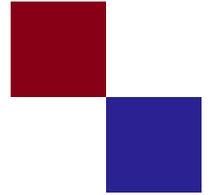




# Internal Financial Controls

The need, procedure and impact

## Requirements under Companies Act, 2013



Director's  
Responsibility  
Statement  
shall state that

The directors, in the case of a listed company, had laid down **internal financial controls** to be followed by the company and that such internal financial controls are **adequate** and were operating effectively.

[Section 134(5)(e)]

The directors had devised proper systems to ensure **compliance with the provisions of all applicable laws** and that such systems were **adequate** and **operating effectively**.

[Section 134(5)(f)]

“In addition to the information and details specified in sub-rule (4), the report of the Board shall also contain: ...“the details in respect of adequacy of **internal financial controls** with reference to the **financial statements**.”

[Section 134(3)(q), sub-rule 8(5)]

Internal Financial Controls” means 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**.

[explanation to Section 134(5)]

## Requirements under Companies Act, 2013 (contd.)

### Audit Committee

Every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall inter alia, include ....., **evaluation of internal financial controls and risk management systems** ...

[Section 177(4)(vii)]

The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

[Section 177(5)]

### Auditor's report

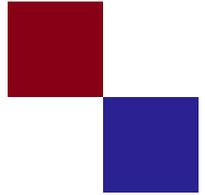
Whether the company has **adequate internal financial controls system** in place and the **operating effectiveness** of such controls.

[Section 143(3)(i)]

Whilst section 134(5) requires directors to state their responsibility on internal financial controls in case of listed companies, auditors are required to report on the adequacy and operating effectiveness of such controls in case of all companies.

Further, Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements

## Requirements under Companies Act, 2013 (contd.)



### To Summarize:

<b>For Listed Company</b>	<ul style="list-style-type: none"><li>✓ Directors to LAY down IFC (including IFC-FR) .</li><li>✓ To STATE in Director's Responsibility statement about the adequacy and effectiveness of IFC.</li><li>✓ STATE in Board report about the Design &amp; Implementation as well as adequacy and operating effectiveness with regards to IFC-FR</li><li>✓ Audit Committee to EVALUATE internal financial controls and risk management systems</li><li>✓ Auditor's to REPORT on adequacy and operating effectiveness of IFCs system.</li></ul>
<b>For every other Companies</b>	<ul style="list-style-type: none"><li>✓ BOD to STATE in Board report about the Design &amp; Implementation as well as Adequacy and Operating effectiveness of Internal Financial Controls with regards to Financial Statements</li><li>✓ Auditor's to REPORT on adequacy and operating effectiveness of IFCs system.</li></ul>

*Internal financial controls reporting covers not just financial reporting aspects, but also the strategic and operational aspects of business and the efficiency with which those operations are carried out*



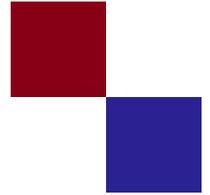
# Components of Internal Financial Controls (IFC)

Components	Sub-components
<ul style="list-style-type: none"><li>Control Environment</li></ul>	<ol style="list-style-type: none"><li>Organisational Structure</li><li>Segregation of duties</li><li>Human resource policies and practices</li><li>Standard operating procedures and manuals</li></ol>
<ul style="list-style-type: none"><li>Entity's risk assessment procedures</li></ul>	<ol style="list-style-type: none"><li>Changes in operating environment or the regulatory environment.</li><li>New personnel</li><li>New or revamped information systems</li><li>Rapid growth</li><li>New technology</li><li>New business models, products, or activities</li><li>Corporate restructurings</li><li>Expanded foreign operations</li><li>New accounting pronouncements</li></ol>
<ul style="list-style-type: none"><li>Control Activities</li></ul>	<ol style="list-style-type: none"><li>Identification of the controls across the key business cycles and testing the effectiveness of these controls by the management</li><li>Information Technology General Controls (ITGC)</li><li>Information Technology Application Controls (ITAC)</li><li>Physical controls</li></ol>

## Components of Internal Financial Controls (IFC) [contd.]

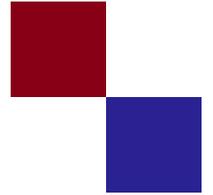
Components	Sub-components
<ul style="list-style-type: none"><li>Information System and Communication</li></ul>	<ol style="list-style-type: none"><li>Infrastructure</li><li>The information system relevant to financial reporting objectives.</li><li>Quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports</li><li>Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda</li></ol>
<ul style="list-style-type: none"><li>Monitoring of controls</li></ul>	<ol style="list-style-type: none"><li>Consider whether the established controls are operating as intended</li><li>Modify the controls as appropriate for changes in conditions</li><li>Ensure that controls continue to operate effectively over time</li></ol>

## Implementation of IFC-FR



There are three phases in implementation of Internal Financial Controls over Financial Reporting. Each phase along with activities and deliverable of each phase are describes as below:

Phase	Activities	Deliverables
Design & Implementation	<ul style="list-style-type: none"><li>➤ Identify Key Processes</li><li>➤ Identify Key Financial and Operational Risk</li><li>➤ Identify design gaps.</li><li>➤ Document risks and controls</li></ul>	<ul style="list-style-type: none"><li>➤ Organisation Charts</li><li>➤ Process Manuals, Process Charts, Standard Operating Procedures (SOP's), etc.</li><li>➤ Segregation of Duties (SOD's) and Delegation of Authorities (DOA).</li><li>➤ Risk Control Matrix.</li><li>➤ Exception Reports on Design gaps</li></ul>
Management Testing	<ul style="list-style-type: none"><li>➤ Create test sheets</li><li>➤ Workshops to process owners</li><li>➤ Templates for capturing exceptions</li><li>➤ Co-develop remediation measures.</li></ul>	<ul style="list-style-type: none"><li>➤ Test sheets</li><li>➤ Management Reporting Templates</li></ul>
Effectiveness	<ul style="list-style-type: none"><li>➤ Receive self reporting from process owners</li><li>➤ Test Operating Effectiveness</li></ul>	<ul style="list-style-type: none"><li>➤ Exception Report on Operating Effectiveness</li></ul>



### What are the consequences when auditor concludes that internal controls were not effective?

The Auditor report will include a qualified opinion. Not only merely for internal control, but also under section 143(3)(f) of the Act as non-existence of appropriate internal control can also have adverse affect on the functioning of the Company.

It can be safely concluded that non existence of internal control would imply that existence of Fraud cannot be effectively monitored and the financial statements would lack credibility.

Credit rating agencies will take it negatively also it may affect negotiation power of the entity with borrowers.

*The requirement of internal control is now legally mandated for every Companies in a way. In respect of:*

- ✓ *Listed Companies – by virtue of Section 134(5) and Rule 8(5); and*
- ✓ *Other than Listed Companies – by virtue of Rule 8(5),*

*The management and TCWG should re-visit the existing internal controls and strengthen them.*

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