

Financial Reporting in Control Framework: Integrated System Helps

Internal control is generally a set of proactively defined and specially designed processes intended for achieving the 'economy and efficiency of operations', 'achievement of performance goals', 'reliable financial and operational data and reports' and 'compliance with laws and regulations'. Although corporate India is concerned about the costs involved in implementing integrated systems for control frameworks, this is a process that yields substantial benefits in the long run. This article provides an overview of the concept.

Vishnugupta Kautilya (Chanakya) had visualised the importance of internal control systems for effective management of economic and financials ages ago in 300 BC. He had described the segregation of duties (SOD) even for the King. "Everyone has to perform his duties as per their Dharma" said Chanakya. He had described even the smallest activities to be performed by different persons. Control points were established with penalty/reward processes to safeguard and mitigate any possible fraud or siege.

Internal control is generally a set of proactively defined and specially designed processes, carried out by people, intended to provide logical assurance for achieving the following targets:

- Economy and efficiency of operations.
- Achievement of performance goals.
- Reliable financial and operational data and reports.
- Compliance with laws and regulations.
- To mitigate risks and achieve objectives & safeguarding of assets against loss.



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Sarbanes-Oxley (U.S.), Guidance to Directors on Combined Code (U.K.) and Clause 49 (India) are some of the regulations that mandate increased suitability, correctness and transparency in financial reporting and ethical tone at the top.

Although regulators do not require a particular internal control framework or methodology, the COSO framework or some close variant should be used as these frameworks are designed in a structured manner to achieve required controls systematically. The COSO framework I (U.S.) defines five key elements of an integrated or comprehensive framework of internal control as follows:

- **Control environment:** A "tone at the top" exercise.
- **Risk assessment:** It helps focus and prioritise internal control framework.
- **Control activities:** They lend themselves to objective analytical criteria.
- **Information & Communication:** The use of information technology can help standardise controls that will identify and report on appropriate external events, activities and situations.
- **Monitoring:** Collaboration environment.

The new COSO framework comprises of three new components:

- **Objective setting:** The objective must exist before the management identifies potential events effecting risk.
- **Event identification:** Internal and external events, which may affect the achievement of enterprises objects.
- **Risk response:** Depending on the risk appetite/tolerance levels of the enterprise, it may avoid, accept, reduce or share the risks.

When an internal control system fulfils the standard, it can be deemed 'effective'. If the organisation does not have technologies in place for accurately measuring and benchmarking the effectiveness of its internal control procedures, these controls can quickly become outdated and ineffective.

Improvement in internal controls is indisputable, and there is a growing acceptance of a business and IT framework upon which to define internal controls and to manage risks. The common elements in the Basel II, Solvency II, the OECD Principles, the U.K. Turnbull Guidance, Canada's Multi-Lateral Instruments 52-109 and 111, and the U.S. SOX (COSO framework & other tools) include requirements or recommendations for control frameworks.

The European Economic Reform White Paper of 2002 defines internal controls as creating standards for five key control elements:

- Control environment.
- Performance and risk management.
- Information and communication.
- Control activities.
- Audit and evaluation.

INDIAN PERSPECTIVE

Comparing Clause 49 with the U.S.' Sarbanes-Oxley Act, Jayashree Narayanan, Sr. Manager, with a global Consultancy and Accounting firm explains: "The amended Clause 49 is aimed at ensuring transparency at every level of a company's functioning. This has seen companies

bring in risk management systems and control framework, including IT safeguards, to ensure better governance."

Clause 49 (Listing Agreement) provides:

- Enhanced accountability of CEO, CFO:** The CEO and CFO are now required to certify to the board annually on matters relating to the accuracy of financial reporting, evaluation of design and operation of internal controls, disclosure of any significant changes in internal controls, and disclosure of frauds.
- Risk management:** Boards must ensure that all significant risks are managed through a well-defined framework and mitigation plans are put in place. Companies would also need to build a framework to track progress on mitigation plans and review the risks on a continuous basis.
- Internal control evaluation:** The specific identification of risks and controls within processes, performing validations of design effectiveness, and the testing process to evaluate the operating effectiveness of the controls.

NEED OF INTEGRATED SYSTEMS FOR CONTROL FRAMEWORK:

"Using integrated solutions, companies can leverage regulatory initiatives to build an on-demand environment that has the flexibility to change quickly in their business environment."

Governance Compliance Regulations do not require the use of systems for compliance or financial reporting, yet the need is absolute. Manual/multi platform systems find it very difficult to provide security and sustainability for the voluminous data and large number of people involved. Auditors may find themselves ill-equipped to address some of the more subjective and technically unfamiliar internal control aspects of compliance audits: internal control framework development methodologies, the risk assessment activities on which they depend, and the information technology (IT) and business process automation systems that fa-

cilitate them. Integrated systems provide them a sigh of relief by providing a fully assessable audit trail system.

McKinsey, International Economy Analyser, in an article Trends to Watch says: "Management will go from art to science. Bigger, more complex companies demand new tools to run and manage them. Indeed, improved technology and statistical-control tools have given rise to new management approaches that make even mega-institutions viable".

Gone are the days of 'gut instinct' management style. Today's business leaders are adopting algorithmic decision-making techniques and using highly sophisticated software to run their organisations. Scientific management is moving from a skill that creates competitive advantage to an ante that gives companies the right to play the game."

Technology has made many changes in traditional accounting controls, thus making them transparent, improving their analytical capabilities, and increasing growth by improving and innovating financial processes. Integrated systems like the Enterprise Resource Planning (ERP) or otherwise, are intensely integrated in the instigating, authorising, recording, processing and reporting of financial transactions, linked to the overall financial reporting process.

PCAOB (Public Company Accounting Oversight Board – U.S.) Auditing Standard No. 2 discusses the relationship of technology and its importance in testing the design and operational effectiveness of internal controls. Broadly, such controls include information technology general controls—on which other controls are dependent. Many integrated systems are giving a widespread platform for all accounting and financial reporting needs by utilising faster financial consolidations, good data warehouse and performance analytics, online reporting and accurate financial results according to specific accounting standards. The integrated system is linked with accounting systems (base systems) and the audit information system.

OBJECTIVES OF INTEGRATED SYSTEMS

"Serious risks to a control environment introduce numerous liabilities; mitigate these through the integrated system of accounting processes" - Sid M. Edelstein

The most efficient and cost-effective way of identifying control gaps and re-mitigating risks is through automated testing and real-time monitoring. The integrated system automates the real-time exposing and prevention of system security and controls violations, preventing internal fraud, reducing IT and audit costs, and strengthening high standards of governance. The result is continuous compliance with regulations. It combines system security skills with a complete set of validated rules and detailed segregation of duties (SOD) analysis, delivering a comprehensive solution for compliance.

More than just establishing new reporting rules, the IFRS changes the valuation of individual business transactions. This will lead to major changes in accounting philosophies and to new systems challenges such as performing effectiveness tests for hedging activities or using project-management information for revenue calculations that involve the percentage-of-completion method for multi-year contracts.

Other objectives are listed below:

- To build a control environment like project organisation, documentation, testing, and sign-off for internal controls.
- Automated rule building and maintenance & test procedures based on the risk management framework defined by regulations; to ensure continuous compliance with regulatory mandates.
- Direct drill-down to root causes.

INTEGRATED SYSTEM’S PRINCIPLES OF OPERATION

- ❖ **Base Financial Systems:** The Base Systems (ERP of operations) depicted at the bottom of Figure 1 represent some of the key applications, enterprises must monitor—and acquire data from—to create a control environment, to assure Control Point (“Best practice” activities) validation and to detect any fraudulent or suspicious activity. The capability to import general ledger account structures and financial data directly from the integrated system’s financial systems into the compliance application should be considered a base capability.
- ❖ **Infrastructure:** The integrated system should integrate with this infrastructure to provide user authentication and role based access as and when applicable.
 - o *Content collection and management applications:* These work with, provide surveillance for, and manage the documented evidence related to your Control Points. Content Management Integrated System administers the process of maintaining documented evidence, document tracking and storage.
 - o *Business Activity Monitoring/Business Systems Management:* The integrated system automates surveillance.
 - o *Rules engine:* This is to be used in concert with Operational Data Stores (ODS) for short-term memory data for processing like customer sales for the week, etc.
- ❖ **Performance Testing:** Performance testing relates to testing the operating effectiveness of key controls. Re-performance testing can be handled through a combination of manual and synthetic transactions. This will prioritise and automate best-practice control-testing project plans.
- ❖ **Reports (Dashboards):** Spreading of information is most easily accomplished through dashboards and reports tailored for each stakeholder group. Reports and

dashboards can be built and distributed with BAM/BSM, Content Management, and/or Business Intelligence. Executive dashboards for managing sign-offs give senior managers better global visibility of the status of control framework projects, through a management dashboard.

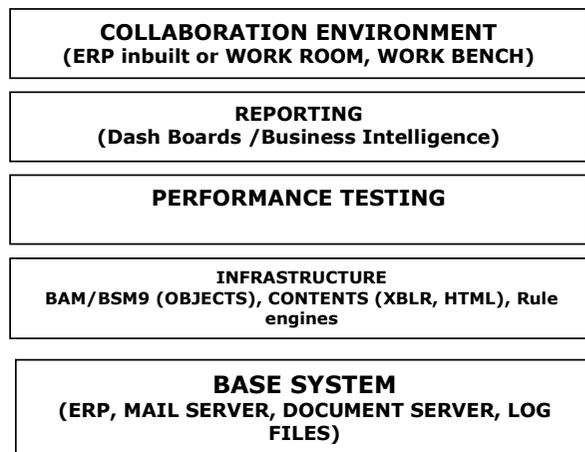
- ❖ **Collaboration Workroom:** At the very top of the framework (monitoring), in the Collaboration Workroom, data is accumulated to investigate and resolve Control Point breaches (notification of material events). Surveillance also assures processes are operating and behaving as expected.

As illustrated, the framework identifies the key technology areas enterprises must leverage to meet the stipulations of a Control framework.

INTEGRATED SYSTEM—MANAGING INTERNAL CONTROLS

Embedded system controls within an integrated system include edit checks and tolerances for document accuracy, required and system-populated fields for document

Figure 1



completeness, and checks to prevent duplication of accounting postings. Reason codes, user-defined error and warning messages, default and predefined master data, automatic integrated postings that use predefined posting

keys, and context-sensitive help ensure the integrity of your financial records. In addition, an integrated system logs all changes in a master data document and all financial postings by user and date to help detect fraud. To support constant reconciliation, all postings are stored in unique documents that cannot be changed. These documents are available in real time—anywhere in the system. The review of postings, a key factor in compliance, becomes more efficient with an integrated system.

- o **Fully integrated general ledger:** General ledger functionality reduces the complexity of parallel reporting of accounting, including the ability to generate a set of balanced and reconcilable accounting statements. An integrated system provides a structure that brings together individual ledgers, such as cost of sales, profit centre accounting and consolidation staging. It speeds up reconciliation and ensures transparency. Complex consolidation processes are handled automatically through a centralised database and through integrated processing for statutory and management consolidation.
- o **Handling whistle blower complaints:** This lets all stakeholders/employees send messages about accounting irregularities directly to the audit committee. The component consists of forms that can be customised to collect certain information from employees/stakeholders, such as an employee's business unit, for supporting problem identification and tracking by the audit committee. Employees can send their messages secretly and receive a confirmation number that they can use when submitting additional information about the same accounting topic.
- o **Filling security pitfalls:** To complement the security controls within an integrated system, the integrated system provides real-time, 24/7 security and controls compliance. By automating real-time detection and prevention of integrated system security

and control violations, it delivers continuous compliance with regulatory mandates—while helping to reduce internal fraud, lowering IT and audit costs and support.

- o **Segregation of conflicting duties (SOD) at the transaction level:** With an integrated system, logical segregation can be enforced at the transaction level instead of the job role level so that employees can still be allowed to perform multiple functions as long as they do not perform conflicting duties on the same transaction. Real-time monitoring of business transactions identifies potential policy violations, payment errors, system misuse and fraud and routes the transaction for executive review and disposition, minimising risk

Today's CFOs have to perform the duties of an enterprise's long-term strategist. With the new face of regulatory compliance they must spend more time on compliance formalities, which they might have delegated to subordinates. CFO's have to play dual roles of a 'strategic business partner of the CEO' and an 'administrator of internal controls'.

without sacrificing productivity or cost. Improper use of authorisation rights is a common source of fraudulent activity.

- o **Managing risk:** According to the COSO I and II, best-practice frameworks for enterprise risk management are setting strategic objectives and are the starting points for most risk management strategies. An integrated system can help identify, quantify, monitor, comment on and control the many risks by determining risks across organisational units and objectives, and they also provide a comprehensive picture of the overall risk situation in an enterprise

as an early-warning system and a control mechanism. For banking companies, the Basel II framework administers increased transparency for information that all businesses provide to their creditors, including deeper visibility into companies' business planning. The integrated systems solutions are based on Basel II best practices and are continuously updated as the regulations change. A key criterion for a creditor's risk-rating process is often the analysis of a business's risk-management practices. The risk management capabilities of integrated systems show that the enterprise is serious about identifying and managing risk.

- o **Measuring performance:** Regulations require company officers to validate financial statements. These rules demand full transparency for financial information, as well as records of supporting operational transactions and events. From the top of the organisation to the lowest level, all employees should work toward accuracy in reporting financial data. Additionally, regulations make CEOs and CFOs responsible for all disclosure controls and procedures. The integrated benchmarking capabilities and performance scorecards of integrated systems can help companies monitor strategic success factors and overall business operations.
- o **Addressing global accounting standards with financials:** Compliance with the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) may result in increased transparency of disclosures, statements of change for retained earnings, and revised segment reporting. An integrated system gives state-of-the-art tools for global accounting-standard compliance. Investors and financial institutions will expect comparable financial data from companies of all sizes when making investment and lending decisions.

Valuations as per standards significantly impact reporting:

- (a) **Currency Valuations:** The currency exposure is measured as the sensitivity of real value (adjusted for inflation) of an enterprise's assets and income (or liability/loss) expressed in functional currency (an enterprise's operational currency) to unanticipated risk. An integrated system functions on various currencies stored in the master currency table, which are calculated and posted in the foreign currency valuation, using an alternative valuation area. On each transaction other than operational currency, currency difference is valued and accounted for on real time basis automatically.
- (b) **Inventory Valuations:** Because of the variety of considerations and problems encountered in the allocation of costs and charges, the valuation of inventories becomes a cumbersome process. All these things are being well handled by integrated systems by configuring each material with a value attached to it, and keeping watch on its every movement, which reflects it in the cost statement—making the process consistent. Goods' movements are triggered by transactions in the Production, Sales and Distribution, or by inventory postings.

More than just establishing new reporting rules, the IFRS changes the valuation of individual business transactions. This leads to major changes in accounting philosophies and to new systems challenges such as, performing effectiveness tests for hedging activities or using project-management information for revenue calculations that involve the percentage-of-completion method for multiyear contracts. An integrated system provides the flexibility and functions that a company needs to meet the IFRS standards and parallel valuation challenges of today as well as the requirements of tomorrow.

- (c) **Control needs fast closing:** Regulators and researchers emphasise that shorter closing cycles are reliable. With more mature

financial control systems, the standardisation and reorganisation of the closing process provides increased transparency and better corrections management, etc. The Fast Early Warning System sounds the alarm if any nasty surprises crop up. Robert D. Kugel in his book *How to Shorten Accounting Closing Cycles* says: "Eliminating as many manual steps as possible will be the most productive approach to shortening the closing".

OTHER BENEFITS OF INTEGRATED SYSTEMS

- It ensures complete and synchronised accounts at all times with a unified structure.
- It lowers the cost of compliance with support for meeting financial reporting regulations in any country or industry.
- It uses data tagging of XBRL—the emerging open standard for integration and reporting.
- It completes transaction-level backup using an imaging integrated system, provides approvals, reviews and audits and is a cornerstone for internal controls.
- It facilitates a robust and accountable approval framework, automated routing, reminders and escalations, all of which can be tracked by workflow software.
- It drives consistency in approach.

CONTROL FRAMEWORK MODEL

Retailing (Inventory control):

In typical retail store documentation of a financial cycle for internal control framework, the object may be the identification of operational systems, identification of excess and absolute modules, identification of control over procurement and monitoring, physical existence control, appropriate estimates for Inventory shrink markdown and warranty accruals and documenting and justifying estimates.

Activities to form this model:

- Segregation of activities involving risk.
- Bifurcation of risk categories.
- Evaluation of risk appetite/tolerance (tolerance indicators).
- Setting appropriate triggers according to risk response.
- Setting up systems validations and control checks.
- Revaluation of performance of triggers.
- Valuation of occasions of high risk triggers used/changed/breached.
- Resetting the risk response after comparisons with benchmarks.

Solving CFO's Dilemma: "Scratch a chief financial officer and you're likely to find an accountant," says John R. Percival, professor of finance at Wharton. The CFOs of companies in developing countries find this a bitter truth.

Today's CFOs have to perform the duties of an enterprise's long-term strategist. With a new face of regulatory compliance they must spend more time on compliance formalities, which they might have delegated to subordinates.

A key-factor in the authoritative role of CFOs is their access to strange financial technology, which allows users to mitigate risks involving currency, interest rates and credit. Now, when regulations are in place, CFOs have to play dual roles of a 'strategic business partner of the CEO' and an 'administrator of internal controls'. For example, many CFOs are involved in risk-hedging strategies that can reduce volatility from financial results and improve value creation. However, now CFOs have to prepare for internal control, check-list questions required for regulatory disclosure and therefore must have a technological system for keeping alongside the changing values of instruments like currency-exchange derivatives—both to satisfy regulations and to effectively implement strategy.

ACCOUNTING AND AUDITING

Key Risk	Risk Assessment (1, 2)	Risk Response	Trigger (Control points) Settings	Control Activities (Integrated Systems)
Un-reconciled commitments	RC	Avoid	Error Message	Central system of creating PO
Incorrect physical inventory	RC	Reduce	System prompts, alerts	System keeps track of count v/s perpetual—subsequent adjustments are tracked separately.
Cost of Sales not reflected	RC	Avoid	Dispatch block	Cost of sales recorded on product shipment.
Standards not correct	MW	Avoid	Not to process Prod Ord if std. not run	Absorption of variance at every month for recalculating standards.
Goods received not in inventory updates	MW	Avoid	Error Messages	Cycle counts, physical existence testing.
Price Variance not calculated	RC	Reduce	Alerts	System verifies two ways match and reports variance.
Inadequate/ excessive Scrap / rework	MW	Avoid	Error Message	Comprehensive recording of scrap against each production order, comparable with planned.

Integrated solutions and technologies can help companies and CFOs to streamline compliance and the balancing act will be maintained as CFOs face continued pressure to raise funds aggressively. Confident investors use hedging instruments, present forward-looking statements, meet their forecasts and make their case to the analysts.

However, the actual technology used for compliance should be based on compliance processes and methods that each company defines in its planning and readiness activities. For example, companies may elect to make internal controls evaluation a shared process, leveraging workflow and collaborating technologies. Factors such as volumes of

data and documents, effort levels, number of people involved, security and sustainability requirements will impact the use of integrated systems and technology assets. Care should be taken to implement technologies in a standard way across the enterprise to achieve company-wide regulatory compliance.

Professionals, CFOs or otherwise, have great roles to play in framing control environments, risk assessment, framing risk response models, setting control points (triggers), choosing the correct integrated system and preparing colouration environments. In the new world of regulations and financial freedom, professionals have to be careful to actively participate in new-age financial instruments and complete compliance formalities. □