System Walk-Through – Tool to Adhere to the Internal Financial Control Requirements of the Companies Act, 2013 in a Computerised Environment

The Companies Act, 2013 requires statutory auditors of the company to report many new requirements. One such new requirement is mentioned under Section 143(3)(i) of the Act that mandates the auditor to report on adequacy as well as operating effectiveness of the internal financial controls. This article tries to explain the requirements of the Section and also how system walk-through may help the auditor to fulfill this statutory reporting responsibility. Read on…

Introduction

"Toshiba – a case of internal audit failure (Business Standard)", "UBS admits failure of internal controls (The Guardian)", "Groupon: Where were the Auditors? (Forbes)" -- The present decade marked a surfeit of such giant internal controls loopholes making headlines in news around the globe that in turn made our regulators and policy makers realise the significance of internal controls in an organisation.

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The new Companies Act, 2013 strongly accentuated the need of robust internal controls in an organisation and was accordingly drafted in a way to establish proactive anti-internal control failure policy by casting specific responsibilities on the board, independent directors, audit committee and the auditors.

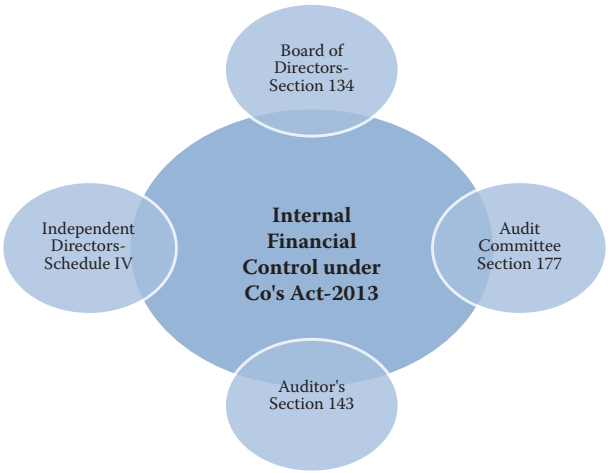
- ***From Ticks to Clicks... IFC in IT Environment:*** With IT revolution, auditors encounter electronic record-keeping in every audit engagement. To evaluate the IT system's internal control design and effectiveness, there is an IT dedicated audit known as Information System Audit (earlier EDP audits).

This article emphasises on the requirements laid down in the Companies Act, 2013 with regard to the internal financial controls and how system walk-through will help auditor to satisfy this onerous responsibility placed on him by the regulators.

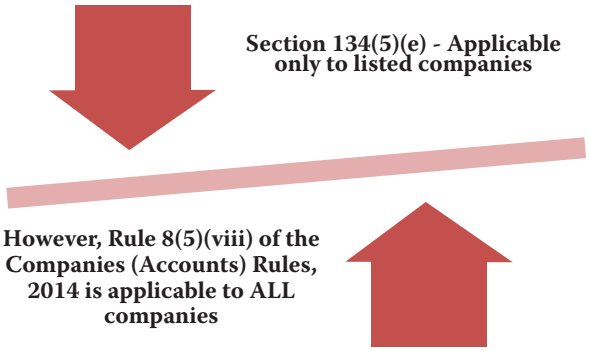
- As defined by *Investopedia, "System walk-through* is a procedure used during an audit to scale system's reliability. Walk-through tests trace the transaction step-by-step through the system from its inception to the final disposition. The test can reveal system deficiencies and material weaknesses that would need to be rectified by the organisation at the earliest."

Regulatory Requirement of Internal Financial Control – The Companies Act, 2013

1. Board of Directors [Section 134 and Rule 8(5)(viii)]
2. Audit Committee [Section 177]
3. Responsibility on Auditor [Section 143]
4. Independent Directors [Schedule IV]



- ***Board of Directors (Section 134)***



Clause (e) of sub-Section (5) of the above Section casts a responsibility on directors of listed company to not only lay down internal financial controls to be followed by the company but also ensure the adequacy and operating effectiveness of such internal financial controls.

The explanation to this clause defines the term 'internal financial controls' as 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.

[*Note:* Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' Report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.]

- ***Audit Committee (Section 177)***

  Responsibility: Section 177 of the Act requires audit committee to evaluate internal financial controls and risk management systems.

  Rights: To facilitate such evaluation, 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 may also discuss any related issues with the internal and statutory auditors and the management of the company. It also has the power to obtain professional advice from external sources so as to have a better understanding and evaluation of internal financial controls.

- ***Responsibility on Auditors (Section 143)***

Clause (i) of sub-Section (3) of the Section 143 mandates auditor to report on the existence of adequate internal financial control and its operational effectiveness in the company.

This Section has cast arduous responsibilities on the statutory auditors because standards on auditing (SAs) do not cover reporting on internal financial

controls and also because of the fact that presently in India, we do not have any commonly accepted framework for internal financial controls to suit Indian business environment and also no framework has been prescribed under the Companies Act, 2013 and the Rules thereunder for the evaluation of internal financial controls.

The Companies Act, 2013 had introduced Section 143(12) and corresponding Rule 13 of the Companies (Audit and Auditors) Rules, 2014 that earlier required the statutory auditors to report to the Central Government about every fraud/suspected fraud committed against the company by the officers or employees of the company. These sections have been now amended that require reporting by statutory auditor to Central Government only for individual frauds of ₹1 crore or above.

Accordingly, the ICAI issued a revised Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 (Revised 2016), that states:

If a fraud has been noted and reported under Section 143(12), the auditor will have to evaluate the implications of the matter reported in the financial statements, on his audit opinion on the financial statements and on any other matter to be included in his report under Sections 143(1) to (3) including with regard to reporting on the adequacy and operating effectiveness of the internal financial controls. The following will need to be considered by the auditor in this regard:

- *When the auditor has reason to believe that the management is involved in the fraud, how did the auditor re-evaluate the risks of material misstatement due to fraud and reliability of the evidences previously obtained.*
- *When the auditor confirms that, or is unable to conclude whether the financial statements are materially misstated due to fraud, how did the auditor evaluate the implications for the audit.*

Notes:

1. In regard to responsibility of board of directors, the explanation to Section 134(5)(e) defines the term 'internal financial control' as the policies and procedures for ensuring the orderly and efficient conduct of business. However, there is no such explanation provided in Section 143(3)(i), to which the ICAI has issued clarification in its Guidance Note[1] stating that the term 'internal financial controls' in the context of the responsibility of the auditor for reporting on such controls under Section 143(3)(i) of the Act, *per se* implies and relates to internal financial controls over financial reporting (IFCoFR) only.
2. The scope of IFCoFR is significantly wider than the reporting under the Companies (Auditor's Report) Order, 2015 [CARO]. CARO covers only adequacy of controls in limited areas and does not even require reporting on adequacy and operating effectiveness of such controls.
   However, the said clause has been deleted in the recently published Companies (Auditor's Report) Order, 2016. That implies, with IFCoFR, the regulators have placed the onus of internal control reporting on the more stringent IFCoFR and removed the additional requirement under CARO. However, CARO 2016 still has clauses relating to fixed assets and inventories which in any case shall be dealt under IFCoFR, and would amount only to repetitive compliance.
3. Assenting to the suggestions given by the ICAI, the Ministry of Corporate Affairs amended the Rules for Chapter 10 (Audit and Auditors) of the Companies Act, 2013 and Reporting on Internal Financial Control under Section 143 (3) (i) of the Companies Act, 2013 and deferred them for one year i.e. up to 31.03.2015. However, auditor may voluntarily report for the year from 01.04.2014 to 31.03.2015.

Clause (i) of sub-Section (3) of the Section 143 mandates auditor to report on the existence of adequate internal financial control and its operational effectiveness in the company.

- ***Independent Directors (Schedule IV)***
  The roles and functions as stated in Schedule IV of the Companies Act, 2013 state that the independent directors shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

Requirement of various Standards on Auditing with respect to Internal Controls

- ***Para 12 of SA 315,*** *Identifying and assessing the risk of material misstatement through*

[1] *Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the ICAI on 14th September, 2015 (http://www.icai.org/new_post.html?post_id=11919&c_id=219)*

Reporting on internal control systems is similar to reporting on the commercial operations of the company. Though the audit is carried out on the transactions recorded during the year, the reporting is *as at the balance sheet date*.

understanding the entity and its environment, requires an auditor to obtain an understanding of internal controls relevant to the audit.

Para A67 of SA 315 states that risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting often termed as *"Walk-Through".*

Inquiry alone, however, is not sufficient for such purposes. Thus, SA 315 requires an auditor to employ some or all of the above mentioned procedures in addition to inquiry for the sake of obtaining evidence about design and implementation of relevant controls.

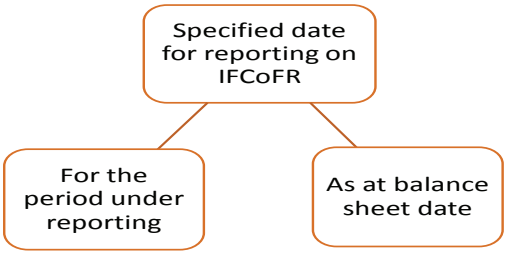
- ***Para 8 of SA 330,*** *The Auditor's responses to assessed risks,* requires that the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.
- ***What internal controls are "relevant"?***

Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit or not.

Guidance Note on Internal Financial Controls over Financial Reporting [IFCoFR]

The Institute of Chartered Accountants of India on 14th September 2015 issued a detailed Guidance Note on audit of internal financial controls over financial reporting. The Guidance Note covers aspects such as scope of reporting on internal financial controls under the Companies Act 2013, essential components of internal controls, technical guidance on audit of internal financial controls, and implementation guidance on audit of internal financial controls. Few of the key issues that this Guidance Note addresses are listed below:

- ***Specified date for reporting on the adequacy and operating effectiveness of IFCoFR***



Issue: Section 143(3)(i) does not specify whether the auditor's report should state if such internal financial controls existed and operated effectively during the period under reporting of the financial statements or as at the balance sheet date up to which the financial statements are prepared.

Guidance Note: Reporting on internal control systems is similar to reporting on the commercial operations of the company. Though the audit is carried out on the transactions recorded during the year, the reporting is as *at the balance sheet date.* Also, paragraph 57(k) of the Statement on the Companies (Auditor's Report) Order, 2003 issued by the ICAI on the auditor's responsibility for reporting on internal control and continuing failure in the internal control requires that the auditor should make an assessment whether the major failures noted by him have been corrected by the management *as at the balance sheet date.*

- ***Reporting on adequacy and operating effectiveness of IFCoFR in case of Interim Financial Statements***

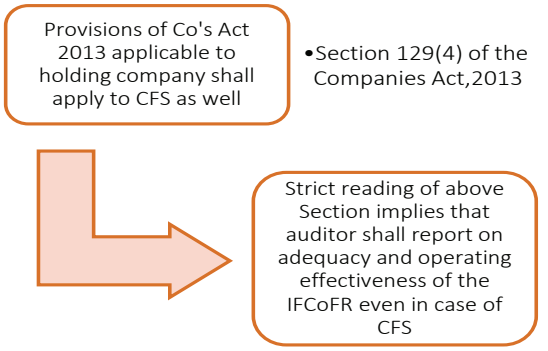
Issue: Whether auditor is required to report on adequacy and operating effectiveness of IFCoFR in case of interim financial statements such as quarterly/half yearly financial statements.

Guidance Note: Such reporting is a requirement specified in the Companies Act, 2013 and therefore will not be applicable with respect to

The concept of walk-through has also been referred for the first time in 'SA-315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment', as a tool to determine relevant changes in information obtained in prior periods.

interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

- ***Reporting on adequacy and operating effectiveness of IFCoFR in case of Consolidated Financial Statements (CFS)***



Issue: Whether auditor is required to report on adequacy and operating effectiveness of IFCoFR of consolidated financial statements (CFS).
Guidance Note: On strict reading of Section 129(4) of the Companies Act, 2013, it appears 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 internal financial controls over financial reporting in the case of consolidated financial statements for the respective components only if it is a company under the Companies Act, 2013.

System Walk-Through: Tool to Test Adequacy and Operating Effectiveness of IFC

- ***Definition of the term 'Walk-Through'***
  Investopedia defines *walk-through* as "a procedure used during an audit of an entity's accounting system to gauge its reliability. Walk-through tests trace the transaction step-by-step through the accounting system from its inception to the final disposition. The test can reveal system deficiencies and material weaknesses that would need to be rectified by the organisation at the earliest."[2]
  By tracing the transaction step-by-step from its inception to its final disposition and documenting the same by way of a flowchart can enable the auditor to compare the actual state of internal controls in an organisation with that of standard internal financial control policy formed by the management.
  Walk-through procedures performed should be mandatorily documented in detail depicting the documents examined, procedures performed, results observed and compliance sought, if any.
  The concept of walk-through has also been referred for the first time in 'SA-315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment', as a tool to determine relevant changes in information obtained in prior periods.
- ***Performing Walk-throughs for Internal Financial Controls (Guidance Note)***
  - o Walk-throughs are not mandated by any of the standards on auditing.
  - o However, they are efficient and cost effective way to:
    - Obtain understanding of the entity's flow of transactions;
    - Identify controls that are relevant to the audit and gain an understanding of those controls;
    - In some instances, when testing controls, obtain evidence about the operating effectiveness of a control (Companies Act, 2013 has cast an onerous responsibility on auditors by virtue of Section 143 to state the operating effectiveness of IFCoFR. Performing walk-throughs and documenting the same may help the auditor prove his diligence in performance of his duties).
  - o Example:
    In performing a walk-through, the auditor generally follows a single transaction from its origination to the transaction's ultimate recording.
    For example, consider the case of ABC Limited. The company has laid down the following internal control policy for stores purchase authorisation.
    Steps:
    1. The store manager raises a purchase requisition (PR).
    2. If quantity of raw material exceeds 5,000 units then authorisation is required from purchase manager before placing purchase order.
    3. If the conditions are satisfied, then PO is placed.

[2] *http://www.investopedia.com/terms/w/walk-through-test.asp*

Now, the auditor actually performed a system walk-through of the stores' purchase and records his observation. Accordingly, he observed that:

1. The store manager raised a PR for 6,500 units of raw material.
2. Ideally, the PR raised should have first flashed as a notification to purchase manager.
3. Only upon authorisation by the purchase manager, should the purchase order be generated and sent to the supplier.
4. However, the auditor observed that, the PO was generated directly by a purchase staff and sent to the supplier without authorisation from the purchase manager.

Thus, the auditor obtains evidence about the operating effectiveness of a control being compromised with.

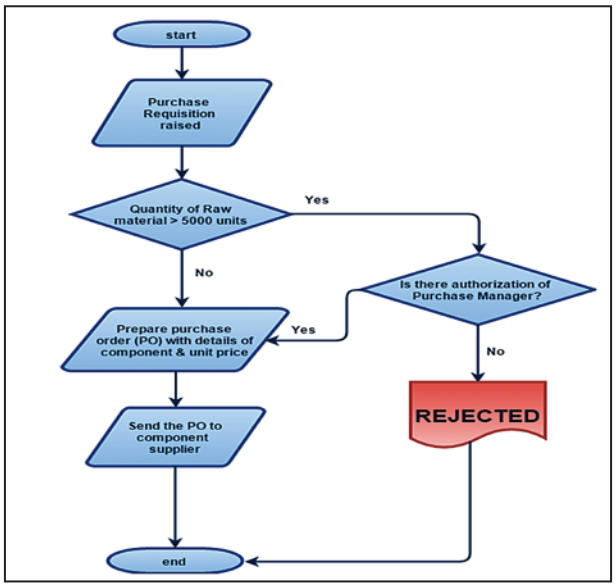


Figure 1: Documented Internal Control Policy

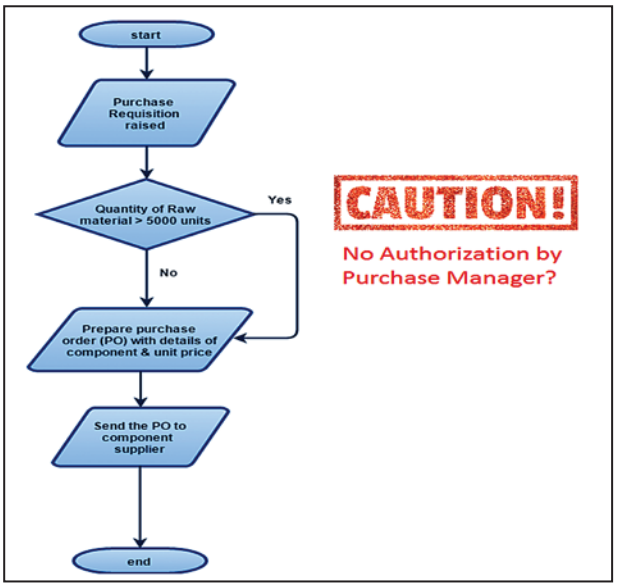
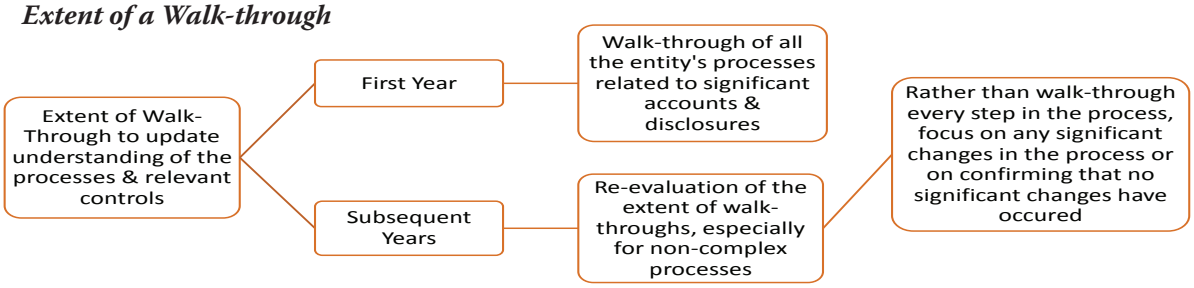


Figure 2: Actual implemented policy that had loophole of no authorisation by Purchase Manager (exposed during the walk-through process)

- ***Extent of a Walk-through***



Summing up

To efficiently perform system walk-throughs, the auditor must have information technology expertise and relevant experience. To help its members cope with the demands of IT dynamics, the Institute of Chartered Accountants of India has commissioned ISA course for its members. The course prepares members to offer value added services of IS audit, which is a need of the hour for the auditors to be able to fulfill their statutory reporting responsibilities.

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