Introduction to Internal Financial Controls

Praveen Kaushik

FCA, DISA, Dip. IFRS (ICAI), FAFD (ICAI), RV-SFA (IBBI), IP (IBBI), Cert. BRSR (ICAI)

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STATUTORY REQUIREMENTS

Companies Act, 2013

- Section 143(3)(i) of the Companies Act, requires the auditors' report to state whether the company has adequate internal financial controls system with reference to financial statements in place and the operating effectiveness of such controls.
- Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

STATUTORY REQUIREMENTS

Section 134(5)(e) of the Companies Act 2013 defines Internal Controls. Following persons are covered:

- Directors, to state in their Director's responsibility statement & Board's Report.
- Auditors, to additionally present an opinion on whether an organization has an adequate internal financial controls (IFC) system

IFC is applicable solely to all listed entities.

However, Companies (Accounts) Rules, 2014 needs the Board of Directors' report of all companies to state the details in respect of adequacy of internal financial controls regarding the "financial statements.

MCA vide its notification dated 13th June 2017 amended provisions providing exemption from IFCs to following private companies.*

- OPC or Small Companies.
- Private companies with turnover less than INR 50 Crore and aggregate borrowings less than INR 25 Crore at any point of time during the financial year

Not applicable to a holding company or a subsidiary company, Section 8 Company and Companies governed by any Special Act.

OBJECTIVE OF INTERNAL FINANCIAL CONTROLS

Preventing and Detecting Errors and Fraud: IFC are designed to prevent and detect errors and fraudulent activities in financial transactions and reporting processes.

Ensuring Accuracy and Completeness: IFC aim to ensure that financial records are accurate, complete, and reflect the true financial position of the organization.

Compliance: IFC help ensure compliance with laws, regulations, and internal policies governing financial transactions and reporting.

Enhancing Operational Efficiency: By streamlining processes and implementing controls, IFC contribute to the efficient operation of the organization.

INTERNAL CONTROLS - MEANING

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 regards to:

reliability of financial reporting,	effectiveness and efficiency of operations,	safeguarding of assets, and	compliance with applicable laws and regulations

INTERNAL CONTROLS

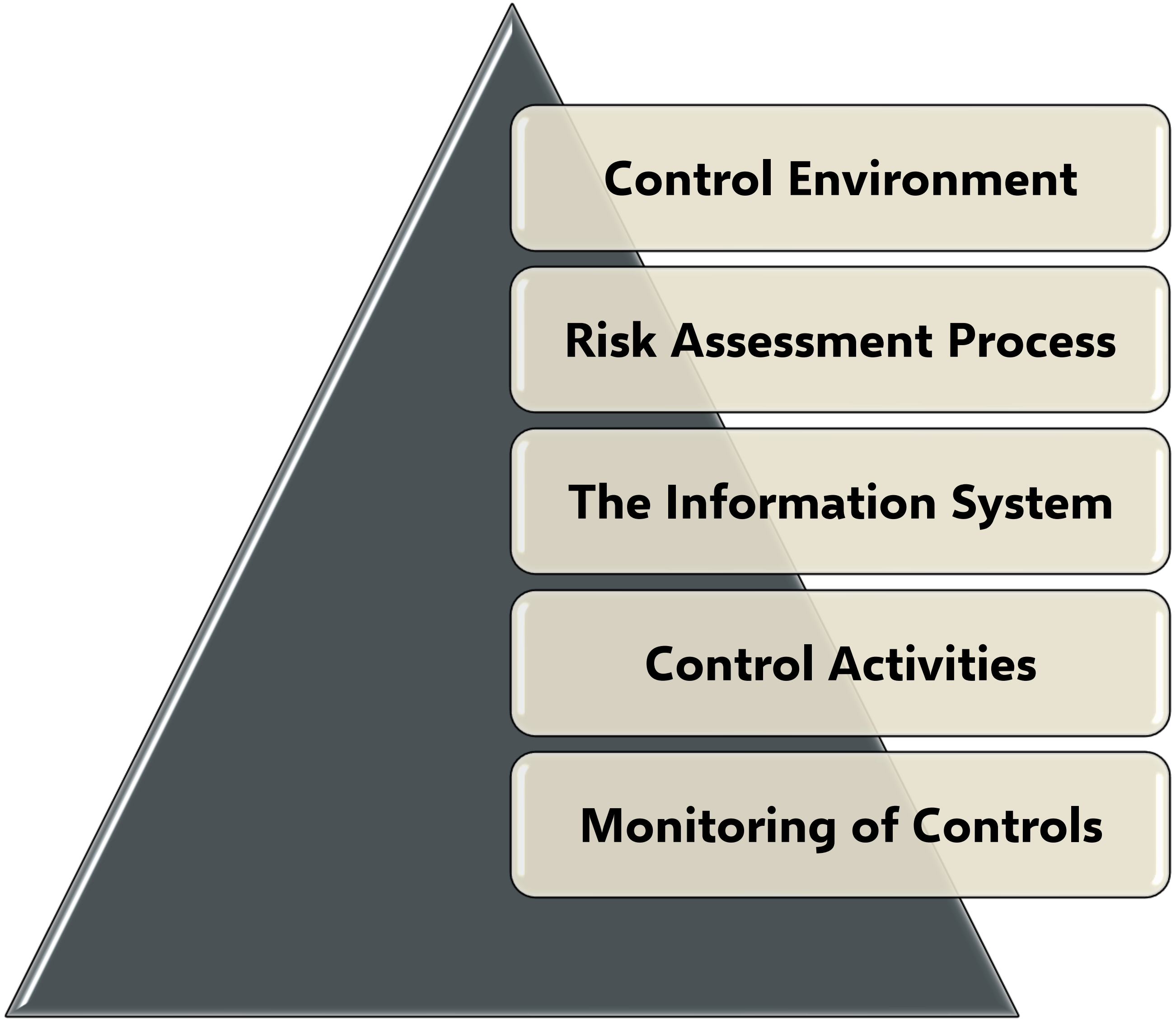
Internal Financial Controls include those policies and procedures that

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

- provide reasonable assurance that transactions are recorded to help in 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

- 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 CONTROLS – COMPONENTS OF INTERNAL CONTROLS



INTERNAL CONTROLS – CONTROL ENVIRONMENT

- Obtain an understanding of the control environment. As part of obtaining this understanding, evaluate whether:

  - Management, with the oversight of those charged with governance, has created and maintained a **culture of honesty and ethical behaviour**. ("Tone at the Top", "Management's Attitude towards Fraud")

  - The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. – Look particular instances of "Management Override of Controls"

INTERNAL CONTROLS – RISK ASSESSMENT PROCESS

Obtain an understanding of whether the entity has a process for:

- Identifying business risks relevant to financial reporting objectives
- Estimating the significance of the risks
- Assessing the likelihood of their occurrence
- Deciding about actions to address those risks

If the entity has established such a process (referred to hereafter as the ‘entity’s risk assessment process’), obtain an understanding of it, and the results thereof.

If the entity has not established such a process or has an ad hoc process, discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.

INTERNAL CONTROLS – INFORMATION SYSTEM

Obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements
- The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary.
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

INTERNAL CONTROLS – INFORMATION SYSTEM

Obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

- Communications between management and those charged with governance.
- External communications, such as those with regulatory authorities

INTERNAL CONTROLS – CONTROL ACTIVITIES

- Control activities are the policies and procedures that help ensure that management directives are carried out.

- Obtain an understanding of control activities relevant to the audit, being those are necessary to understand in order to assess the risks of material misstatement at the assertion level and design further procedures responsive to assessed risks.

- It requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which are relevant in risk assessment process.

- In understanding the entity's control activities, obtain an understanding of how the entity has responded to risks arising from IT.

INTERNAL CONTROLS – MONITORING OF CONTROLS

- Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

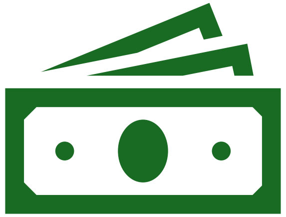
- Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.

- Obtain an **understanding of the major activities that the entity uses to monitor internal control over financial reporting**, including those related to those control activities relevant to the financial statements, and how the entity initiates remedial actions to deficiencies in its controls.

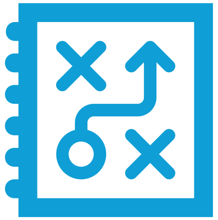
- If the entity has an internal audit function, the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organisational status, and the activities performed, or to be performed.

- Obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose.

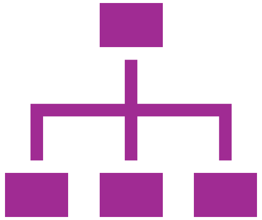
IMPORTANCE OF INTERNAL FINANCIAL CONTROLS



Provides stakeholders with confidence in the organization's financial statements.



Helps in identifying and mitigating risks associated with financial operations.



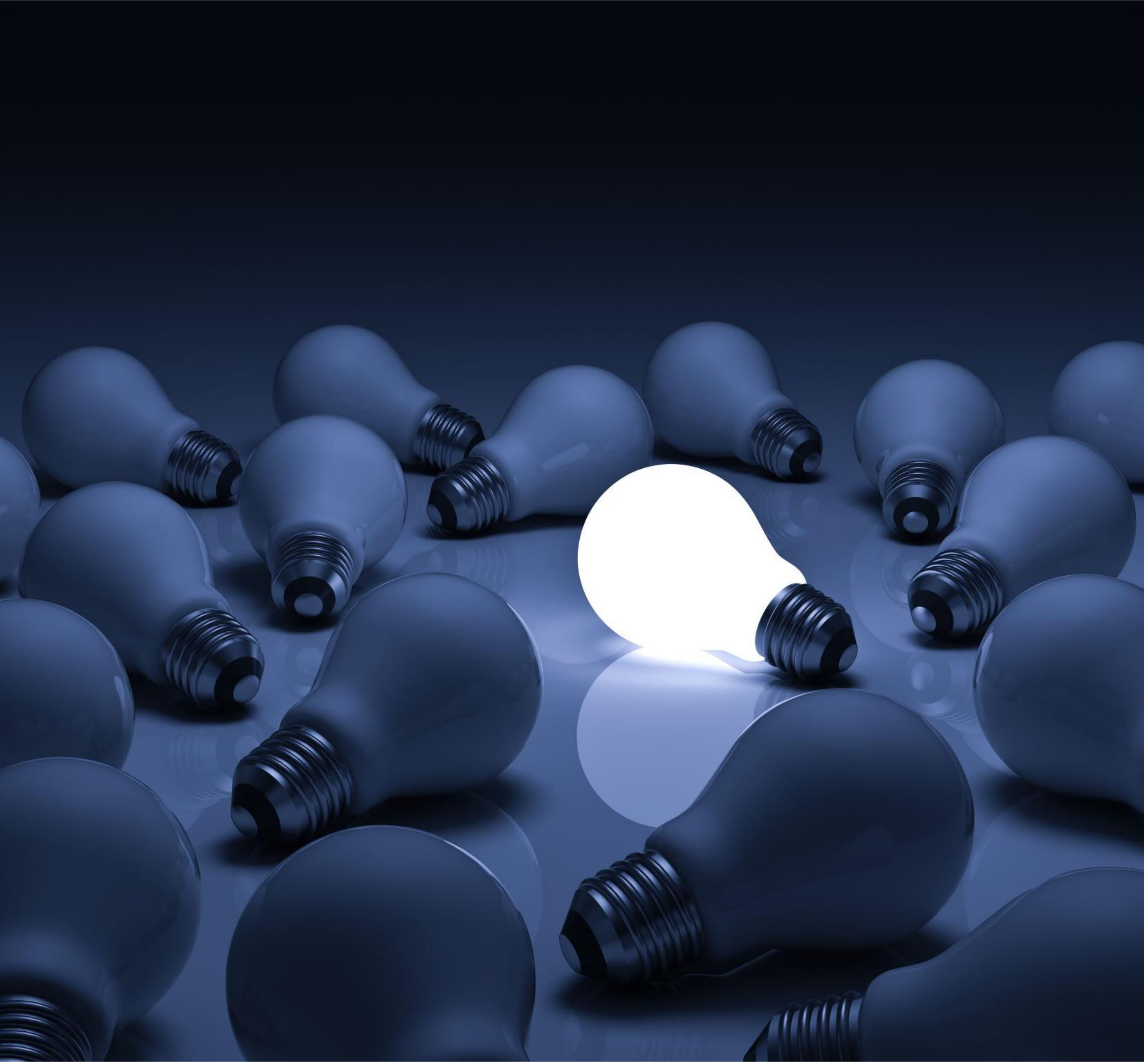
Facilitates efficient and effective operation of the organization.

SIGNIFICANCE OF IFC IN ORGANIZATIONAL OPERATIONS

Internal Financial Controls (IFC) are the backbone of an organization's financial management system, ensuring the integrity and reliability of financial information.

IFC provide a framework that helps organizations achieve their financial objectives by promoting transparency, accountability, and compliance with regulations.

By implementing robust IFC, organizations can effectively manage financial risks, enhance decision-making processes, and maintain stakeholder trust.



Practical Challenges in Implementation of Internal Financial Controls

- Lack of Resources or Expertise.
- Resistance to Change.
- Complexity of Business Processes

Lack of Resources or Expertise

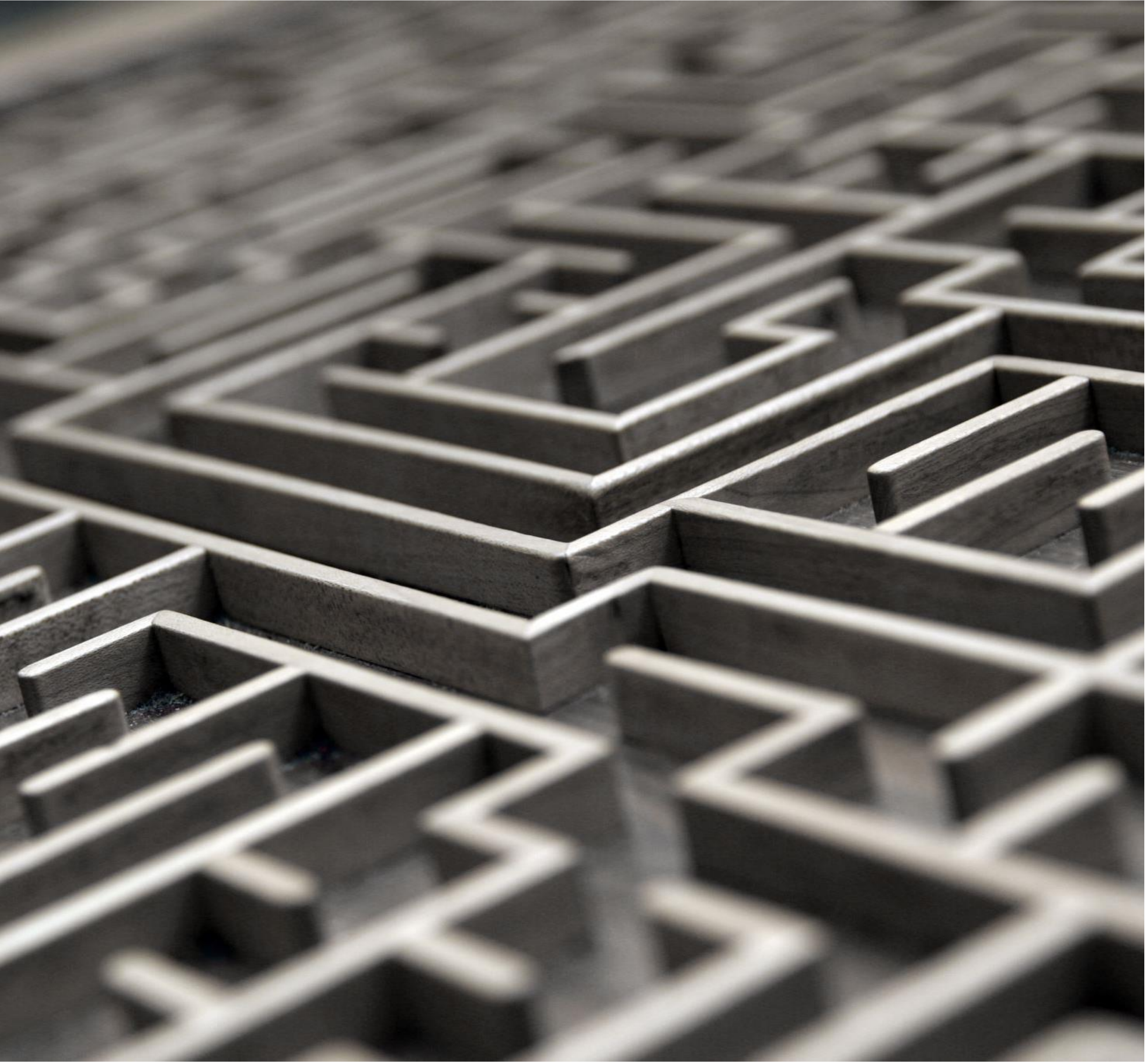
- Insufficient budget allocation for implementing and maintaining IFC measures.
- Limited availability of skilled personnel to design, implement, and monitor controls.
- Shortage of staff with specialized knowledge in internal controls and regulatory compliance.
- Difficulty in hiring and retaining qualified professionals due to competitive job markets.

Resistance to Change

- Resistance from employees or stakeholders to adopt new processes or controls.
- Reasons for resistance:
- Fear of job displacement or changes in job roles.
- Perceived increase in administrative burden or workload.
- Lack of understanding about the benefits of IFC and how it aligns with organizational goals.

Addressing resistance to change:

- Implement effective change management strategies, including clear communication and stakeholder engagement.
- Highlight the benefits of IFC implementation for employees and the organization as a whole.



Complexity of Business Processes

Modern business operations involve intricate processes spanning multiple departments and systems. Challenges posed by complexity:

- Difficulty in identifying all potential risks and control points within complex processes.
- Increased likelihood of errors or inefficiencies due to the interdependence of various processes.
- Cost and time implications associated with implementing controls in complex environments.

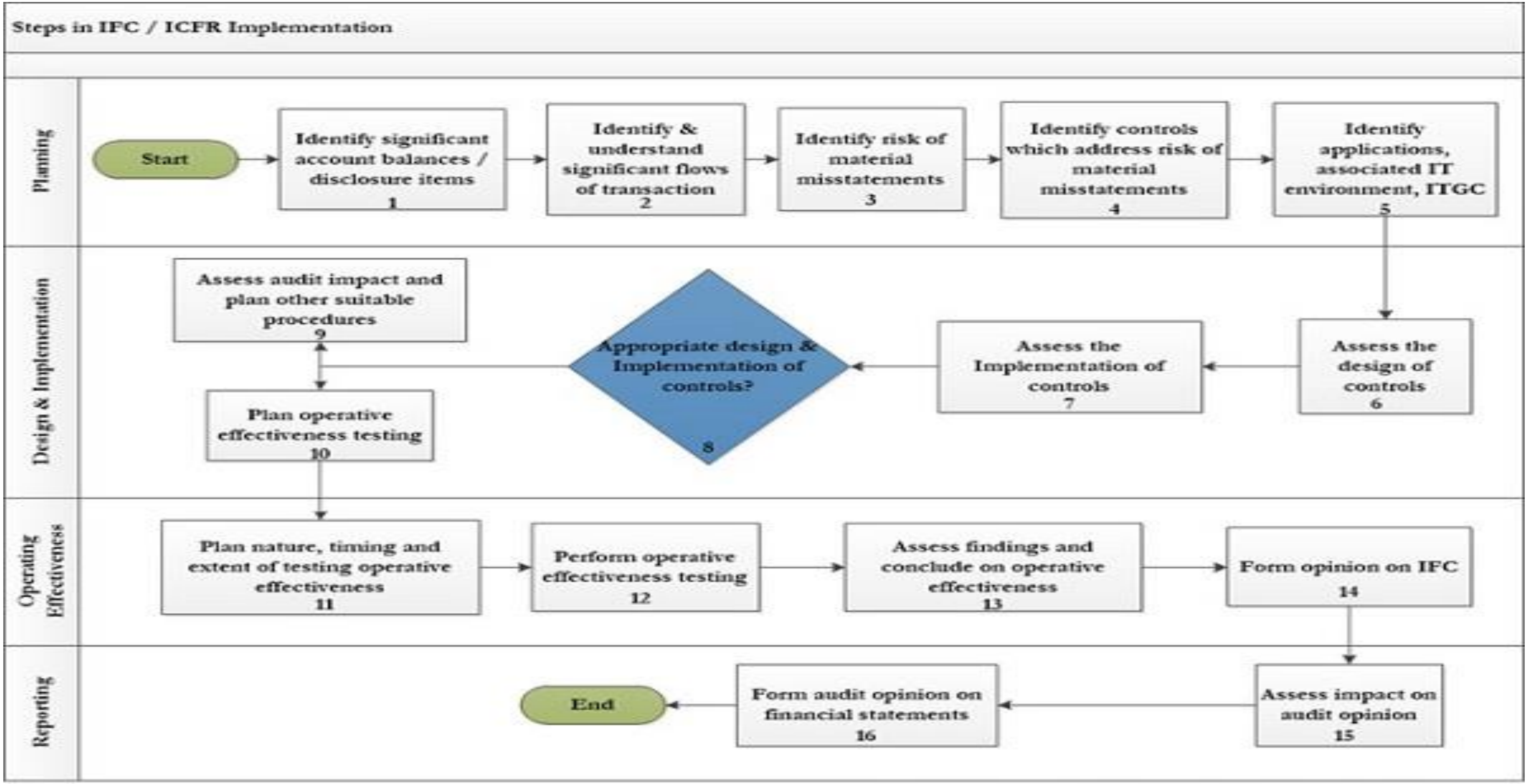
Managing complexity of business processes:

- Conduct comprehensive process mapping and risk assessments to identify key control points.
- Implement technology solutions to automate and streamline complex processes where possible.

Best Practices for Internal Financial Controls

- Strong Tone at the Top
- Regular Risk Assessments
- Clear Communication
- Documentation

INTERNAL CONTROLS – TESTING



sourced from Guidance Note on Audit of Internal Financial Controls Over Financial Reporting – issued by ICAI

Thank You

Praveen Kaushik

Mob: +91 – 98117 17900

Email: praveen@valuesquare.in

www.valuesquare.co.in I New Delhi | Mumbai

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http://linkedin.com/in/praveen-kaushik-a5940836

@Kaushik_1707