Internal controls over Financial Reporting – Key concepts

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at
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Agenda

- Scope and requirements
- Overview of internal controls as per SA 315
- Planning and Approach for ICFR Audit
- Design effectiveness
- Operative effectiveness
- Exceptions and deficiencies
- Material weakness

Internal financial controls

Internal controls V/s Internal financial controls

SA 315	Internal control

- the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to :
  - reliability of financial reporting,
  - effectiveness and efficiency of operations;
  - safeguarding of assets, and
  - compliance with applicable laws and regulations.

Internal financial controls

Sec134(5)(e) of the Act	Internal financial control

- 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.

Section 143(3)(i)of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls – applicable to all companies irrespective of nature and size.

ICFR - defined

“Internal financial controls over financial reporting” shall mean

Reliability of financial statements

+

Financial Statements
(in accordance with GAAP)

+

Maintenance of financial records
(Detail / Accuracy & Fair)

+

Transactions are authorized and
as per GAAP

+

Safeguarding of the assets

+

Internal financial controls over
financial reporting (ICFR)

Auditor’s objective

- Express an opinion on the effectiveness of the company's internal financial controls over financial reporting
- Carried out along with an audit of the financial statements
- Auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the balance sheet date

To note –

Significant deficiency or material weakness in internal financial controls over financial reporting may exist even when financial statements are not materially misstated.

Scope for Reporting on Internal Financial Controls

- Significantly larger and wider than the reporting on internal controls under CARO 2015
- Reporting on internal financial controls will not be applicable with respect to interim financial statements
- Applies to consolidated financial statements - Reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting would apply for the respective components **only if it is a company under the Companies Act**.
- Should report if the company has adequate internal control systems in place and whether they were operating effectively as at the balance sheet date.

NOTE: While forming the opinion on internal financial controls, the auditor <u>should test the same during the financial year under audit</u> and not just as at the balance sheet date

Components of Internal controls – SA 315

- According to Guidance note, Criteria can be established by the Company for ICFR by considering the essential components of internal control as stated in SA 315.
- Internal control operating at the entity level versus operating at the transaction or process level for each of the five components:

Component	Entity level	Transaction/Process level
Control environment		
Risk assessment		
Monitoring		
Information and communication		
Control activities		

Control environment

The control environment encompasses the following elements:

- Integrity, ethical values and behaviour of key executives

  The enforcement of integrity and ethical values include management's actions to:

  - Remove or reduce incentives, pressures and opportunities;
  - Being alert to behaviour that may indicate management's motivations and intentions
  - Communicate ethical values
- Management's commitment to competence
- Participation in governance and oversight by those charged with governance
- Organizational structure and assignment of authority and responsibility
- Management's control consciousness and operating style
- HR policies and practices

Control environment

- The auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess:
  - Whether management's philosophy and operating style promote effective internal financial controls over financial reporting;
  - Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
  - Whether the board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

Risk assessment

- We obtain an understanding of whether the entity has a process for:
  - Identifying business risks relevant to financial reporting
  - Estimating the significance of the risks
  - Assessing the likelihood of their occurrence
  - Determining actions to address those risks
- If the entity has not established a risk assessment process, or has an ad hoc process:
  - Inquire of management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed
  - Evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances
  - Determine whether the absence of a documented risk assessment process represents a significant deficiency in internal financial control

Monitoring

- Understand the activities, implemented by management and overseen by those charged with governance, that monitor the ongoing effectiveness of controls.
- Inquire of management about the sources of information it uses in monitoring activities and how management becomes satisfied about the integrity of that information.
- Monitoring is a process of:
  - Assessing the effectiveness of the performance of internal controls over time
  - Determining whether controls are operating as intended
  - Determining that internal control systems are modified as appropriate for changes in conditions

Information system and communication

- Obtain an understanding of the information system, including the related business processes, relevant to financial reporting,
- Understand how the entity communicates financial reporting roles and responsibilities and any matters that are significant to financial reporting, including:
  - Communications between management and those charged with governance
  - External communications, such as those with regulatory authorities
- In understanding an entity's communication process, consider
  - Duties and control responsibilities
  - Communication channels
  - Accounting policies and changes to processes
  - Adequacy of communication
  - Timely follow-up action
  - Monitoring and compliance requirements
  - Ethical standards and policies

Control activities

- Control activities relevant to an audit may be categorised as policies and procedures relating to:
  - Performance reviews
  - Information processing
  - Physical controls -- physical security for adequate safeguard of assets and records including access to computer programs and data files.
  - Segregation of duties
- Emphasise on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher.

Understanding of the components of internal control

- To obtain an understanding of the components of internal control at the entity level and related elements we:
  - Inquire of management and of others within the entity who, in our judgment, may have information that is likely to help in identifying risks of material misstatement
  - Observe processes and controls in operation
  - Inspect documents and reports

Limitation of internal control system

Internal control systems are subject to certain inherent limitations, such as:

- Management's consideration of cost of an internal control to its expected benefits
- Do not tend to be directed at transactions of unusual nature
- Circumvention of internal controls through collusion with employees or with parties outside the entity.
- Abuse of responsibility, for example, a member of management overriding an internal control.
- Manipulations by management

Combining the audits

- What is a combined (integrated) audit

  In a combined audit, the auditor expresses opinion on the following aspects:

  a. Opinion on internal control over financial reporting, which requires evaluating and opining on the adequacy and effectiveness of the entity's system of internal financial controls; and

  b. Opinion on the financial statements

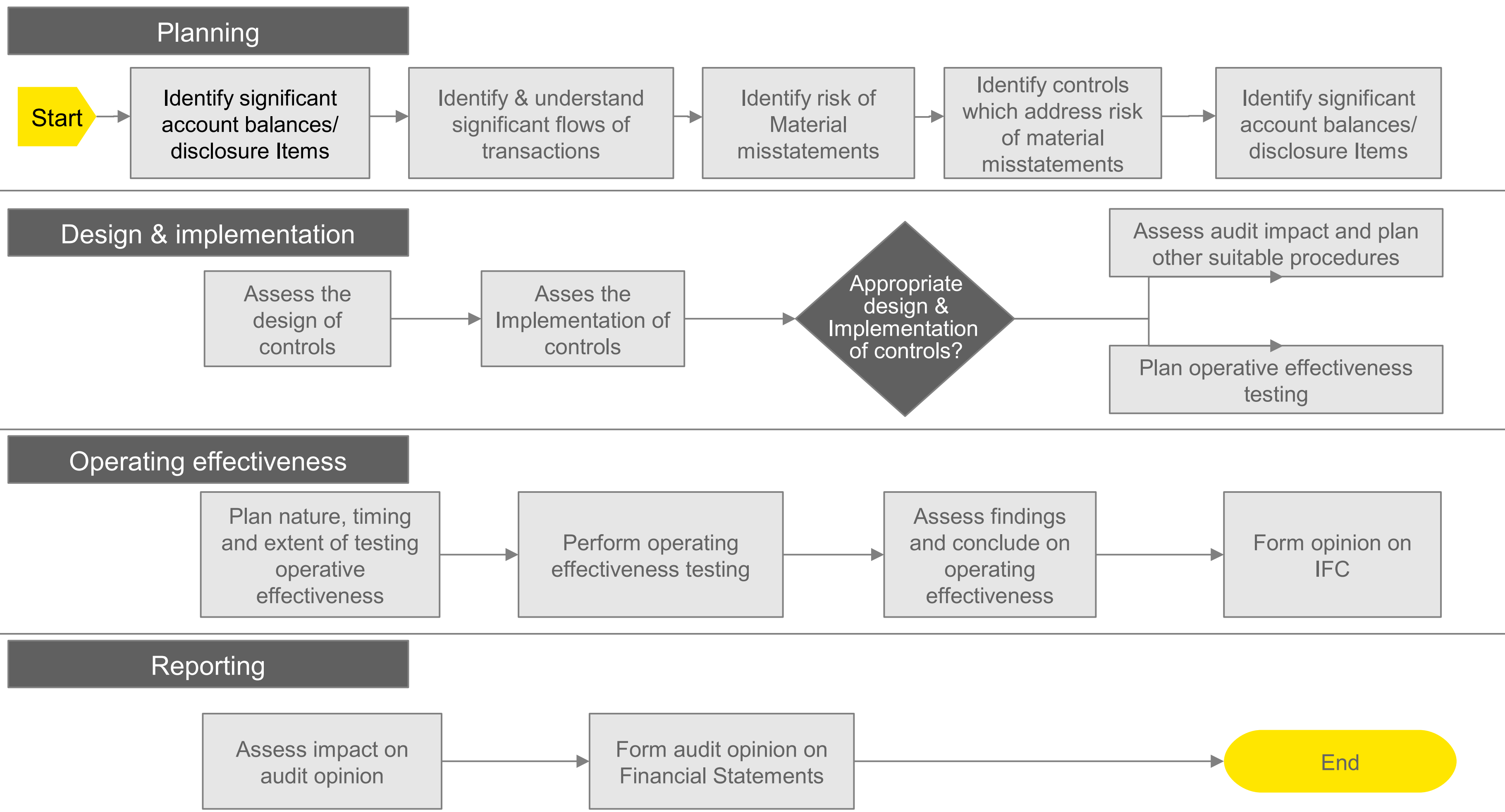
  Should design procedures for testing of controls to accomplish the objectives of both audits simultaneously.

Planning the IFC Audit

- Following considerations may impact the procedures planned in the combined audit:
  - Matters affecting the industry in which the company operates and complexity of the company's operations
  - Matters relating to the company's business, including its organisation, operating
  - characteristics, and capital structure;
  - The extent of recent changes, if any, in the company, its operations, or its internal financial controls over financial reporting;
  - Control deficiencies previously communicated to the audit committee or management;
  - Legal or regulatory matters of which the company is aware;

Assess and Manage Risk

Manage Audit Engagement– route map



Source: Guidance note on Audit of ICFR issued by ICAI

Reporting on IFC
Using Top Down approach

- Use a 't**op-down**' **approach** in identifying and understanding the controls that are relevant to the audit.

- Entity level controls (ELC), provide the "tone at the top" of the organization, and as a result directly or in-directly impact all underlying controls.
- Benefits from leveraging effective ELC's:
  - Reduce the extent of reliance on transaction level controls
  - Better define and communicate the expectations of management across the organization
  - through leveraging on experienced personnel, Increase the effectiveness of internal controls
  - Reduce redundancy in controls performed across the organization at different levels

- **Direct entity level controls** monitor specific business and financial risks, and operate at the

Testing of entity-level controls

Entity-level controls include:

- Controls related to the control environment;
- Controls over management override;
- The Company's risk assessment process;
- Centralised processing and controls
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process;
- Controls over recording of unusual transactions; and
- Policies that address significant business control and risk management practices

Design Assessment

- **Start with** ELC and IT General controls
  - Focus on **Segregation of Duties** + Functional **MIS**
  - Review strength of IT general controls
- Prepare **documentation templates** – Flowchart / Narratives / IPE
- Document process and application **controls**
  - Identify What can go Wrong (**WCGW**) - Risks
  - Prepare **Risk & Control matrix** with control description, owner, frequency, control evidence etc
  - Perform & document **walkthroughs**
  - Update **process maps** with risks, controls references
  - Identity controls into **Manual, Automated, IT dependent, Preventive/ Detective**

- Identify **design gaps**

IT General Controls

- The **IT General Controls** protect data integrity and are a significant component of an organization's IFC

- Importance of ITGCs
  - Improve the consistency of control operation (i.e. automated processes vs. manual)
  - Improve the security (confidentiality, integrity and availability) of corporate information
  - Reduce the extent of testing and reliance on manual transaction-level controls
  - Improve reliability of manual controls dependent on IT information

Key worksteps – Adequacy and operating effectiveness

Key work-steps/considerations for Gap identification:

- Identify Design gaps – ICFR
- Prioritize gaps - carry them forward to SOCD and evaluate

Key work-steps/considerations for controls testing:

- Decide Testing methodology
- Testing Sampling - Align TOC approach with IFC approach – (Possible impact on audit strategy – controls v/s substantive)
- Prepare test plans and test scripts
- Test controls
- Prioritize testing gaps – to carry them forward to SOCD and evaluate

Assessment

- Evaluate severity of each control deficiency
- Communication to management and those charged with Governance of all material weaknesses and significant deficiencies (determined individually or collectively) identified during the audit.
- Inquire about subsequent events
- Auditor must obtain management representation letter
- If the BoD / management report contains elements which are incomplete / improperly presented, auditor should follow requirements of SA 720.
- Issue report, containing material weaknesses, after obtaining approvals

Key aspects -- Understanding and confirming the process

- Significant class of transactions (SCOT) is a class of transactions
  - that materially affects a significant account and its relevant assertions,
  - includes significant routine, non-routine and estimation transactions from initiation, recording, processing, correcting as necessary, and reporting to the financial statements.

- Understand the following elements of the critical path of SCOTs:
  - Major input and output sources
  - Relevant transaction data and master data, documentation and records
  - Significant processing procedures, including how IT applications support the processing
  - The entity's policies and procedures related to authorization, segregation of duties, safeguarding of assets, monitoring of processes and information processing

Key Aspects -- Understanding and confirming the process

- In an integrated audit, we identify and test the design and operating effectiveness <u>for all </u>SCOTs (Routine, Non-routine and Estimation SCOTs)
- **Maintain documentation** of our understanding and evaluation of the critical path of SCOTs and the relevant controls within the

Example – Understanding of critical path of Purchase to Pay SCOT should be adequately documented with process models, flowcharts, procedural manuals available with the entity, and adequate documentation of results of our inquiries regarding risk assessment, job descriptions, segregation of duties, safeguard of assets, monitoring of IT application etc

- To understand the SCOTs, use a combination of
- inquiry,
- observation and

Key Aspects – Performing walkthrough

Performing walkthroughs helps achieve the following objectives on selection of control:

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded;
- Verify points identified within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

Assess whether management has designed appropriate segregation of duties .

Key Aspects – Performing walkthrough

- Walkthrough encompasses, confirming our understanding:
  - of the routine and non-routine SCOTs **every period**, by selecting one transaction and tracing that transaction along its critical path.
  - of the **whole critical path** of initiation, recording, processing and reporting in the general ledger,
  - of the journal entries that post transactions into the general ledger from sub-ledgers.
  - of how wrongly processed information is corrected.

- Perform walkthrough for integrated audit involves:
  - inquiry of appropriate personnel,
  - inspection of relevant documentation.

Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

How ineffective ITGCs affect audit

- If control exception is identified,:
  - Make specific inquiries and investigate the nature and cause of the exception
  - Determine whether the exception is systematic or random •
  - Evaluate the effect of the exception on our planned audit procedures and other areas of the audit
- If "support" conclusion through substantive procedures is achieved, there are no further implications for the financial statement audit (one can rely on ITGCs)
- Ineffective ITGC conclusions will require a higher level of senior team member involvement to develop an appropriate response

ITGC exceptions and deficiencies

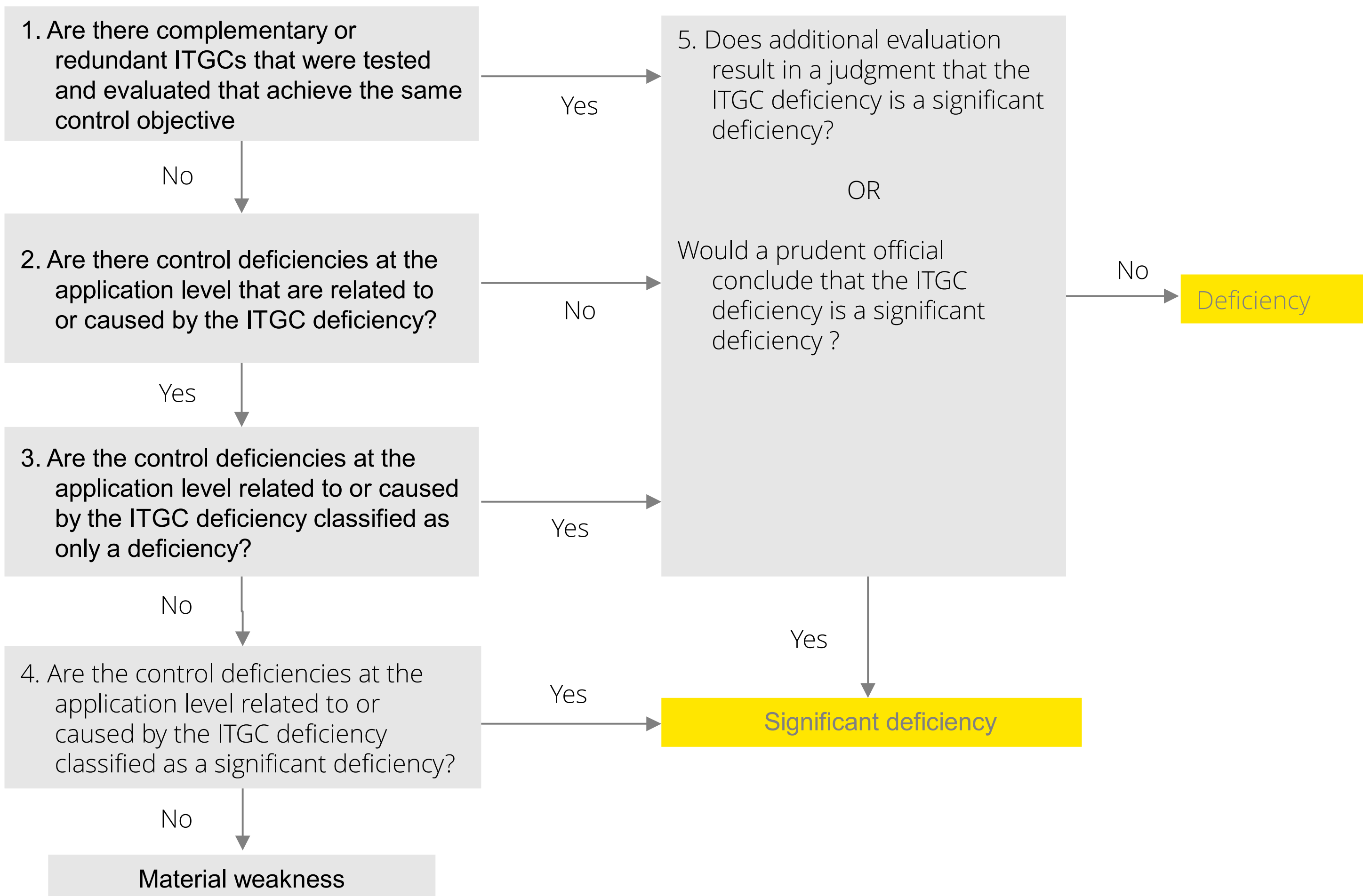
- If ITGCs are not effective, then it is generally necessary to test the automated control at or near the balance-sheet date in support of the opinion on internal financial controls.

- When, through testing, auditors identify an ineffective ITGC, one should consider it as an ITGC deficiency and include it on the Summary of control deficiencies (SOCD) for further evaluation, even though one has identified and test compensating controls

- For the ICFR opinion (assuming ITGC deficiencies are not remediated), one need to evaluate the effect of the ITGC deficiency on a control by control basis
  - Some controls may be unaffected
  - For some controls one may identify compensating controls (e.g., SCOT controls)
  - For the remainder , accumulate in the SOCD

Evaluating ITGC deficiencies

Illustrative decision tree for ITGC Deficiencies:



Evaluating ITGC deficiencies

- The classification of an ITGC deficiency considers many factors, including but not limited to, the following:
  - The nature and significance of the deficiency
  - The pervasiveness of the deficiency to applications and data
  - The complexity of the company's IT environment and the likelihood that the deficiency could adversely affect application and IT-dependent manual controls
  - The relative proximity of the deficient ITGC to applications and data
  - Whether an ITGC deficiency relates to applications or data for accounts or disclosures that are susceptible to loss or fraud
  - The cause and frequency of known or detected exceptions in the operating effectiveness of an ITGC.
  - An indication of increased risk evidenced by a history of misstatements relating to applications affected by the ITGC deficiency

- If the ITGC conclusion is "ineffective", one needs to include both the ITGC deficiency, as well as all controls within the SCOT that rely on the ITGCs, as deficiencies in the

IT Consideration in less complex IT environments

- Characteristics of less complex IT environments:
  - Computer systems centralised and limited interfaces between systems.
  - Access to systems managed by a limited number of personnel.
  - Software - Uses off-the-shelf packaged software without programming modification.
  - Management tends to rely primarily on manual controls over transaction processing.
  - End-user computing - The company is relatively more dependent on spreadsheets and other user-developed applications

- Audit Approach in a less complex environment,
  - Identify IT related risks by understanding the software being used
  - Understand how software is installed and used by the company.

IT Consideration in smaller entities

- May use off-the-shelf accounting / business processes. Hence the audit focus:
  - For ITGC, the testing of those controls that are important to the effective operation of the selected application controls;
  - No need to perform all manage change primary control procedures for those IT applications if we are able to confirm that changes have not occurred
  - on the application controls built into the off-the-shelf software that management relies on to achieve its control objectives
- Directly testing the underlying data used in ITDM controls cannot be used to support our opinion on internal control over financial reporting
- Evaluate and test controls that assess the completeness and accuracy of the related data or reports used to perform ITDM or application control

Information Produced by the Entity (IPE)

- **What is Information Produced by the Entity?**

  Information Produced by the Entity (IPE) are Data generated or processed through an IT application and/or end user computing solution, be it in electronic or printed form, used to support audit procedures.

  Specifically, it includes

  - **Data and reports** used by management in the **performance of controls**;
  - Data and **reports used in substantive procedures**;
  - Other data and reports provided by the entity

- Some common IPEs are system-generated aging reports, expense amortization reports, Fixed asset system-generated reports used to calculate depreciation/amortization etc

Substantive procedures cannot be used to support opinion on internal control over financial reporting.

documents to test the completeness and accuracy of the IPE, and testing the clerical accuracy, computations and relevant categorizations.

Types of control deficiencies

- ***Control Deficiency*** – Exists when the design or operation of a control does not allow management or employees to prevent or detect and correct misstatements on a timely basis

  - ***Design Deficiency*** – A control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met

  - ***Operation Deficiency*** – A properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority, capabilities, competence, or objectivity to perform the control effectively

Potential sources of control deficiencies

- Walkthroughs:
  - Segregation of incompatible duties, safeguarding of assets
- Understanding and evaluating entity-level controls
- IT general controls
- Internal audit reports
- Tests of controls:
  - Auditors testing
  - Management, internal audit and third-party testing
- Understanding of management's assessment
- Corrected and/or uncorrected errors/misstatements identified through substantive procedures
- Reclassifications identified
- Understanding/testing the FSCP

Significant deficiency and Material weakness

- Definition of significant deficiency – A deficiency (or combination of deficiencies) that is less severe than a material weakness, yet important enough to merit attention of the audit committee or those charged with governance

- Definition of material weakness – A deficiency, or combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's annual financial statements will not be prevented or detected on a timely basis

- Evaluate the <u>severity of each control deficiency</u> to determine whether individually or in the aggregate it is a material weakness

Severity of a deficiency

- Whether there is a reasonable possibility that the controls will fail to prevent or detect a misstatement of an account balance or disclosure

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies

- <u>Severity of a deficiency does not depend on whether a misstatement actually has occurred</u> *but rather on* <u>*whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement*</u>

Thank You