

# ICAI releases revised guidance on Internal Financial Controls Over Financial Reporting

16 September 2015



## First Notes on:

Financial Reporting  
**Corporate law updates**  
Regulatory and other information  
Disclosures

## Sector:

**All**  
Banking and Insurance  
Information, Communication, Entertainment  
Consumer and Industrial Markets  
Infrastructure and Government

## Relevant to:

**All**  
Audit committee  
CFO  
Others

## Transition:

**Immediately**  
Within the next 3 months  
Post 3 months but within 6 months  
Post 6 months

## Background

Under Section 143(3)(i) of the Companies Act, 2013 (2013 Act), an auditor of a company is required to state in his/her audit report whether the company has an adequate internal financial controls (IFC) system in place and the operating effectiveness of such controls. Explanation to Section 134(5)(e) of the 2013 Act defines IFC to include policies and procedures adopted by the company for ensuring orderly and efficient conduct of its business, accuracy and completeness of the accounting records, and timely preparation of reliable financial information.

The Institute of Chartered Accountants of India (ICAI) had issued a Guidance Note in November 2014. This Guidance Note has been revised subsequently and the ICAI issued a revised 'Guidance Note on Audit of Internal Financial Controls Over Financial Reporting' (Guidance Note) on 14 September 2015. This issue of First Notes provides an overview of the Guidance Note issued by ICAI.

## Reporting responsibility of the management

- Section 134(5)(e) of the 2013 Act (which deals with the directors' responsibility statement) requires directors of listed companies to state whether they had laid down IFC to be followed by the company and that such IFC are adequate and were operating effectively.
- Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 (Rules) requires Board's report of every company to state the details in respect of adequacy of IFC with reference to the financial statements.
- Though not specifically mentioned, the Guidance Note appears to suggest that for:
  - *Listed companies*: The directors' responsibility statement to state that IFC are adequate and operating effectively. The Board's report to state the adequacy of IFC with respect to financial statements.
  - *Other companies*: The Board's report to state adequacy of IFC with respect to financial statements.

## Criteria to be considered for developing, establishing and reporting on IFC

- Similar to the 2013 Act, the Guidance Note does not prescribe a particular framework for IFC. Instead the Guidance Note states that a benchmark system of internal control, based on suitable criteria, is essential to enable the management and auditors to assess and state the adequacy and compliance of the system of internal controls.
- In the Indian context, e.g. Appendix I 'Internal Control Components' of Standards on Auditing (SA) 315 - *Identifying and Assessing the Risk of Material Misstatement Through Understanding An Entity and Its Environment*, provides the necessary criteria for IFC over financial reporting (IFC – FR) for companies.
- The components of internal controls under SA 315 takes into account control environment, entity's risk assessment process, control activities, information system and communication and monitoring of controls.

## Reporting by auditors – whether same scope as that of management

- The auditor's objective in an audit of IFC – FR (which is generally carried out along with an audit of financial statements) is to express an opinion on the adequacy and operating effectiveness of the company's IFC – FR. A company's internal control cannot be considered effective if one or more material weakness exists. Paragraph A1 of SA 200 - *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, inter alia*, states that the auditor's opinion on the financial statements does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which the management has conducted the affairs of the entity.
- Globally also, auditor's reporting on internal controls is together with the reporting on financial statements and such internal controls reported upon relate only to internal controls over financial reporting.
- The Guidance Note states that consistent with the requirements of the 2013 Act and the Rules as well as the practice prevalent globally, the term IFC wherever used in the Guidance Note in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the 2013 Act, per se implies and relates to IFC – FR.
- For the above purpose, the Guidance Note defines IFC – FR to mean a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, 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.

## How to audit IFC – FR

- Since the SAs do not address the auditing requirements for reporting on IFC, though certain portions of the SAs may still be relevant, the Guidance Note provides supplementary procedures that would need to be considered by the auditor for planning, performing and reporting in an audit of IFC – FR under Section 143(3)(i) of 2013 Act.
- The Guidance Note specifically states that since the audit of IFC is in connection with financial reporting, the concept of materiality will be applicable even in such audits. The auditor should use the same materiality considerations as would be used in planning the audit of the company's annual financial statements as provided in SA 320 - *Materiality in Planning and Performing an Audit*.

Though the audit procedures mentioned in the Guidance Note have been framed for an auditor, these procedures could also be used by companies to perform a self-evaluation. The audit procedures would typically involve the following steps:

- **Step – 1 Planning:** Under the planning stage, the auditor is required to establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. The planning stage involves identification of significant account balances/disclosure items, identification and understanding significant flow of transactions, identification of Risk of Material Misstatements (RoMM), identification of controls which will address RoMM including applications, associated IT environment and general IT controls.
- **Step – 2 Design and implementation:** The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.
- **Step – 3 Operating effectiveness:** Operating effectiveness of a control is tested by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Testing of operating effectiveness involves planning the nature, timing and extent of procedures to be performed, assessing findings and concluding on operating effectiveness.

- **Step – 4 Reporting:** Where there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor should evaluate the need to express a modified opinion i.e. qualified or adverse on the company's IFC – FR, unless there is a restriction on the scope of the engagement in which case the auditors should either disclaim the opinion or withdraw from the engagement. The auditor should determine the effect of the modified opinion on IFC – FR has on his opinion on the financial statements. Additionally, the auditor should disclose whether his opinion on the financial statements was affected by the modified opinion on IFC – FR.

#### IFC reporting on consolidated financial statements (CFS)

- Section 129(4) of the 2013 Act states that provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, *mutatis mutandis*, apply to the CFS. A strict reading of this Section might indicate that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the IFC – FR, even in the case of CFS.
- The Guidance Note has clarified this by stating that reporting on the adequacy and operating effectiveness of IFC – FR would apply even in the case of CFS, for the respective components included in the CFS only if it is a company under the 2013 Act.
- Accordingly, in line with the approach adopted by the ICAI in case of certain other reporting matters on CFS, the reporting on adequacy of IFC would also

be on the basis of the reports on Section 143(3)(i) of 2013 Act as submitted by the statutory auditors of components that are Indian companies under the 2013 Act.

#### Specified date for reporting on the adequacy and operating effectiveness of IFC – FR

- Section 143(3)(i) of the 2013 Act does not specify whether the auditor's report should state if IFC existed and operated effectively during the period under reporting of the financial statements or at the balance sheet date up to which the financial statements are prepared. Paragraph 57(k) of the Statement on the Companies (Auditor's Report) Order, 2003 issued by the ICAI, *inter alia*, states that an auditor is required to assess whether the major weakness, if any, noted by him have been corrected by the management at the balance sheet date.
- Accordingly, the auditor should report if the company has adequate internal control systems in place and whether they were operating effectively at the balance sheet date.

#### IFC reporting on interim financial statements

- It may also be noted that an auditor's reporting on IFC is a requirement specified in the 2013 Act, and therefore will apply only in case of reporting on financial statements prepared under the 2013 Act and reported under Section 143 of the 2013 Act.
- Accordingly, reporting on IFC will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

#### Our comments

- Due to enhanced reporting responsibilities, companies should immediately start evaluating their present components of internal controls and ensure that they are aligned with the framework prescribed under the Guidance Note.
- In absence of any guidance under the 2013 Act, the Guidance Note is expected to serve as a guide for the management while implementing the requirements under the 2013 Act.
- The implementation of the Guidance Note would entail setting up a robust governance framework including consideration of outsourced processes, assessment of key risks, detailed documentation of risks and mitigating controls, strong information technology systems, periodic reviews, etc.
- The enhanced reporting responsibilities would result in an increase in the cost of compliance. Though this is a valid concern, however, in the long run, an effective IFC is expected to lead to high quality financial reporting and a robust corporate governance mechanism.

#### The bottom line

The Guidance Note is likely to help implement the requirements of the 2013 Act. Companies and auditors were looking for guidance and a framework to help them discharge their obligations. The ICAI has responded and the time for action and implementation is now.

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## KPMG in India's IFRS institute



KPMG in India is pleased to re-launch its IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework..

## IFRS Notes



### The IASB proposes clarifications to the new revenue standard

Based on the discussions with the TRG, on 30 July 2015, the IASB published for public consultation proposed clarifications with respect to the following topics:

- Identifying performance obligations
- Principal vs agent considerations
- Licensing, and
- Transitional relief.

The IASB's deadline for receiving comments is 28 October 2015.

Our issue of IFRS Notes provides an overview of key clarifications proposed by the IASB to IFRS 15 and also highlights what the FASB is proposing to do in these areas.

## Missed an issue of Accounting and Auditing Update or First Notes?



### August 2015

The August 2015 edition of the Accounting and Auditing Update examines the impact of Ind AS 115, *Revenue from Contracts with Customers* on the real estate sector in light of the guidance available in the current Indian GAAP.

We have also covered significant observations made by the Financial Reporting Review Board of the Institute of Chartered Accountants of India with respect to reporting practices under the Revised Schedule VI of the Companies Act, 1956. The requirements relating to the preparation and presentation of the financial statements under the Schedule III to the Companies Act, 2013 are similar as that of Revised Schedule VI.

Recently, the International Accounting Standards Board (IASB) has proposed clarifications to IFRS 15, Revenue from Contracts with Customers for public consultation. We provide an overview of these clarifications and also highlight the U.S. Financial Accounting Standards Board's thinking on these proposals.

Finally, in addition to our regular round up of regulatory updates, we also provide a summary of the important proposals set out in the exposure draft on the Conceptual Framework for Financial Reporting issued by the IASB.



### The MCA amends norms relating to the preparation of financial statements

9 September 2015

The Ministry of Corporate Affairs (MCA) has been issuing various amendments and clarifications to the Companies Act, 2013 (2013 Act) and to the corresponding Rules to remove practical challenges faced by companies while implementing certain provisions of the 2013 Act. Recently, the MCA amended the Companies (Accounts) Rules, 2014 (Rules) and Schedule III to the 2013 Act. Amendments to the above Rules and Schedule III to the 2013 Act will come into force from the date of publication in the Official Gazette. This issue of First Notes summarises the important aspects arising from the amended Rules and Schedule III to the 2013 Act

Our issue of First Notes provides an overview of the clarifications issued by the MCA.



### KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 23 September 2015 4:00 PM – 5:00 PM, we will aim to cover key financial reporting and regulatory matters that are expected to be relevant for stakeholders as they approach the quarter ending 30 September 2015. This will be a new feature to the topics that are discussed on the call.

Our call will include updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), the Institute of Chartered Accountants of India (ICAI), the International Accounting Standards Board, etc.

Details will be available on [www.kpmg.com/in](http://www.kpmg.com/in)

## Feedback/queries can be sent to [aaupdate@kpmg.com](mailto:aaupdate@kpmg.com)

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