Global Consolidated Requirements of Internal Control over Financial Reporting

Nowadays, organisations are under tremendous pressure to achieve revenue and profit growth while constantly exploring the cost-effective geographies, untapped lucrative markets, different models of operations to reduce their own operational costs and achieve higher efficiency. Such competitive conditions have resulted in more mergers and acquisitions, joint ventures, and off-shoring and outsourcing. CEOs and CFOs quite justifiably face a dilemma and a need to certify the true and fair consolidated financial statements, while being geographically dispersed. The author in this article explores the statutory provisions in the cases of US, European Union, India, etc., vis-à-vis various issues revolving internal control. Read on…

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In today's competitive scenario, while organisations are under constant pressure to achieve growth both in terms of revenue and profit, they are constantly exploring cost-effective geographies, untapped lucrative markets, different models of operations to reduce costs and achieve higher efficiency. These competitive conditions have

resulted in more and more acquisitions, joint ventures, mergers, off shoring and outsourcing. The dilemma faced by CEOs and CFOs is well conceived as they are required to certify the true and fair consolidated financial statements while, in most instances, they are geographically dispersed from ground zero.

The unscrupulous practices adopted by large corporate entities, *e.g.* Enron and WorldCom, to inflate their revenue and asset position lead to multimillion dollar frauds. The Enron scandal (October, 2001) and WorldCom bankruptcy (July, 2002) were instrumental in the acceleration of passing SOX legislation, which lays increased focus on internal control over financial reporting, to ensure that the figures reported represent true and fair view of the affairs of the organisation. Similar legislations are framed in various countries, to ensure that the financial figures are best representation of the affairs of the organisation.

Internal Control–Integrated Framework developed by Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides the tools and methodologies to develop an effective and efficient internal control framework over financial reporting.

Relevant extracts of the legislations adopted by various countries are elaborated below:

United States of America—Sarbanes–Oxley Act

The Sarbanes-Oxley Act of 2002 (hereinafter referred to as SOX) came into effect from July 30, 2002, applicable to all companies listed on national securities exchange (hereinafter referred to as exchange). The underlying purpose of SOX was to prevent shareholders and investors from losing money and erosion of general public confidence in the US security markets by laying greater stress on the top management of public listed companies to ensure that adequate steps are adopted to prevent financial misstatements.

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The SOX consists of 69 sections divided in 11 chapters. The Sections 302 (corporate responsibility for financial reports) and 404 (management assessment of internal controls) are those sections which have clearly identified the responsibility of the management to certify that the financial statements contain no material misstatements and establish an internal control structure for financial reporting procedures and assess the effectiveness of established internal control structure.

Section 302 of SOX (Corporate Responsibility for Financial Reports):

Relevant extracts from Section 302 (a) are:

"... that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statementswere made, not misleading;

(3) based on such officer's knowledge, the financial statements,and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

The Companies Act, 2013 came in to force on 29th August, 2013. Section 134 of the Act deals with preparation of financial statements and responsibilities for the Board of Directors.

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operationof internal controls which could adversely affect the issuer's ability to record, process, summarise, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses."

To put the requirements of Section 302 in simple words, it requires CEOs and CFOs to certify in each annual and quarterly submission of financial data to the U.S. Securities and Exchange Commission (*Commission*), the following:

- There are no material misstatements or omission of any facts.
- Financial data portrays the true and fair view of financial conditions and operations.
- Internal control systems over financial reporting have been established and all material information regarding the company and other consolidated entities are made available to CEOs and CFOs.
- Effectiveness of internal control systems is evaluated once every quarter and conclusions are reported.
- Auditors and audit committee have been informed about the deficiency of internal control systems over the financial reporting including any fraud (irrespective of materiality) identified.
- Any change in internal control systems, including change to rectification of deficiency or material weakness, or any other change that could render controls weak or ineffective.

Section 404 of SOX (Management Assessment of Internal Controls):

Relevant extracts of Section 404 are:

"(a) ...each annual report required by .....to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure andprocedures for financial reporting; and

(2) contain an assessment, as of the end of the most recentfiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by sub-section (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board."

To put the requirements of Section 404 in simple words:

- Annual reports or data filed with the *Commission* must contain a report stating that the responsibility of establishing the internal control over financial reporting is the responsibility of management.
- Effectiveness of the control system must be assessed annually and results must be reported to the *exchange*.
- Assessment of internal control system done by the management must be verified by an auditor responsible for auditing the books of accounts of a company.

Compliance to SOX

Compliance to the requirements of Sections 302 and 404 primarily requires:

- CEOs and CFOs must certify that financial statements including operational information are free from any material misstatements.
- CEOs and CFOs must certify that an internal

control system over financial reporting is established and evaluated once every quarter and also annually for effectiveness. Any deficiency must be reported to the *Commission*.

- Any instance of fraud must be reported to the *Commission*.
- Any change in internal control system or such change which may render the system ineffective or deficient must also be reported.

In addition to the self-assessment of control system, the system must also be verified by statutory auditors for effectiveness and adequate functionality.

India—Companies Act and Clause 49 of Listing Agreement

The Companies Act, 2013 came in to force on 29th August, 2013. Section 134 of the Act deals with preparation of financial statements and responsibilities for the Board of Directors. The details are:

Sub Section 3 of Section 134:

"There shall be attached to statements laid before a company in general meeting, areport by its Board of Directors, which shall include—

.....

(c) Directors' Responsibility Statement;....

(l) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report;...

(n) a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any,which in the opinion of the Board may threaten the existence of the company..."

Sub Section 5 of Section 134:

" The Directors' Responsibility Statement referred to in clause (c) of sub-section (3) shallstate that—

.....

(e) 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.

Explanation.—For the purposes of this clause, the term "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;....."

To put the requirements of Section 134 in simple words:

- Procedures must be set up to identify any material changes occurred between the end of the period and the date of reporting.
- Setting up of risk management policy and procedures to identify risks existing at all levels including existential risks.
- Procedures must be set up for running the operations of the organisation efficiently.
- Procedures must be set up for safeguarding of assets.
- Prevention and detection of fraud and errors.
- Financial information and statements must be reliable.

Organisations seeking listing of their securities in the stock exchanges regulated by the Securities and Exchange Board of India (SEBI) must enter into a listing agreement with the stock exchange. Clause 49 of the listing agreement mandates the organisation to comply with the provisions related to corporate governance provisions. Relevant provisions of Section V of Clause 49 are:

"The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act,1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

a. They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:

i. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

ii. these statements together present a true and fair view of the company's affairs and are in compliance

European Parliament and Council of European Union have issued the said *Directive* to the member states dealing with the annual financial statements and consolidated financial statements including management reporting and corporate governance.

As per the *Internal Control– Integrated Framework* by COSO, internal control system is a continuous and ongoing process that requires contributions from employees at each level to keep the system efficient and effective. It is the responsibility of management to ensure that a control environment exist in the organisation to ensure control over financial reporting.

with existing accounting standards, applicable laws and regulations
b. There are, to the best of their knowledge and belief, no transactions entered into by thecompany during the year which are fraudulent, illegal or violative of the company's codeof conduct.
c. They accept responsibility for establishing and maintaining internal controls for financialreporting and that they have evaluated the effectiveness of internal control systems of thecompany pertaining to financial reporting and they have disclosed to the auditors and theAudit Committee, deficiencies in the design or operation of such internal controls, if any,of which they are aware and the steps they have taken or propose to take to rectify thesedeficiencies.
d. They have indicated to the auditors and the Audit committee
i. significant changes in internal control over financial reporting during the year;
ii. significant changes in accounting policies during the year and that the same have beendisclosed in the notes to the financial statements; and
iii. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in thecompany's internal control system over financial reporting."

To put the requirements of Section V of Clause 49 in simple words, CEOs and CFOs require to certify:

- There are no material misstatements or omission of any facts.
- Financial data portrays the true and fair view of the financial conditions and operations.
- There are no fraudulent/illegal activities or transactions during the year.
- An internal control system over financial reporting is established and evaluated annually for effectiveness. Deficiency must be reported to both statutory auditors and audit committee.
- Significant change in internal control system or such change which may render the system ineffective or deficient must also be reported to both statutory auditors and audit committee.

European Union—Directive 2013/34/EU of the European Parliament and the Council of June 26, 2013

European Parliament and Council of European Union have issued the said Directive to the member states dealing with the annual financial statements and consolidated financial statements including management reporting and corporate governance. Relevant extracts of the *Directive* are:

Article 19 (Contents of Management Report):
1. The management report shall include a fair review of the development and performance of the undertaking's business and of its position, together with a description of the principal risks and uncertainties that it faces.
The review shall be a balanced and comprehensive analysis of the development and performance of the undertaking's business and of its position, consistent with the size and complexity of the business.
To the extent necessary for an understanding of the undertaking's development, performance or position, the analysis shall include both financial and, where appropriate, non- financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. In providing the analysis, the management report shall, where appropriate, include references to, and additional explanations of, amounts reported in the annual financial statements.

Article 20 (Corporate Governance Statement):
Undertakings referred to in point (1) (a) of Article 2 shall include a corporate governance statement in their management report. That statement shall be included as a specific section of the management report and shall contain at least the following information:
.....
(c) a description of the main features of the undertaking's internal control and risk management systems in relation to the financial reporting process;

Article 29 (Consolidated Management Report):
1. The consolidated management report shall, as a minimum, in addition to any other information

required under other provisions of this Directive, set out the information required by Articles 19 and 20, taking account of the essential adjustments resulting from the particular characteristics of a consolidated management report as compared to a management report in a way which facilitates the assessment of the position of the undertakings included in the consolidation taken as a whole.

2. *The following adjustments to the information required by Articles 19 and 20 shall apply:*

.....

(b) in reporting on internal control and risk management systems, the corporate governance statement shall refer to the main features of the internal controls and risk management systems for the undertakings included in the consolidation, taken as a whole.

In various segments of the *Directive*, it is mentioned that financial statements must present true and fair view of the operations of the organisation. In other words, the requirement of various articles and clause of the *Directive* is that the management of any organisation whose securities are admitted for trading on a regulated market of any member state must confirm in their management report:

- Review of the risks faced by the organisation both financial and non-financial.
- Key features of internal control over financial statements for both individual and consolidated statement.

Compliance with the *Directive*

Compliance with the requirement of the said *Directive* can be ensured when the management must:

- Establish a risk management policies and procedures
- Set up an internal control system over financial reporting to ensure reliable financial statements

Internal Control – Integrated Framework:

As per the *Internal Control–Integrated Framework* by COSO, internal audit is defined as:

"Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *Effectiveness and efficiency of operations.*

The first step towards establishing a robust control environment is to ensure that organisational goals and objectives are well established and broken into periodic milestones. Also important is that these goals are communicated to each member of the organisation.

- *Reliability of financial reporting.*
- *Compliance with applicable laws and regulations..."*

An internal control system is a continuous and ongoing process that requires contributions from employees at each level to keep the system efficient and effective. It is the responsibility of management to ensure that a control environment exist in the organisation to ensure control over financial reporting.

The *Framework* consists of following components which will help management to develop a robust internal control system which can be relied upon to enable achievement of the objectives of internal control as per the definition above and in turn comply with the requirements of SOX, Indian Companies Act (Clause 49 of the listing agreement) and Directive of European Union:

1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring

Control Environment:

Oxford Dictionary defines *environment* as *setting* or *condition in which a particular activity is carried on*. In the business context, the control environment is a setting where top-down cultural tone is established so that the dealings, transactions and overall business is conducted in an ethical, disciplined and structural manner. It is the responsibility of top management and senior executives to establish a controlled environment which is conducive to achieve organisational goals along with the compliance.

To establish a *control environment*, following steps must be considered among others:

- Establish an ethical code of conduct encompassing employees at all levels.
- Establish a fraud prevention, detection and reporting policy.

- Have a policy to hire and retain competent personnel with adequate back ground checks and verification.
- Establish an authority matrix for all major and critical transactions and decisions, *e.g.* payments, procurements, investment, supplier selections, etc.
- Organise trainings and sessions periodically for employees to regularly stress upon the benefit and importance of above said policies, procedures and codes.

Risk Assessment:

Organisations today are operating in multinational, multi lingual environments. Different countries have different set of rules and regulations, which coupled with geographical differences pose varied categories of risks to organisations in their daily operations. These risks can be both internal and external. Organisations must set up a procedure to identify and assess all the risks that organisations may confront and identify relevant mitigating procedures for such risks. Organisations must set up risk management process and categorise the risks in the following categories:

- ***Operational Risks:*** Risks that organisations may face on day-to-day basis in performing their operations are referred to as *operational risks*, which include natural disasters, accidents, lack of business and functional understanding of employees, weak employee background checks, weak hiring and appraisal procedures, frauds, *etc.*
- ***Strategic Risks:*** Risks which pose threat to long-term organisational goals can be considered as *strategic risks*, *e.g.* loss of key customer, concentration of revenue or profits from one revenue or business stream, delayed projects, risk of key personnel or director's liability (especially in case of pharmaceutical or consumer products), change in government policies or other related laws, *etc.*
- ***Existential Risks:*** Risks such as war, nationalisation (especially in times of war), *etc.*, which pose threat to continuity of business in a key locations may be termed as existential risks.

The first and most important step is to establish the short and long-term goals and objectives of an organisation and map these risks against those goals and objectives. It is the responsibility of top management to assemble the key personnel with relevant experience to keep a track of all such risks and identify mechanism to counter those risks as and when they appear or there is a possibility of appearance of these risks.

Control Activities:

Organisational goals such as profit, output or productivity, are a sum total of various transactions and activities performed at various levels and various employees throughout a period of time. These activities are performed by various functions such as Operations, Commercial, Sales & Marketing, Human Resource, Finance & Accounts, Stores, Procurement, *etc.* All such activities must have proper and documented standard operating procedures (SOP) containing management directives on how an activity will be performed, when the activity will be performed and who will perform the activity. Control activities are those procedures that ensure that these directives are carried out. Another purpose of control activities is to ensure that any risk of error or fraud that may exist in execution or recording of any transaction is identified and rectified. These control activities include approvals, authorisations, reconciliations, periodic performance reviews, ratio and trend analysis, authority matrices, segregation of duties, physical verifications, assets security and safeguarding. The SOP must be prepared in such a manner that the above mentioned control activities are embedded in the SOP itself.

Information and Communication:

The first step towards establishing a robust control environment is to ensure that organisational goals and objectives are well established and broken into periodic milestones. Also important is that these goals are communicated to each member of the organisation. The level of details may depend on the professional maturity and place of the member in the hierarchy but the key factor is correct understanding of the goals and objectives by all.

Next step is to lay down the steps to achieve those goals by defining process and sub processes. The processes must be dissected into clear and understandable SOPs including control activities embedded within, which must be communicated to all concerned. It is also imperative that any change in the process must also be communicated and

SOPs modified on a real time basis. Any change in organisational policies which may or may not be resultant of change in government policies, external markets, competition, new risks identified by risk management committee, *etc.*, must be effectively communicated along with clear definition of responsibility or change in responsibility resultant of such change.

Apart from the above said decision-making and strategic communication, it is equally important that the following information must also flow without any bottleneck in the organisation:

- Operational performance and alignment with goals and objectives;
- Communication regarding outcome of any audits conducted;
- Communication with external stakeholders such as suppliers, customers, shareholders, statutory agencies, *etc.*, to ensure smooth journey towards overall goals; and
- Regular communication to explain business dynamics and inter dependant functional dynamics.

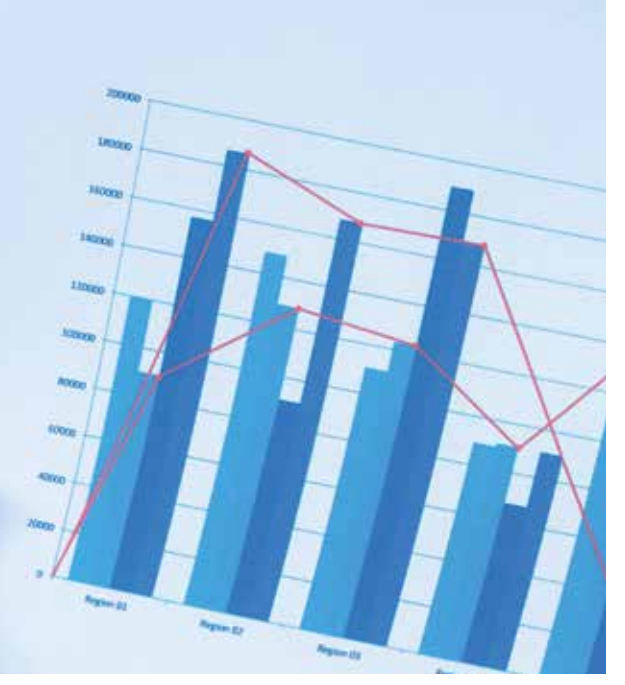
The top management must also effectively communicate the duty and responsibility each department must perform with respect to the overall control environment of the organisation.

Monitoring

Monitoring can be defined as an activity to provide reassurance to the management that the processes and related control activities are performing adequately and as envisaged. It involves periodic evaluation of control activities.

Monitoring of processes and control activities can be done concurrently or on defined intervals internally or through external independent agencies. The extent and periodicity of evaluation may depend on the risk assessment of activities. Activities that are fraud prone or contain risk of financial loss must be considered critical. An example of such activities is bank reconciliation and relevant control activity is segregation of duties. Another example can be payment to suppliers and control measure can be up to date delegation of authority matrix. Similarly, activities that have direct impact on legal and statutory compliance must be deemed critical.

Monitoring is performed by studying and undertaking process walk through and comparing the same with the defined SOPs. Along with it, a



study must be done that control steps identified in the SOPs are also complied with. It is also important that the SOPs are relevant and duly updated to capture the current operating process and procedures.

Results of monitoring must be recorded and communicated to the process owner and operator. If any deviation or discrepancy is observed, adequate remediation plan must be prepared and implemented to ensure compliance in foreseeable future so that books of accounts represent true and fair position of affairs of the organisation. Such remediation plan must be followed up regularly until implemented.

Conclusion:

ICAI must also develop guidelines to pave the way and assist the management to establish systems and procedures for internal control over financial reporting in lines with the COSO. There are internal audit standards but they are from the perspective of compliance with the requirements of Companies Act and these set the path for auditors to perform their tasks. Similarly, ICAI must also develop guidelines for organisations to achieve the desired controls over financial reporting to ensure accuracy and reliability of figures reported to various external agencies which in turn are used by public in general. ■