FAQs ON Internal Financial Controls (IFC)

Q1. What are Internal controls?

Internal controls are 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 regard to:

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

Q2. What are Internal Financial Controls?

As per 134(5)(e) of the Companies Act 2013, "Internal Financial Controls" (IFC) 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

Q3. What are Internal Controls over Financial Reporting?

A process designed 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. A company's internal financial control over financial reporting includes those policies and procedures that

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

(ii) provide reasonable assurance that transactions are recorded as necessary to permit 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

(iii) 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.

Q4. How are Internal Financial Controls different from Internal Controls Over Financial Reporting?

Internal Financial Controls is much wider in scope when compared to ICOFR. Internal financial controls include Internal controls over financial reporting and operational controls and anti-fraud controls.

Q5. What are the reporting responsibilities of the management related to IFC?

a) 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.
b) 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.

Q6. What are the regulatory requirements, responsible authority and their respective applicability related to IFC?

Applicable On	Regulatory Requirement w.r.t to relevant clauses
Listed Companies	**Director' Responsibility u/s 134(5)(e) -** Director's responsibility statement to state that the directors, have laid down IFC to be followed by the company and that such internal financial controls are adequate and were operating effectively. Board to confirm that IFCs are adequate & Operating effectively
All Companies	**Board Report- Rule 8(5) of companies (Accounts) Rules –** Requires the board report to state the details in respect of the adequacy of Internal Financial Controls with reference to the Financial Statements.
All Companies having ID's.	**Code for Independent Director's (ID)-Sec 149(8) & Schedule V –** Should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible

All Companies having an AC	**Audit Committee (AC) terms of reference-Sec 177 –** AC requires the auditors to call for the comments about Internal Controls and may also discuss any related issues with the internal auditor and Statutory auditor and the management of the company.
All Companies	**Auditor's report u/s (143)(3)(i) –** Auditor to report if the company has adequate IFC systems in place in relation to Financial statements and the operating effectiveness of such controls.

Q7. What are the regulatory requirements in Clause 49 of Listing Agreement related to ICOFR?

The requirements mentioned in Clause 49 of Listing Agreement related to ICOFR are:

- Responsibility of the CEO/CFO to maintain ICOFR.
- Evaluate the effectiveness of internal control systems pertaining to financial reporting.
- Indicate to the auditors and the audit committee significant changes to accounting policies and ICOFR.

Q8. What is the auditors' responsibility for reporting on internal financial controls over financial reporting in case of consolidated financial statements?

Section 129(4) of the 2013 Act states that the 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 consolidated financial statements.

Hence, the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements.

Q9. What is the applicability of reporting on IFC in case of Interim Financial Statements?

Auditor's reporting on internal financial controls over financial reporting is a requirement specified in the Companies Act, 2013 and therefore will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143. Accordingly, reporting on internal financial controls over financial reporting 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

Q10. What is the specified date for reporting on the adequacy and operating effectiveness of IFC?

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.

Q11. What internal control framework should management should be considered for developing, establishing and reporting on Internal Controls over Financial Reporting?

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.

However, 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.

Q12. What are the various steps in the implementation and audit of IFC?

1. **Planning**
   i. Identification of significant account balances / disclosure items
   ii. Identify and understand significant flow of transactions
   iii. Identify risks of material misstatements
   iv. Identify controls which address risk of material misstatements

v. Identify applications, associated IT environment, IT general controls

2. **Design and Implementation**
   i. Assess the design of controls
   ii. Assess the implementation of controls
   iii. Assess audit impact and plan other suitable procedures
   iv. Plan operative effectiveness testing
3. **Operating Effectiveness**
   i. Plan nature, timing and extent of testing operative effectiveness
   ii. Perform operative effective testing
   iii. Assess findings and conclude on operative effectiveness
   iv. Form opinion on IFC
4. **Reporting**
   i. Assess impact on audit opinion
   ii. Form audit opinion on financial statements

Q13. What are the 5 components of Internal control Framework related to audit of Financial Statements as per SA 315?

1. Control environment
2. Entity's risk assessment process
3. Control activities
4. Information system and communication
5. Monitoring of controls

Q14. What are the various elements covered in Control Environment?

The control environment encompasses the following elements:

a) Communication and enforcement of integrity and ethical values
b) Commitment to competence.
c) Participation by those charged with governance.
d) Management's philosophy and operating style
e) Organisational structure
f) Assignment of authority and responsibility

g) Human resource policies and practices

Q15. What are the various Control Activities relevant to an audit of financial statement?

Control activities relevant to an audit may be categorised as policies and procedures relating to:

a) Performance reviews.
b) Information processing.
c) Physical controls - physical security for adequate safeguard of assets and records including access to computer programs and data files
d) Segregation of duties.

Emphasise on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher.

Q16. What are manual controls and automated controls?

Manual controls - Manual controls are carried out by people, as opposed to automated controls (i.e., application controls) that take place without direct human intervention. E.g. Manually reconciling a bank statement or a manager reviewing sales based on budgeted amounts are examples of manual controls.

Automated controls - Application controls are embedded within software programs to prevent or detect unauthorized transactions and allow the authorization and processing of transactions. E.g. Automated controls help ensure a customer number is valid, all required data is entered for a PO and debits equal credits.

Q17. What are the various activities included in Monitoring of Controls?

Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies.

Q18. What are entity level controls?

Broad level objectives defined at an organisation level which may include the tone at the top, operating style and ethical values. They are internal controls that help ensure that management directives pertaining to the entire entity are carried out. Entity-level controls have a pervasive influence throughout an organization. If they are weak, inadequate, or non-existent, they can produce material weaknesses relating to an audit of internal control and material misstatements in the financial statements of the company.

Q19. What are the various examples of entity level controls?

Examples of Entity level controls:

- Controls related to the control environment;
- Controls over management override; The Company's risk assessment process;
- Centralised processing and controls
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process;
- Controls over recording of unusual transactions; and
- Policies that address significant business control and risk management practices

Q20. What are transaction / process level controls?

Represent more basic level objectives and controls which are defined at a process or transaction level. These controls apply to specific transaction. Examples of transaction level controls:

- Segregation of accounts payable transaction processing from bank reconciliations
- Approval requirements for new vendors
- Regular bank account reconciliation
- Time cards approval policies
- Authorization for pay rate changes

Q21. What are preventive and detective controls?

- **Preventive controls -** Preventive controls are designed to avert problems rather than identify them. Some examples include the use of passwords to gain access to computer application systems, or required approval for all purchase orders over a certain rupee threshold.
- **Detective controls -** Detective controls are meant to identify errors or irregularities after the fact. These may take the form of reviews, reconciliations, and analyses.

Q22. What are IT General Controls?

IT general controls generally include controls in information security, application development, and systems maintenance and operations. In addition to internally developed controls, management should take into account any relevant controls existing at a service organization that impact ICFR.

Q23. What are significant classes of transactions?

Significant class of transactions is a class of transactions

- that materially affects a significant account and its relevant assertions,
- includes significant routine, non-routine and estimation transactions from initiation, recording, processing, correcting as necessary, and reporting to the financial statements.

Q24. What are financial statement assertions and various types of financial assertions?

Financial statement assertions – These are claims made by an organization's management regarding its **financial** statements.

Various types of financial assertions:

- **Accuracy/ Existence / Occurrence -** Assets, liabilities and ownership interests exist at a specific date, and recorded transactions represent events that actually occurred during a certain period
- **Completeness -** All transactions that occurred during a specific period have, in fact, been recorded.
- **Valuation -** Assets, liability, revenue and expense components are recorded at appropriate amounts.
- **Rights and obligations -** Assets are the rights, and liabilities are the obligations, of the entity at a given date.
- **Presentation and disclosure -** Items in the statements are properly described, sorted and classified.

Q25. What are the Auditor's objective w.r.t to ICOFR?

- Express an opinion on the effectiveness of the company's internal financial controls over financial reporting
- Carried out along with an audit of the financial statements
- Auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists as of the balance sheet date.

Q26. What is an integrated audit?

In an Integrated audit, the auditor expresses opinion on the following aspects:

a) Opinion on internal control over financial reporting, which requires evaluating and opining on the adequacy and effectiveness of the entity's system of internal financial controls; and
b) Opinion on the financial statements

The auditor should design procedures for testing of controls to accomplish the objectives of both audits simultaneously.

Q27. When should the auditor modify the audit report on internal financial controls?

The auditor should modify the audit report on internal financial controls if any of the following conditions exist:

a) The auditor has identified deficiencies in the design or operation of internal controls, which individually or in combination has been assessed as material weakness.
b) There is a restriction on the scope of the engagement.

Q28. What is the effect of a modified report on internal financial controls over financial reporting on the audit of financial statements?

A modified report on internal financial controls over financial reporting does not in effect imply that the audit report on financial statements should also be qualified. In an audit of financial statements, the assurance obtained by the auditor is through both internal controls and substantive procedures.

Q29. What is a control deficiency?

Control Deficiency exists when the design or operation of a control does not allow management or employees to prevent or detect and correct misstatements on a timely basis.

Q30. What are the different types of control deficiencies?

- Design Deficiency – A control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- Operation Deficiency – A properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority, capabilities, competence, or objectivity to perform the control effectively.

Q31. What are the various examples of design deficiencies?

Examples of Deficiencies in the Design of Controls:

- Inadequate design of internal control over the preparation of the financial statements being audited.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.

Q32. What are the various examples of operational deficiencies?

Examples of Failures in the Operation of Internal Control:

- Failure in the operation of effectively designed controls over a significant account or process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy.
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
- Failure to perform reconciliations of significant accounts.
- Undue bias or lack of objectivity by those responsible for accounting decisions.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.

Q33. What is a material weakness?

A deficiency, or combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's annual financial statements will not be prevented or detected on a timely basis.

Q34. What are the various examples of material weakness?

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control.
- This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts.
- An ineffective internal audit function or risk assessment function.
- Identification of fraud of any magnitude on the part of senior management.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment.

Q35. What is a significant deficiency?

A deficiency (or combination of deficiencies) that is less severe than a material weakness, yet important enough to merit attention of the audit committee or those charged with governance.

Q36. What are the various examples of significant deficiency?

Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with generally accepted accounting principles.
- Antifraud programs and controls.
- Controls over non-routine and non-systematic transactions.
- Controls over the period end financial reporting process.

Q37. What are various methods of sample selection?

The principal methods of sample selection are as –

1. Using a computerised random number generator or through random number tables
2. Systematic selection – In this method, the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 20, and having thus determined a starting point within the first 20, each 20th sampling unit thereafter is selected.
3. Haphazard selection – In this method, the internal auditor selects the sample without following any structured technique. The internal auditor should attempt to ensure that all items within the population have a chance of selection, without having any conscious bias or predictability.
4. Block selection – This method involves selection of a block(s) of adjacent or contiguous items from within the population.

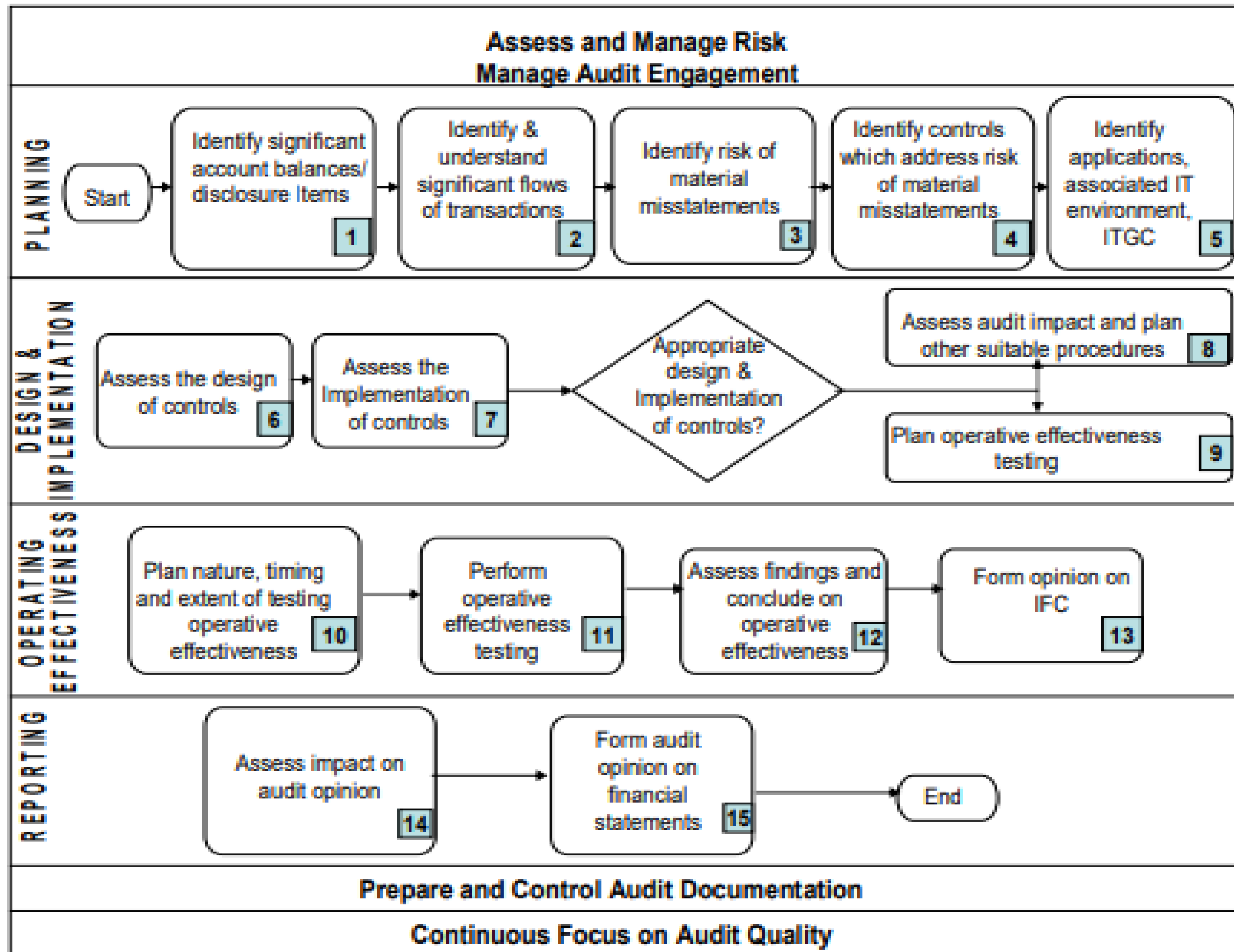
Q38. What is tolerable error?

Tolerable error is the maximum error in the population that the internal auditor would be willing to accept and still conclude that the result from the sample has achieved the objective(s) of the internal audit. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the internal auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

In Tests of controls, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the internal auditor would be willing to accept, based on the preliminary assessment of control risk.

In Substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the internal auditor would be willing to accept so that when the results of all audit procedures are considered, the internal auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

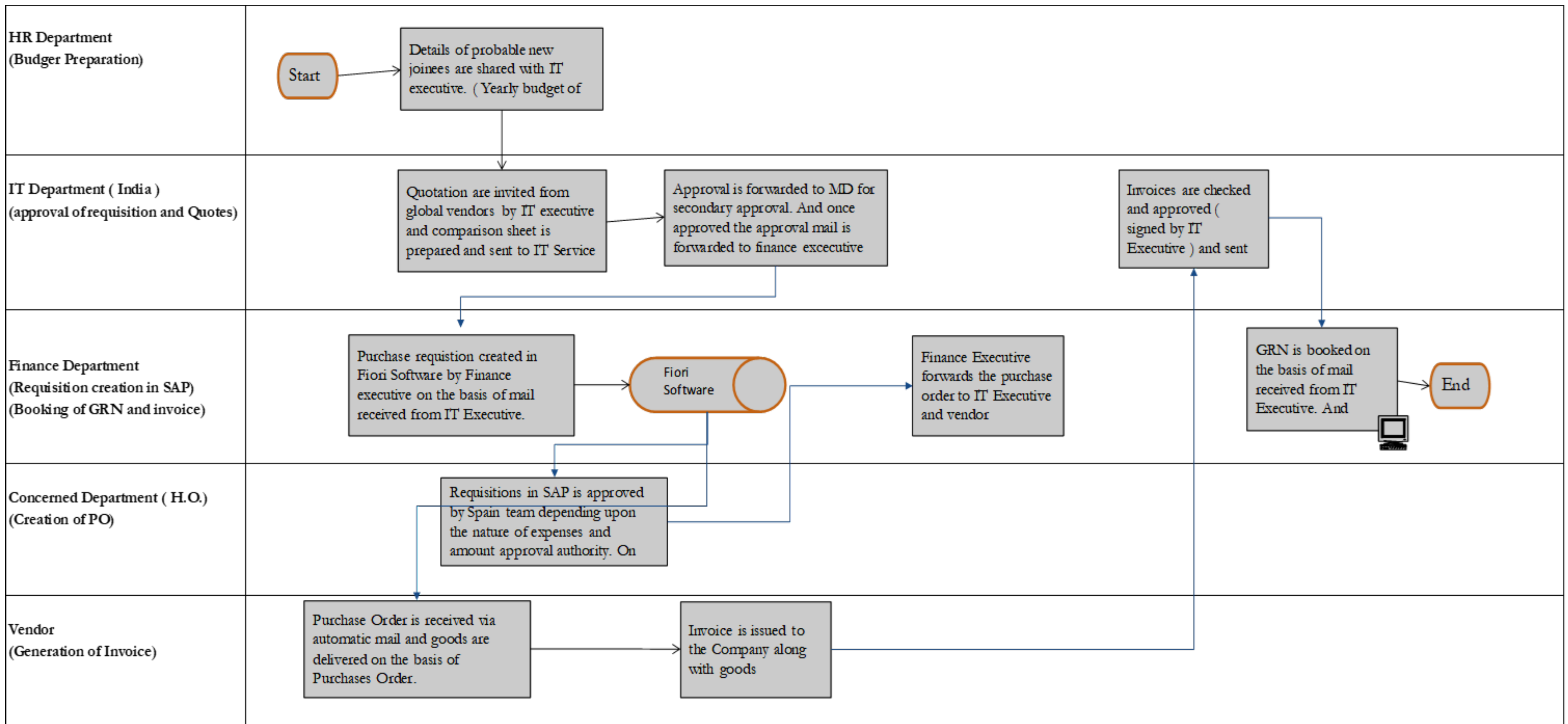
Steps in IFC/IFCR implementation



Source: Guidance Note on Audit of Internal Financial Controls Over Financial Reporting-ICAI

Sample of Business Process Narratives

Process: Fixed Asset Management Process



Sample of Risk Control Matrix

Process: Fixed Asset Management Process

S. No.	Activity	Sub Activity	Process Description	Risk	Control Description (To be certified by Process owner under Control Self Assessment, CSA process)	Maker	Checker	Risk Category		Internal Financial		Control Category										Frequency
														Financial Assertion								
								Fraud risk (Yes/No)	Risk rating (H/L)	IFC (Yes/No)	IFC component *(Refer guide)*	Key Control	Control Level (ELC/PLC/ITGC)	Accuracy/ Existence / Occurrence	Completeness	Valuation / Allocation	Authoritsation / Rights / Obligat	Timeliness	Presentation / Disclosure	Manual/ Automatic	Preventive/ Detective *(refer guide)*	
1	Needs Analysis & Approval	Budget for Purchase	->Yearly Budget for the Fixed assets (Only Computers) is prepared by Senior Finance Manager on the basis of recuitment data received from HR-Manager regarding the probable new	-> Risk of Fixed Assets purchase plan being made	-> Budget is reviewed by Senior Finance Manager -> Further the budget is approved by MD and International Director/MD/	HR Manager	Finance Manager MD International Director/	No	L	No	Policies and procedures	No	ELC	r	a	r	a	r	r	Manual	Preventive	Yearly
2	Requisition Analysis	Request for New Asset	**1) Computer** -> Manager- HR sends the details of new emloyees to be recruited as per budgeted plans to IT executive. On the basis of this sheet, IT executive prepares indent (requirement list) for Laptops for upcoming new joinees for next three months. Indent (requirement list) mail is sent by IT executive to	-> Risk of unauthorized Purchase requisition being raised	**<u>In case of Computer Assets</u>** -> IT Executive ensures that proper requirement is being raised. -> Further Finance Executive reviewes the indent at the time of creation of requisiiton in the SAP.	HR Manager	IT Executive, Finance Executive	No	L	No	Policies and procedures	No	PLC	r	a	r	a	a	r	Manual	Preventive	Routine
			2) Other than Computer -> Indent (requirement list) are made to Management Support Specialist (MSS) via mail/oral communication by concerned department. MSS takes approval from the MD and informs		**In case of Assets other than Computer** -> MSS reviews the requirement list and Managing Director approves the requirement list of assets.	MSS	MD, Finance Executive	No	L	No	Policies and procedures	No	PLC	r	a	r	a	a	r	Manual	Preventive	Routine