undocumented controls)
  - Inadequate governance controls

# Management Evaluation process contd..

Analysis of Controls design-

Management should determine whether deficiencies identified rise to the level of **significant deficiencies or material weaknesses.**

**Management should** Report the Significant Deficiencies and Material Weakness in design of controls with remediation plans to Audit committee or equivalent.

# Management Evaluation process contd..

Test of Controls-

Management, after determining that controls are designed effectively, then they must test the operating effectiveness of governance and activities-level controls to obtain sufficient evidence to support its assessment.

Management to test how the control was applied, the consistency with which it was applied and who applied it. Such testing should be done through out the year so that operating effectiveness of the controls as of date of balance sheet can be determined.

# Management Evaluation process contd..

Test of Controls-

to determine operative effectives the management should

- Identify the controls to test
- Select testing strategy
- Determining in testing procedures, also determining the number of items to test and the period that testing should cover
- Performing control tests and evaluating the impact of any deviations found
- Conclude whether deficiencies rise to the level of material weaknesses

# Management Evaluation process contd..

Test of Controls-

Management may choose the following type of tests-

- Inquiry and observation
- Sampling
- Reperformance

Management should document results of test and deviations if any.

The following guidance related to the frequency of the performance of control may be considered when planning the extent of tests of operating effectiveness of manual controls for which control deviations are not expected to be found-

# Management Evaluation process contd..

Test of Controls-

| Control Frequency | Minimum Sample size Risk of Failure Lower | Minimum Sample size Risk of Failure Higher |
|---|---|---|
| Mutliple times a day | 25 | 40 |
| Daily | 15 | 25 |
| Weekly | 5 | 8 |
| Monthly | 2 | 3 |
| Quarterly* | 1+1 | 1+1 |
| Annually | 1 | 1 |

* Includes period end

# Management Evaluation process contd..

Test of Controls-

- Controls are designed and implemented to operate effectively all the time.
- Any deviation is evidence that the control is not operating effectively.
- After considering the nature and cause of deviations found in control tests, management should determine whether the deficiency rises to the level of a **significant deficiency or a material weakness**

Management should then evaluate the:

- Likelihood that a misstatement could occur
- Magnitude of the potential misstatement

# Management Evaluation process contd..

**Reporting**

Management should communicate the progress of the project and any findings to the audit committee and the auditor. Management should report significant deficiencies and material weaknesses in the design or operation of controls to the audit committee and auditor as soon as practicable.

# Key Definitions

Design effectiveness

- The right person, using the right information to make the right decision in a timely manner, to mitigate identified key risks.
- Design effectiveness determines whether the controls over financial reporting, **if operating effectively**, would be expected to prevent or detect errors or fraud that could result in a material misstatement in the financial statements.

Operative effectiveness

- The consistent application, without exception, of an effectively designed control.
- **Operating effectiveness** is whether the control is **operating as designed** and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively

# Key Definitions

Significant Deficiency

- is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Material Weakness

- is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that 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.

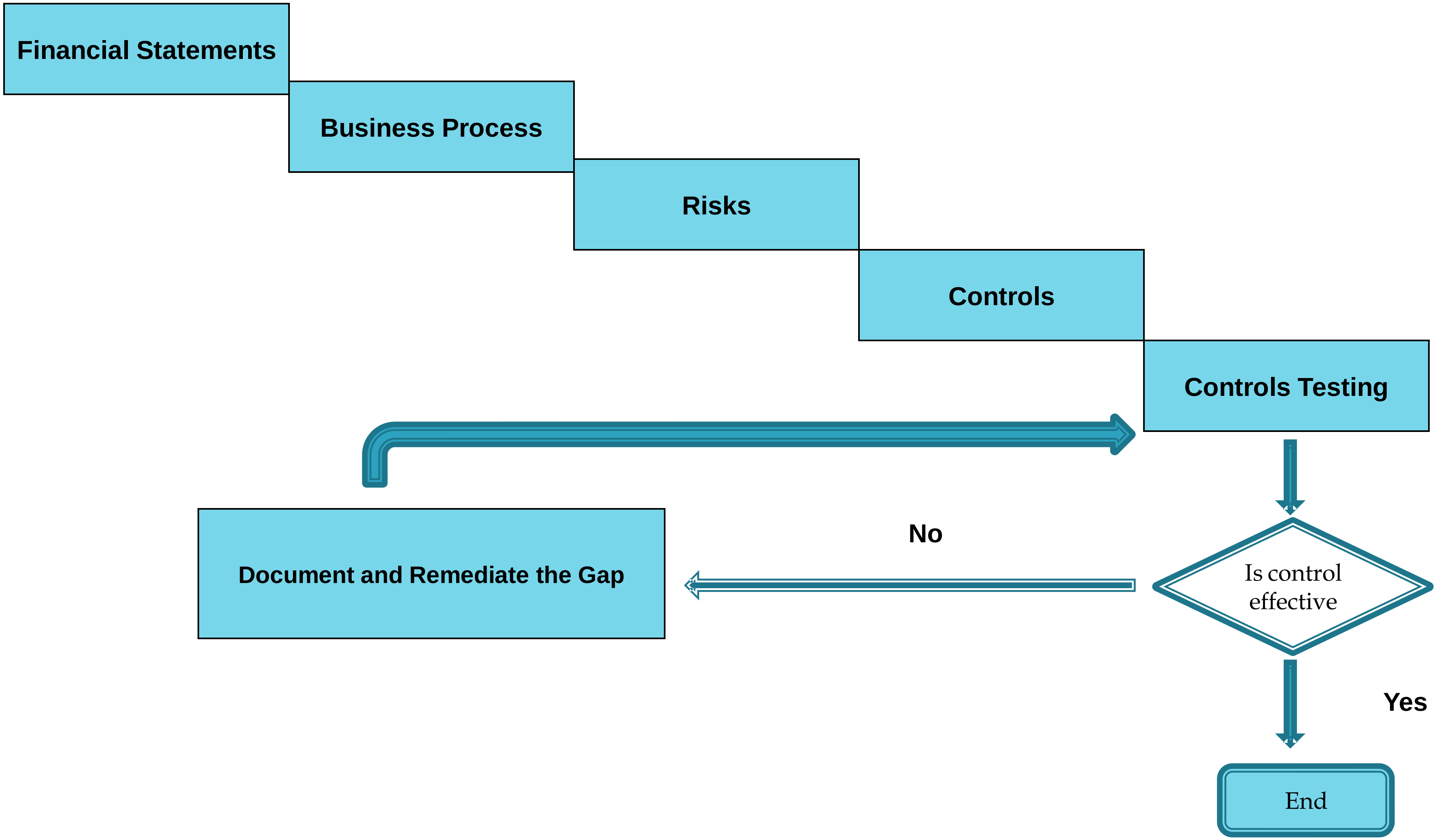
# Key Definitions

| *Description* | *Definitions* |
|---|---|
| Control Owner | *The person responsible for the control activity* |
| Control Objectives | *Management's goals which, if achieved, reduce the identified risk to an acceptable level* |
| Control Activities | *Policies and processes implemented to achieve the control objectives. These activities prevent or detect errors in financial reporting on a timely basis* |
| Control Gaps | *Describe the root cause of an ineffective control* |
| Design Evaluation | *Evaluation of the adequacy of the control activities in achieving the control objective* |
| Assertions | *Representations by management that are embodied in financial statement components* |

# Key Definitions

| *Description* | *Definitions* |
|---|---|
| *Automated Control* | *Activities are executed by a system automatically. Examples of automated control activities include access restrictions, edit and validation checks, automated journal entries that ensure general ledger postings are made to valid, predefined accounts, etc.* |
| *Manual Control* | *Activities are performed by hand. Examples of manual control activities include management approvals, comparing computer output to source documents, reconciliations performed by hand, etc.* |
| *Detective Control* | *Detective controls have the objective of detecting errors or fraud that have already occurred that could result in a misstatement of the financial statements.* |
| *Preventive Control* | *Preventive controls have the objective of preventing errors or fraud from occurring in the first place that could result in a misstatement of the financial statements.* |

# Model Process



# Documentation

Why is documentation important?

- Documentation of the design of significant controls (e.g., policies and procedures) provides evidence that such controls have been identified and are capable of being monitored by the company.
- Inadequate documentation of the design of controls is a control deficiency and may result in a significant deficiency or material weakness.
- A properly conducted documentation process will identify the majority of the existing control deficiencies. If material or significant weaknesses exist, these substantial deficiencies are most often discovered through the process of discussing and documenting current control activities.

# Documentation

No Documentation Nothing Exist

# Documentation

Required Elements  of Documentation

- The design of controls over all relevant assertions related to significant accounts and disclosures in the financial statements
- The control environment and company-level/entity-level controls
- Information about how significant transactions are initiated, authorized, recorded, processed and reported
- Sufficient information about the flow of transactions to identify the points where material misstatements due to error or fraud could occur
- Controls designed to prevent or detect fraud, including who performs the controls and the segregation of duties
- Controls over the period-end financial reporting process
- Controls over safeguarding of assets
- The results of management's testing and evaluation

# QUIZ

Scenario 1

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts **are not** performed on a timely basis. Management **does** perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

# QUIZ

Scenario 1

## Significant Deficiency

- Based only on the facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material, and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts.

# QUIZ

Scenario 2

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts **are not** performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management **does not** perform any alternative controls to investigate significant intercompany account differences.

# QUIZ

Scenario 2

## Material Weakness

- Based only on the facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual un-reconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

# Thank You

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