



INTERNAL CONTROLS OVER FINANCIAL REPORTING

understanding & evaluating
financial reporting process



PROCESS

Refers to a set of inter related activities intended to achieve a result

**CONTROL
ACTIVITIES**

Processes & procedures that ensure management activities are carried out

EVALUATION

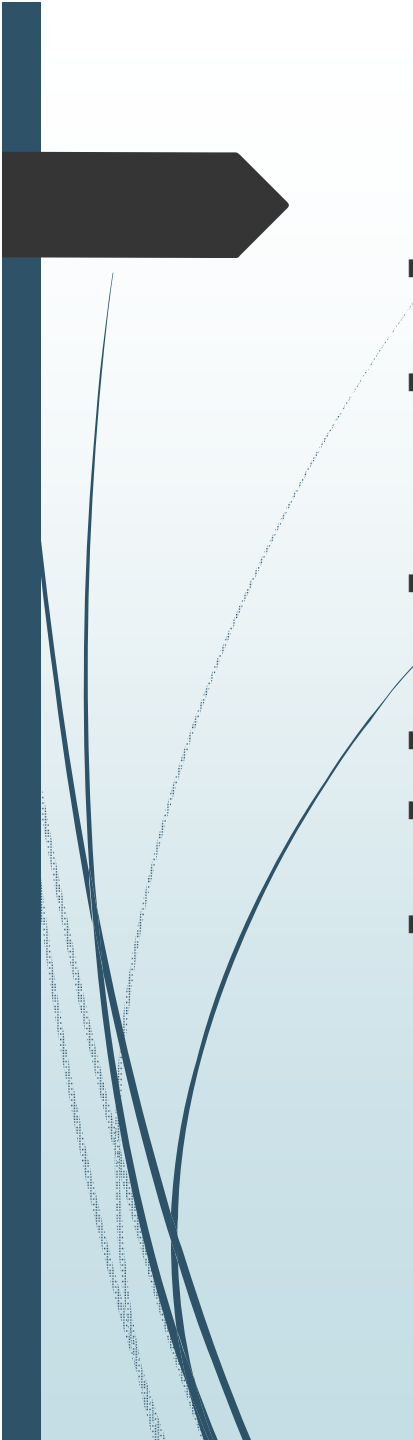
A systematic determination of the merit, significance using criteria governed by a set of standards



Financial Reporting Process

- Refers to the sequence of activities to –
 - Prepare
 - Review
 - Approve the quality
 - Ensure regulatory compliance
- Includes –
 - Required disclosures as per rules

Materiality is a matter of professional judgment & experience of the auditor – contextual – ability to influence decision making

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- ▶ How many of us would be shocked after hearing news of an accounting scandal -
 - ▶ Media company was in the news recently for mis-reporting its numbers – revenue & films distributed – they came out with a clarification that it was meant to mislead the public & handiwork of short sellers –
 - ▶ A Pharmaceutical Company was in the news for alleged mis-representation of facts in the US a couple of days back -
 - ▶ Is Bofors material in today's context
 - ▶ A minister in the news for unauthorized expenses in a trust for a couple of lakhs cited Materiality –
 - ▶ Has the management & the auditors considered accounting mis-statement risk



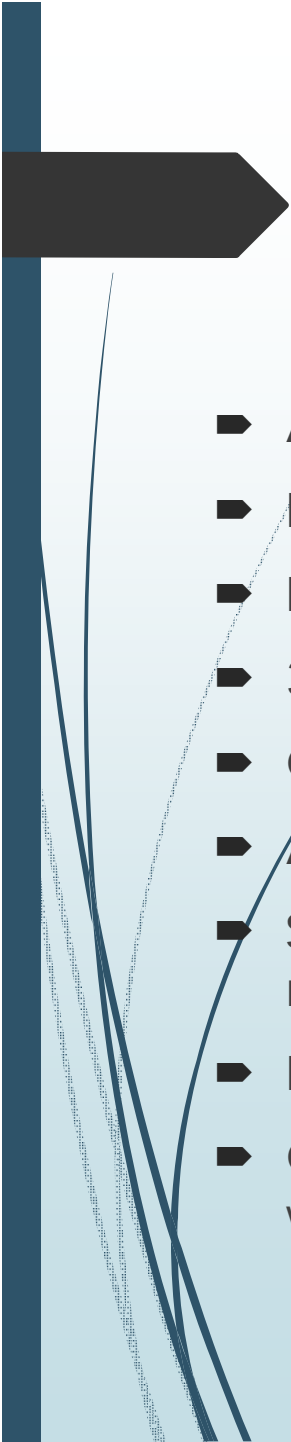
Is our financial statement really error free ?

- ▶ E&Y fraud survey 2015 – 3800 respondents from 38 countries in Europe, Middle East, India & Africa –
- ▶ Nearly 40% respondents said that their company reports better financial performance than it is
- ▶ More than 1 in 5 senior managers reported early revenue recognition last year
- ▶ 73% respondents said that the management will be under increased pressure to deliver better financial results next year
- ▶ 42% stated that their company does not have anti bribery or anti corruption policies in place or is unaware of the same



Issues

- **VUCA world** – Volatility, Uncertainty, Complexity & Ambiguity
- Data – Information – Knowledge – Wisdom –
- Information Overload –
- Missing the trees for the woods – separating the grain from the chaff
- In the world of smart phones, fast foods & T-20 do we really make decisions, frame opinion, give judgments a bit too fast-
- Exercising the right amount of professional skepticism

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- ▶ Assumptions is the mother of all goof ups
 - ▶ Ensure that a thing is done right first time
 - ▶ Efficiency vs Effectiveness
 - ▶ 3 lines of defense theory
 - ▶ Controls have a cost & can be colluded & circumvented
 - ▶ Accounting Fraud is a white collar economic crime -
 - ▶ Sherlock Holmes – I see no more than you but I have trained myself to notice what I see.
 - ▶ Root cause analysis – Cause effect relationship –
 - ▶ Cow fell in the ditch theory – do we treat the error without finding why it happened –

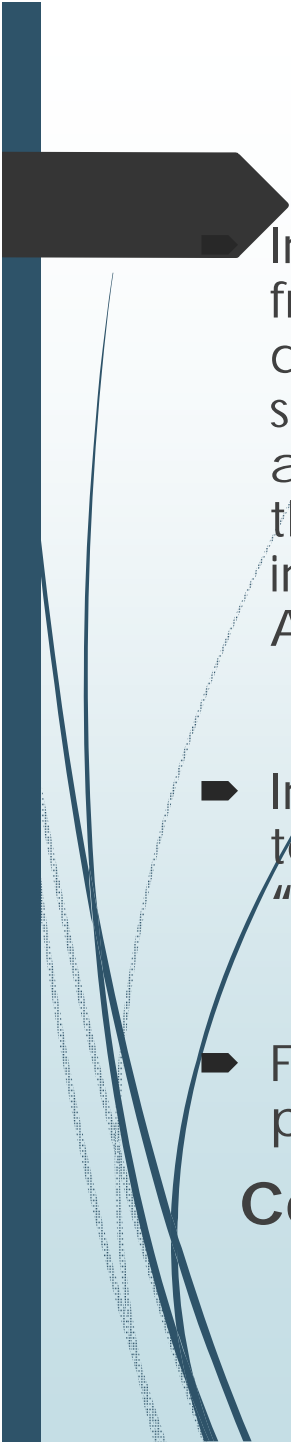
Policies & Procedures Stated in IFC

- ▶ Sec 134(5)(e) – IFC – policies & procedures adopted by a company for ensuring the orderly & efficient conduct of business including adherence to policies, safeguarding of assets, prevention & detection of frauds & errors, timely preparation of reliable financial information
- ▶ ICOFR includes policies & procedures –
 - Maintenance of records to accurately & fairly reflect the transactions & dispositions of assets of the company.
 - Provide reasonable assurance that transactions are recorded as necessary to permit presentation of financial statements in accordance with GAAP & receipts / expenditures are made with proper authorizations.
 - Provide reasonable assurance regarding prevention & timely detection of unauthorized acquisition, use or disposition of the company assets that could have a material effect on the financial statements.



Financial Statement Frauds

- **ACFE Report to the Nations** classifies fraud into 3 types
 - Financial Statement Frauds
 - Corruption
 - Asset Misappropriation
- Median loss of fraud caused by fraudulent financial statements was 1 million USD compared to corruption – 2 Lakh USD & Asset misappropriation- 1.30 Lakh USD though % wise it is the least.
- **Sec 447** of the Companies Act defines Fraud – which includes concealment, abuse of position, act of omission or commission whether or not there is wrongful gain or loss with intent to deceive.
- **SA 240 Para 11(a)** defines fraud as involving use of deception to obtain an unjust or illegal advantage.



In 1985 James Treadway, a former SEC Member stated on fraudulent financial reporting – Fraudulent financial reporting does not begin with an intentional act to distort the financial statements; rather it frequently comes about as a series of acts designed to respond to operational difficulties. Initially the activities may not be fraudulent but in time they become increasingly questionable until someone finally steps the line. At the core it is all about 'Pressure'.

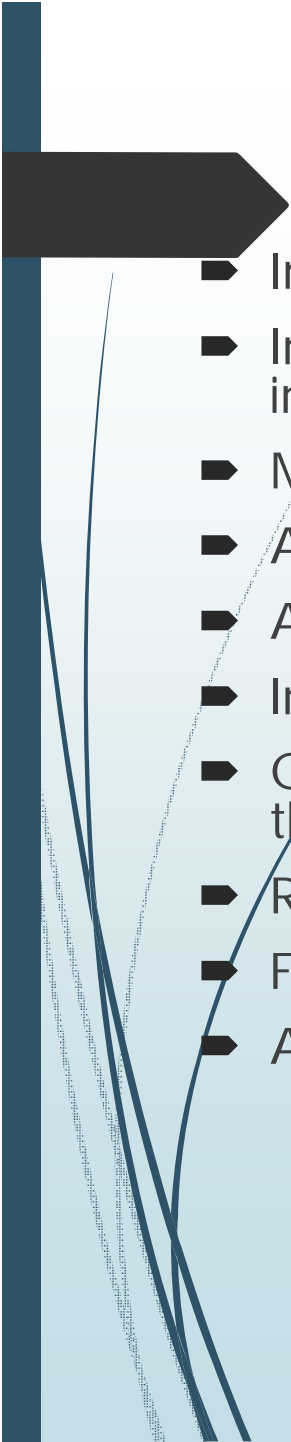
- ▶ In 1988 Arthur Levitt, SEC Chairman in his lecture used the terms '**Number Games**' "**Accounting hocus pocus**" & "**Earnings management.**"
- ▶ Financial statement fraud can be perpetrated when 3Cs are present

Condition, Corporate Culture & Choice



Types of Fraud

- Fictitious or illegal booking of income
- Timing of revenue recognition
- Side arrangement w.r.t unilateral cancellation
- Improper revenue recognition
- Improper related party transactions
- Non-booking or non-accrual of expenses
- Improper capitalization
- Improper authorization
- Omission of liabilities for future obligations
- Improper use of estimates - calculation of useful life of assets / Actuarial valuation of leave benefits
- Improper asset valuation

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- ▶ Improper cutoff procedures at year-end
 - ▶ Inadequate discussion/omission to disclose material key information in Notes to Accounts /MDA
 - ▶ Misclassification of income
 - ▶ Adjusting Prior Period Items to reserves
 - ▶ Adjustment above the line items as below the line items
 - ▶ Incorrect statement of Facts in MRL
 - ▶ Companies intentionally disseminating information that suits them
 - ▶ Research report issued at behest of management
 - ▶ Failure to provide for impairments
 - ▶ Asset Stripping



Reasons for frauds

- ▶ Lack of transparency & accountability
- ▶ Lack of governance & oversight
- ▶ Lack of effective gatekeepers
- ▶ Conflict of interest
- ▶ Opportunities to engage in earnings manipulation
- ▶ Lax regulatory structures
- ▶ Ineffective judicial system
- ▶ Incentive structure focusing on short term performance
- ▶ Cost benefit ratio favoring the fraudster



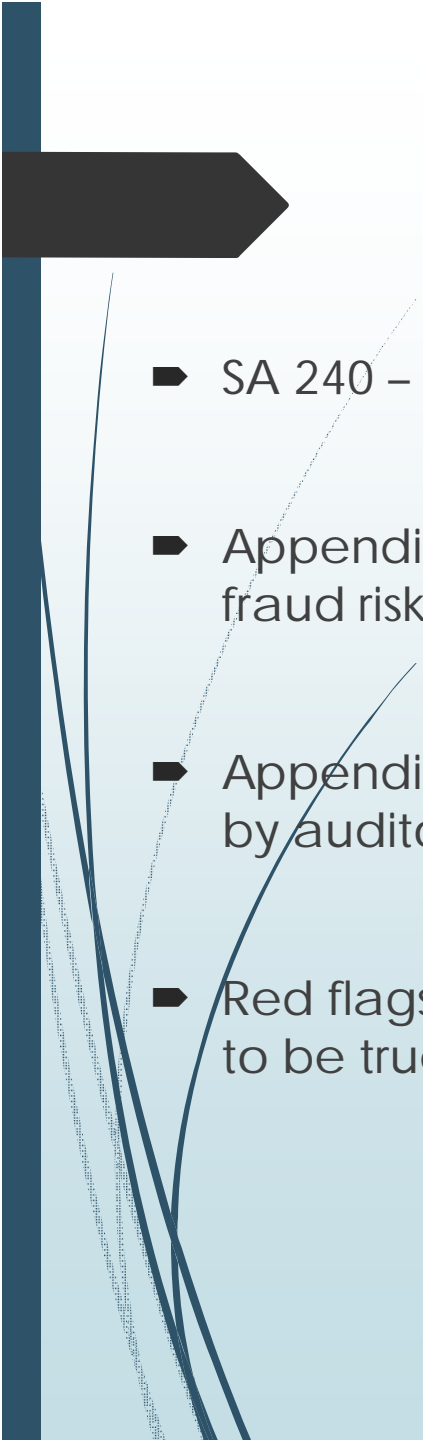
Theories of fraud

- ▶ **Rotten Apple theory** – one rotten apple can spoil an entire barrel
- ▶ **Low hanging fruit theory** – attack the easier frauds and take fast swift action to deter fraudsters from committing bigger frauds
- ▶ **Potato chip theory** – commitment to frauds is addictive
- ▶ **Cockroach theory**- if you see a cockroach it is not the only one as in frauds when if there is a fraud there could be more undetected
- ▶ **Oops theory** – fraudster defense is that OOPS it was a mistake



6 Red Flags of Fraud as per ACFE

- ▶ Experiencing financial difficulties
- ▶ Living beyond means
- ▶ Close association with a vendor
- ▶ Unwillingness to share duties, abide to controls
- ▶ General wheeler dealer attitude
- ▶ Family issues – health / divorce

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- ▶ SA 240 – Appendix 3 gives examples of accounting red flags
 - ▶ Appendix 2 on the Guidance Note on Fraud Reporting – list of fraud risk factors
 - ▶ Appendix 4 of the Guidance Note – procedures to be followed by auditors to detect frauds
 - ▶ Red flags are early warning signals while Green flags are too good to be true



Theories on Fraud

- **Fraud Triangle** – Opportunity, pressure, rationalization – Donald Cressey – 1973 -
- **Fraud Diamond** – Capability or Competency – Wolf & Hermanson 2004
- **Fraud Pentagon** – Crowe Howarth – lack of conscience
- **Fraud Circle** – Where there is money there is fraud
- **Fraud scale** – Steve Albrecht – stronger the internal control, lesser is the fraud.
- **Iceberg theory of dishonesty** – Volume of undisclosed frauds is higher than the volume of disclosed ones
- **Hollinger Clark** – Co-relation between employee dissatisfaction & fraud
- **Edwin Sutherland** – Work place culture is one of the major causes of deviant behavior



Financial Reporting process

- ▶ End to end process - **Issue - authorize - record - process - report**
- ▶ Documented process - SOP - accounting manual - Job descriptions - flow charts - Organization chart - KRA - authorization matrix -
- ▶ Do we have a fraud policy defining accounting fraud - preventive - detective - deterrent controls - investigation process - punitive actions -
- ▶ **who - what - why - when - where - which - How -**
Process deviations within limits of defined acceptable tolerance
- ▶ Demonstrable audit trail of testing of controls independent of the checker - authorizer -
- ▶ Any testing gaps noted rectified & the remediation process documented - controls on error correction procedures -
- ▶ Are key or critical activities - sub activities defined -
Policies on impairment, revenue recognition, arms length pricing, segmental reporting, provisioning & write offs, Materiality etc
- ▶ Competencies - skill set gaps - customized training -succession plans -



Can we demonstrate functioning of controls

- Maker- Checker
- Segregation of duties
- Job rotations
- Mandatory vacations
- Reconciliations
- Balance confirmations
- Authorization – Deviation – Exception – Ratification approvals
- Stop loss limits –
- Physical Verifications
- Independent audits
- Documented policies & procedures

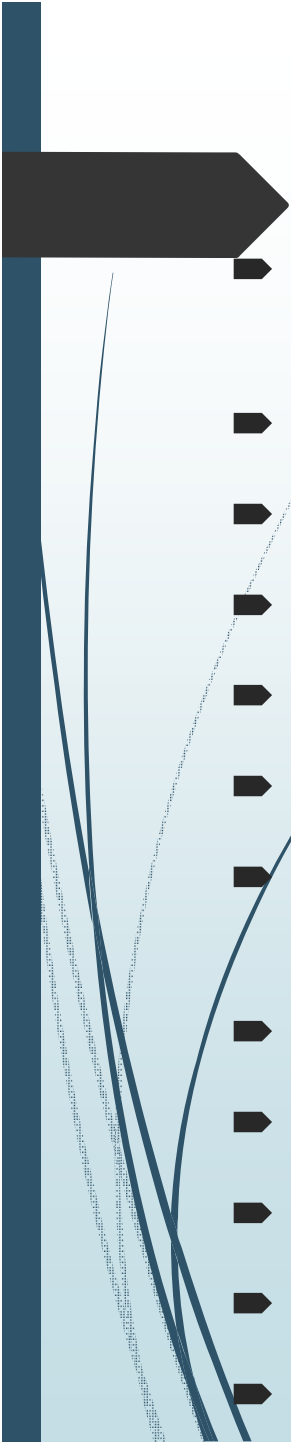
Techniques of control testing

- Discussions with management on each of the 5 COSO components
- Corroborative enquiry – interviews, walkthroughs
- Observation
- Verification
- Examination of documentation – written or electronic
- Reperformance
- Using work of others



Issues in controls

- ▶ Costs of controls vs benefits achieved
- ▶ Potential for mistakes due to –
 - ▶ Carelessness
 - ▶ Distraction
 - ▶ Mistakes of judgment or understanding of instructions.
- ▶ Management override of controls
- ▶ Manipulations of estimates & judgments

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- Auditor - access inputs, procedures performed & output of the process used to prepare financial statement.
 - Obtain sufficient audit evidence
 - Involvement of technology
 - Participation of management
 - Locations involved
 - Adjusting and elimination of entries
 - Consistency of classifications - accounting policies & estimates
 - Appropriate disclosures
 - Understanding significant accounts
 - Interfaces between various systems
 - Analytical procedures
 - Analysing business risks



Deficiency & Material Weakness in Controls

Control Deficiency

Exists when the operation of the control does not allow management or employees to perform their designed function in the normal course & detect or prevent material misstatements on a timely basis.

Significant Deficiency

When the control deficiency adversely affects the ability of a company to initiate, authorize, record, process & report data as per GAAP

A material weakness is a significant deficiency.

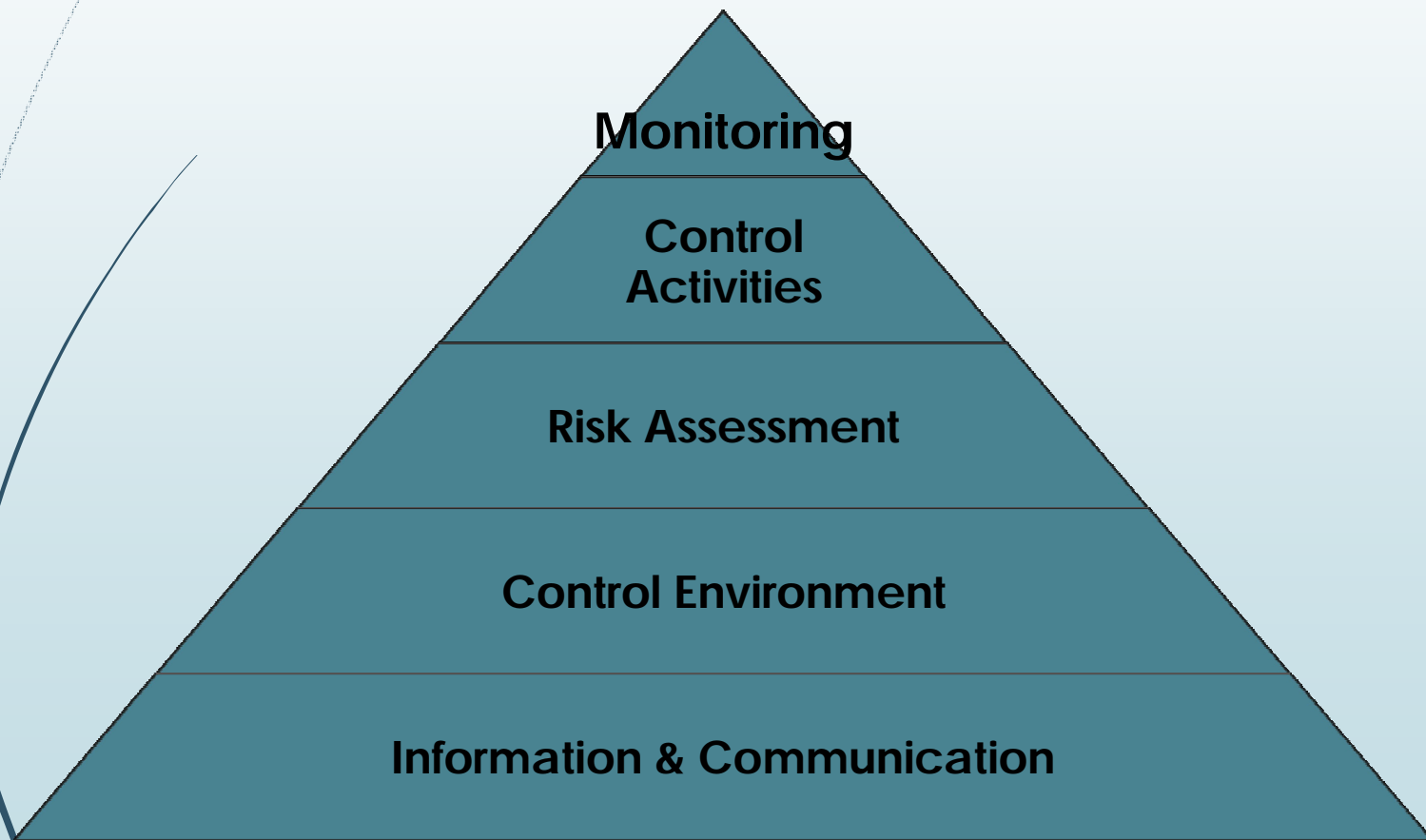


Misstatements and Material Weakness

- ▶ When the possibility of a misstatement is more than remote – i.e. reasonably possible or probable or likely then it is a material weakness
- ▶ A material weakness in IFC may exist even when the financial statements are not materially misstated

COSO Internal Control Integrated Framework

Any system of internal control is based on consideration of risks in operations, compliance & financial reporting



Characteristics

- IFC needs to be dynamic to address the changes in the operating environment of an entity due to –
 - Business developments
 - Acquisitions, mergers & divestments
 - Changes in IT & business processes
 - Key management personnel
 - New products, new markets & rapid growth.
- Changes in regulations
- Changes in accounting frameworks i.e accounting standards or IFRS
- IFC is at the operating level unlike ERM which is at the strategic level
- Audit opinion on IFC does not ensure the future viability of the entity or the efficiency / effectiveness with which the management has conducted the affairs of the company

Control Environment

- Refers to governance & management function of attitudes, awareness & actions.
- Communication & enforcement of integrity & ethical values
- Commitment to competence
- Participation of those charged with governance
- Management philosophy & operating style
- Organizational structure
- Assignment of authority & responsibility
- Human resources policies & practices
- Whistle Blower Mechanism
- Audit committee oversight



Risk Assessment

- ▶ It is how management identifies risks (significance or impact & probability & likelihood) & takes actions to manage & mitigate the risks.
- ▶ Are we Risk Centric – Risk Focussed -
- ▶ Gross Risk – Residual Risks -



Control activities

- ▶ **Performance reviews** (actual vs budget, review of functional & activity performance relating to different sets of data to one another, analyzing relationships; comparing internal & external data)
- ▶ **Segregation of duties** – competency of maker & authority of the reviewer.
- ▶ Spreadsheet controls, data base controls, controls over specific user developed applications.



Information Processing

- Application & IT General Controls :
- Checking arithmetical accuracy of records edit checks
- Change controls
- Access controls,
- Audit trails
- Migration & implementation of new software
- Authorizations for access to programs & data files
- Periodic counting & comparison with amounts shown in control records.



Information systems must –

- ▶ Identify & record all transactions
- ▶ Describe transactions in sufficient detail to permit proper classification
- ▶ Proper recording of value
- ▶ Determining proper time periods
- ▶ Proper presentation & disclosure



Monitoring Activities

- ▶ Internal audit evaluations
- ▶ Management reporting
- ▶ Regulatory reports
- ▶ Customer complaints
- ▶ Communications from external sources – balance confirmations, receipts for money payments.
- ▶ Attention to be given to large unusual, non recurring transactions – circumstances where errors are difficult to define, anticipate or predict
- ▶ Changing circumstances requiring manual intervention – risk of inappropriate manual intervention
- ▶ Automated control testing
- ▶ Potential loss of data



Audit planning

- Consideration of control deficiencies communicated earlier
- Evidence available w.r.t IFC
- Preliminary judgment of risk & materiality
- Complexity of operations
- Availability of public information

Fraud Risk Assessment



Assessing susceptibility to fraud

Fraud risk scenarios

Opportunities, pressures & attitudes to rationalization

Capability to conceal

Brainstorming fraud risks

How fraud risks are assessed?

Materiality

Substantive Testing

Using the work of others

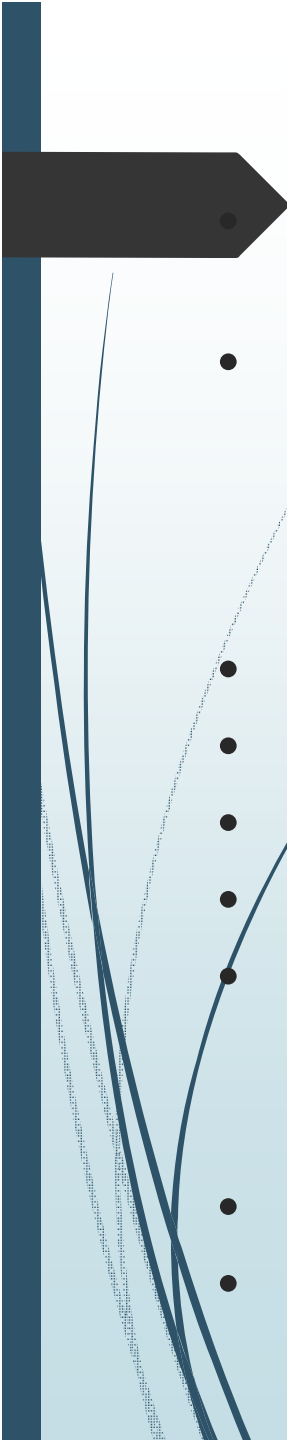
Sampling – SIA 5


Documentation

Walkthroughs – from start or initiation or origin to end or conclusion to understand the flow of transactions

Entity level controls

- Control environment, risk assessments, centralized processing, controls to monitor other controls
- Controls addressing significant risks
- Controls over selection & application of accounting policies
- Processes to IARPR – initiate, authorize, record, process & report JV's
- Controls over adjusting entries
- Controls over significant entries w.r.t occurrence & existence, completeness, valuation, rights or obligations, assertions of presentation & disclosure
- Controls over error correction procedures
- Management estimate for bias
- Training of employees involved in the financial reporting process
- Oversight of work done by outsourced professionals
- Availability of in depth manuals, flow charts, questionnaires, job descriptions

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- Deficiency in design of controls exists when control is missing or absent or exists but does not meet the objective.
 - Testing operating effectiveness -
 - Necessary to understand the objective of the control
 - The correlation to the risk assertion
 - The significance of the risk
 - Competency & authority of the person performing the control
 - Frequency of testing & consistency of performance
 - Level of aggregation & predictability
 - Dependency on other controls
 - Automated or manual controls –
 - preventive controls
 - detective controls
 - Complexity of the company
 - Plan the nature & extent of the tests

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- There always exists an inherent risk that there could be a material misstatement
 - Evidence to support that a control is operating effectively is much higher than evidence to conclude that a control is not operating effectively
 - Redundant controls
 - Details on how the control is performed – who, what & when
 - Timing of control testing
 - periodicity of testing &
 - the testing period – before, after or during the activity
 - Clarity on what is a deviation / exception & a control deficiency



Tolerance levels / Materiality

- Concept of evaluation of a control deficiency –
 - Probably or likely**
 - Reasonably possible**
 - Remote**
- Roll forward procedures from an interim date of testing to year end
- Remediation testing – i.e. post control implementation after gap analysis
- Pervasive deficiencies in controls

Modified opinions - Qualified , Adverse or Disclaimer

- Qualified or Adverse opinion is issued when there is inability to detect or prevent material misstatements on a timely basis; missing controls or weakness in controls is material -
-
- In an adverse opinion the material weakness is pervasive or fundamental
- Disclaimer is issued when IFC is not established or on inability to obtain sufficient appropriate audit evidence to express an opinion
- A modified opinion on IFC does not mean that the audit report of financial statements should also be qualified.
- Similarly effectiveness of IFC cannot be inferred from absence of misstatements

Deficiencies in the Design of Controls

► Inadequacy in –

- design of internal control over the preparation of the financial statements
- design of internal control over a significant account or process
- documentation of the components of internal control
- segregation of duties within a significant account or process
- controls over the safeguarding of assets
- design of general IT and application controls
- design of monitoring controls used to assess the design & operating effectiveness of the entity's internal control over time

► Employees / management lacking qualifications & training to fulfill their assigned functions

► Absence of an internal process to report deficiencies timely



Failures in Operation of IC

- ▶ Operation of effectively designed controls over a significant account or process
- ▶ Information and communication component of internal control
- ▶ Accuracy Controls designed to safeguard assets from loss, damage, or misappropriation.
- ▶ Reconciliations of significant accounts.
- ▶ Undue bias or lack of objectivity by those responsible for accounting decisions
- ▶ Misrepresentation by client personnel to the auditor
- ▶ Management override of controls.
- ▶ Failure of an application control due to deficiency in design or operation of an IT general control

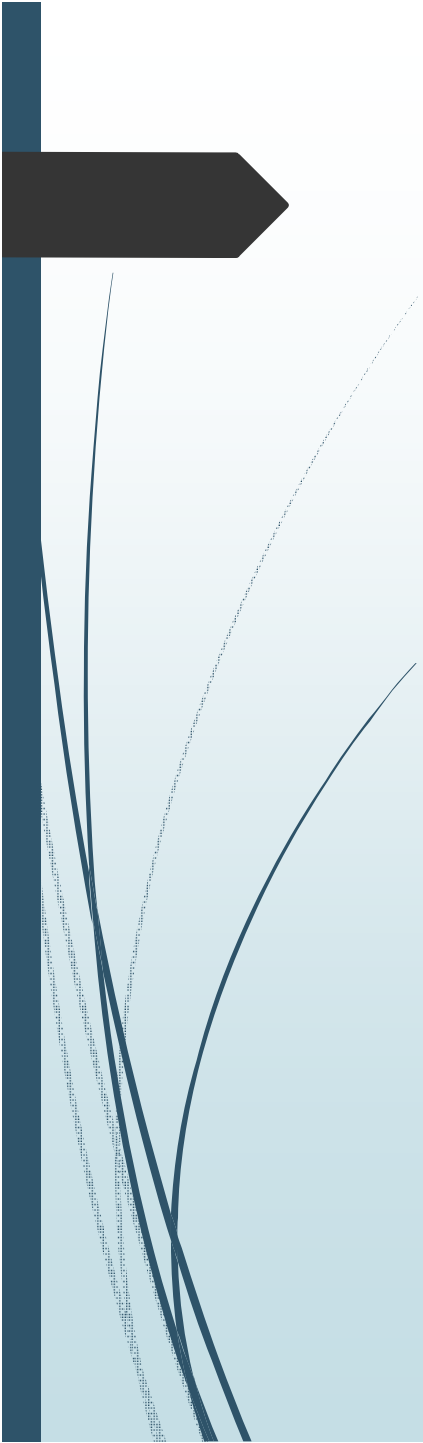


Significant Deficiencies

- Controls over the selection & application of accounting principles that are in conformity with generally accepted accounting principles.
- Anti fraud programs and controls.
- Controls over non-routine and non-systematic transactions.
- Controls over the period end financial reporting process, including
- Controls over procedures to enter transaction totals in general ledger; initiate, authorize, record and process journal entries & record recurring and non-recurring adjustments to the financial statements.

Material Weaknesses

- Ineffective oversight of the entity's financial reporting & IC by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Misstatements involving estimation & judgment
- Material adjustments & corrections of the recorded amounts.
- Reliability of financial reporting.
- Identification of fraud of any magnitude by senior management.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them
- Ineffective control environment.
- Material weakness exists in the control environment.



*'The more you learn, you
learn that you still have a
lot to learn'*