


IFC - Entity Level Controls
Using a Top Down Approach
(Entity Level Controls, likely sources of misstatement)

Nandita Parekh
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Overview

You are looking for a safe and pleasant apartment – where are you more likely to find one?

Here? **Or Here?**



Our Experience



- A well maintained structure is more likely to have good quality apartments within it as compared to a dilapidated structure.
- However good the quality of construction, the structure will remain good only if there is a responsibility cast on a small team to manage the premises and that team takes its responsibility seriously.
- A structure will be maintained well only if the residents are informed of the rules of conduct and there are processes to ensure adherence.
- In a good structure, a resident who is deviant (say, throws trash in the compound or leaves the water tap on when on holidays) will be detected, reprimanded and will be pushed to change his/her ways.
- A structure will be well maintained if adequate care is given to its on-going maintenance and periodic overhauls, as required.

Fast Forward to Organizations.....

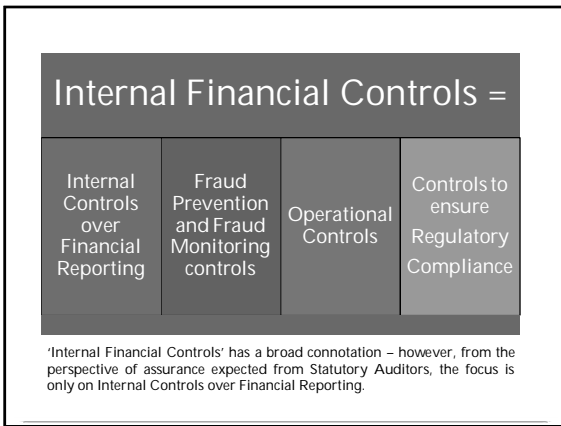
- Effective Entity Level Controls (ELCs) are akin to a strong structure – they do not guarantee adequate internal controls at process/activity/entity level, but they certainly increase the probability.
- ELCs relate to the controls instituted through the framework of Governance and Management Principles adopted by the organization – the stronger the framework, the higher the chance of better controls at unit level.
- ELCs thus relate to the Management philosophy, governance principles and value system adopted by the leadership team and transmitted across the organization.
- **ELCs are controls that have a pervasive effect on the entity's internal controls.**

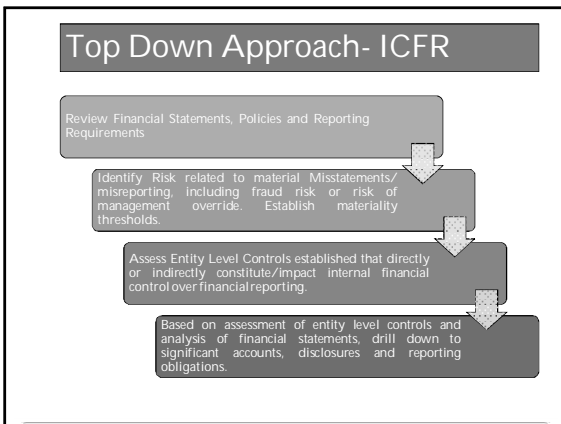
Practical Insights

- The evolving Corporate Governance requirements have resulted in development of different management /governance tools and policies and processes.
- IFC may be viewed as a consolidating exercise that connects all these pieces to make a whole that is larger than the sum of its parts.
- The approach to establishing Internal Financial Controls and auditing them can only be top down, as it starts with the senior most management and drills down to the lowest operating level.

Ethics and Governance Policy	Risk Management Policy
Code of Conduct	IT System Manuals
Standard Operating Procedures	Accounting Policies
Whistle Blower Policy	Anti Bribery Policy



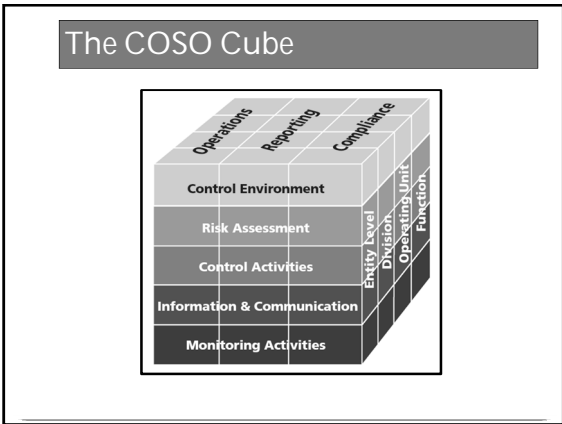


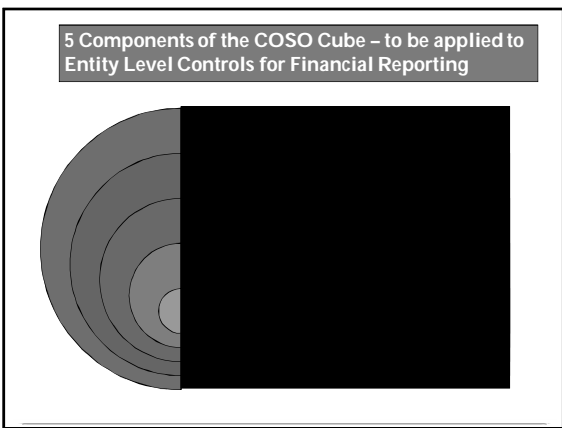




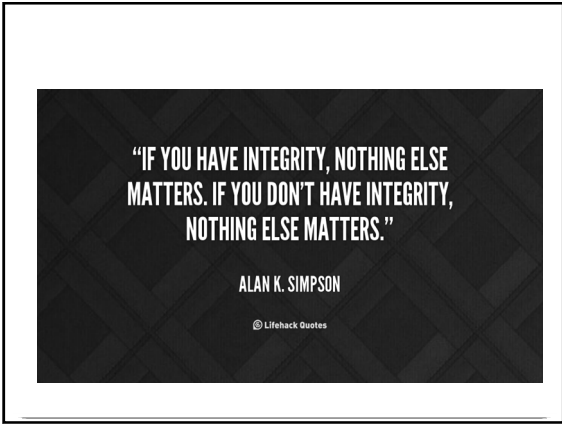
- Risks of Material Misstatements**
- Some potential risks could arise due to:
- Significant changes in the reporting requirements (IND-AS)
 - Untested IT systems relied upon for generating financial reports
 - Inability to retain competent staff – high attrition level, inadequate induction/training
 - Business exigencies creating compulsions for misstatements – listing, borrowing requirements, pressure from investors/shareholders
 - Incentive structures not backed by appropriate controls
 - Inadequate time allotted for review and audit scrutiny
 - Inadequate quality of audit staff for internal/external audits – sub-optimal partner review before finalization

Entity Level Controls - Components





- ### Control Environment - with specific focus on Financial Reporting
1. Organization demonstrates **commitment to integrity** and ethical values
 2. Board exercises **oversight** of the development and performance of internal control mechanism
 3. Management establishes **structure, authority, and responsibility**
 4. Organization demonstrates commitment to attract and retain **competent individuals**
 5. Organization enforces **accountability** for internal control responsibilities






Does the organization have an Anti-Bribery Policy? Or an Ethics policy?

The Ground Reality

- Ethical code of conduct is neither documented, nor communicated
- Board meetings are not actually held – the minutes are written to cover the required agenda matters
- Audit committee allots 15 minutes of time for 6 monthly presentation of Internal Audit Reports – if the meeting is running late, the reports are taken as read
- The Company with a turnover of Rs 300 crores does not have a single qualified CA in its Accounts department.
- Organization structure is not formalized; job responsibilities are either not documented, or not reviewed periodically.



Very few companies are able to demonstrate a control environment that creates confidence in entity level controls.

The Importance of the Tone at the Top



"Yes, I technically did give illegal orders, but I naturally expected that the integrity of my subordinates would prevent their being carried out."

Risk Assessment – Risk that financial statements may contain material misstatements

6. Organization specifies **objectives** to enable the identification and assessment of related risks

7. Identifies and **analyzes** risk related to the objectives

8. Considers the potential for **fraud**

9. Identifies and **analyzes** significant changes that would impact the internal control system

Diligence in Risk Assessment – are all key risks identified?



What do we come across?

- Risk Management framework is not formalized or it is totally outdated – there is no process of amending risk management framework in light of changes in the business or regulatory conditions.
- The company has moved to net banking – however, the authority matrix continues to state only cheque signing limits; the risks related to net banking have not been identified.
- Occurrence of risk events is not tabulated and risk rating is not modified to reflect such incidents.
- Frauds uncovered are hushed up and not fully informed to the Board of Directors – nor is the risk assessment modified.
- Controls identified in the Risk Management Framework as Risk Mitigators are not mapped to the SOP or not embedded in the IT system – hence, controls are visualized but not made operational.

Risks that may not be identified in the ERM Document

- Risk of management fraud – manipulation warranted due to business exigencies.
- Risk of inappropriate Board/Audit Committee oversight – quality of Board, matters considered by Board, time spent by the Board members prior to and during the meetings.
- Risk of inadequate audit quality – quality of staff, time spent on audit, information relied upon



Control Activities

10. Organization selects and develops control activities for risk mitigation

11. Selects and develops general controls over technology

12. Deploys control activities through policies and procedures

Controls? What Controls?

Likely Findings.....

- Risk Management Framework, RCMs and SOPs are all stand alone documents – and actual activities are conducted based on neither of these.
- ERP system is tweaked every now and then, but IT system audit has not been done since last 5 years – there is no review of log reports, unauthorized access, vulnerability to external security breaches, change management processes.
- Policies and procedures remain undocumented for many of the key activities.



The Need for Documentation



- Assessing IFC in absence of well documented policies, procedures, Authority Matrices etc becomes almost impossible.
- Quality of documentation is a general concern area in many organizations.
- Policies for period closure for financial statements also need to be documented and a structured process for preparation of financial statements needs to be formally documented and adopted.

No job is complete unless the paperwork is done!!

Information & Communication

13. Organization obtains/generates/uses relevant information

14. Communicates internally to support the internal control functioning

15. Communicates externally matters affecting the functioning of internal control



Information and Communication Breakdown

- The process of generating MIS is not robust - MIS is based on incomplete data.
- Unusual events/transactions are not captured, escalated or appropriately approved.
- Problems known at lower levels are not always escalated to senior management in absence of appropriate platforms
- Whistleblower Policy exists only on paper
- Open communication is not encouraged
- Exit interviews are not taken/recorded.

The illustration shows two men in business suits. The man on the left is shouting into a megaphone, while the man on the right is talking on a mobile phone. This visualizes the communication breakdown mentioned in the text.

Monitoring

16. Organization conducts ongoing and/or separate evaluations of internal controls

17. Evaluates and communicates internal control deficiencies to those responsible for remedial actions including the board/senior management

Who is Monitoring?

- Self assessment of controls (Control Self assessment or CSA) is not an established practice as yet.
- Review of Internal Controls is done by internal Auditors – however, the scope of internal audit is at times limited and the internal auditors have limited access to the senior management.
- The SOP and the IT systems are designed primarily to ensure functionality – control thinking is not an integral part of these initiatives. Hence, identification and reporting of internal control failures is not automated or part of structured reporting to the management.

To summarize: A framework for assessing ELCs...

Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring Activities
1. Demonstrates commitment to integrity and ethical values.	6. Specifies suitable objectives.	10. Selects and develops control activities.	13. Uses relevant information.	16. Conducts ongoing and/or separate evaluations.
2. Exercises oversight responsibility.	7. Identifies and analyzes risk.	11. Selects and develops general controls over technology.	14. Communicates internally.	17. Evaluates and communicates deficiencies.
3. Establishes structure, authority, and responsibility.	8. Assesses fraud risk.	12. Deploys through policies and procedures.	15. Communicates externally.	
4. Demonstrates commitment to competence.	9. Identifies and analyzes significant change.			
5. Enforces accountability.				

Assessing Relevance of ELCs for Financial Reporting

- All ELCs may not have an impact on ICFR
- Identification of relevant ELCs and assessing their precision level based on:
 - Purpose of control – e.g. inventory verification
 - Level of aggregation – e.g. review of consolidated statements
 - Quality and consistency of performance – e.g. control exercised at random intervals when time permits
 - Correlation to relevant assertions – e.g. selective confirmation of debtors
 - Criteria for identifying exceptions/conducting investigations – e.g. too high a materiality threshold
 - Comparison with expectations/budgets – e.g. budgets may be unrealistic, estimates may not have the desired level of precision.

The Next Steps

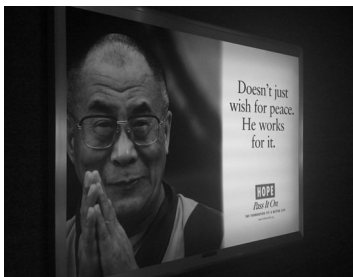
- Deficiencies in ELCs to be informed to the management for remediation
- Specific attention to be paid to:
 - Risk of Management Override and mitigating controls
 - Evaluating Audit committee/board oversight
 - Evaluating whistleblower programme
 - Evaluating IT infrastructure and general controls
 - Monitoring of controls outsourced to other agencies
- Conclusions on ELCs to be incorporated into testing plan for other controls.

To Conclude

- Effective Entity level Controls are fundamental to an effective IFC.
- The quality of ELCs determine the quantum and nature of testing to be done at account line item, unit or process level.
- Deficiencies observed at the ELC level need to be communicated to the management for remedial actions.
- It is time for us, as auditors or controllers, to start working on helping organizations in setting up an effective framework of IFC - such a framework will go a long way in enhancing the reliability of the financial statements.



Importance of Action



It is time to get going!!
