Are the new guidelines in the context of internal financial controls a boon or a bane, for the statutory auditors and other stakeholders of a company in India?

This thought leadership paper, which contains views of our expert (Monish Chatrath), explains.

The latest guidelines of September 14, 2015 from the Institute of Chartered Accountants of India ("ICAI") reassert specific roles of various stakeholders of Indian companies. These are in the context of the seemingly intricate but definitely not incongruous construct for internal financial controls ("**IFC**")s, enterprise wide risk management ("**EWRM**") & governance frameworks.

The Companies Act, 2013 ("the Act"), the Companies (Accounts) Rules, 2014 ("the Rules"), and the aforesaid guidance note, need to be read together, to understand the **specific responsibilities** of the board of directors ("BoD")s, independent directors, audit committees, management and auditors of all companies in India, in the context of IFCs, EWRM and corporate governance.

Non compliance of the provisions therein, specifically the provisions of section 134 of the Act, have **wide reaching ramifications in terms of fines and penalties, for defaulting companies and their officers** *(which constitutes a relatively diversified population of people engaged with the said company)* and include the potential imprisonment of the latter.

The pertinent encumbrances for the main stakeholders, are set forth in the ensuing paragraphs.

Audit committee

The existence of an objective audit committee that independently manages relationships with auditors, is globally considered to be an important facet of good corporate governance.

The audit committee's role should include an evaluation of IFCs and the EWRM framework. In this context, the provisions of **Section 177 (4) (vii) & (5) of the Act** specify that audit committees:

- May call for **comments of auditors on the 'internal control systems' before their submission** to the BoD and may also discuss any related issues with the internal and statutory auditors apart from the management of the company; &
- Should act in accordance with the terms of reference specified in writing by the BoD, which should **include evaluation of IFC and risk management systems**.

BoD

As a principal stakeholder, the BoD **has a key role in setting the ethical tone at the top**. High ethical standards serve the long term interests of a company well, while providing means to make it credible and trustworthy, not only in day-to-day operations but also with respect to its longer term panorama.

Section 134 (3) (n) of the Act requires the director's report to include a statement on the **development and implementation of a risk management policy for the company including identification of elements of risk** if any, which in the opinion of the BoD may threaten the existence of the company.

Section 134 (5) (e) of the Act requires the **directors of listed companies to establish IFCs and ensure that such controls are not only adequate, but are also operating effectively**. In addition, directors are also required to ensure that proper systems are enabled for IFCs & for ensuring compliance with all applicable laws.

Section 134 (5) (f) requires the responsibility statement of directors to confirm that they have **devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems are adequate & operating effectively**.

Rule 8 (5) (viii) of the Rules **expands the realm of coverage to unlisted entities** by specifying that the directors' report of all companies need to state details in respect of adequacy of IFCs, albeit with reference to financial statements only.

It follows that while listed entities are required to have adequate IFCs covering aspects which go beyond financial reporting *(such as those impacting strategy, operations and compliances),* **unlisted entities are currently required to ensure adequacy of their IFCs with respect to financial reporting only.**

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Independent directors

The Act has also brought to the fore, the role of the independent directors in terms of EWRM and IFCs. Schedule IV now requires independent directors **to satisfy themselves on the integrity of financial information, while ensuring that that IFCs and systems of EWRM are robust and defensible**.

Management

The Act has **significantly expanded the scope of internal controls to be considered by the management of companies, to cover all aspects of the operations** of the company. The management also needs to be in a position to provide the company's statutory auditors comfort in terms of the provisions of section 143 (3) (i) the Act.

This apart, as the primary custodian of financial information, the **accountability for the design and operation of financial controls, inextricably & essentially, rests with the finance function.**

Statutory auditors

Although tight financial controls are essential for instilling market confidence; cultural and operational risks are equally important and cannot be ignored. And this is where the debate starts to proliferate. The Sarbanes-Oxley Act of 2002 in USA insists on the auditor's attestation over the management's assertion on the financial control environment, whereas the combined code of corporate governance in the UK maintains a focus on the wider control environment, but without the requirement for a positive assertion.

Section 143 (3) (i) of the Act which deals with powers and duties of auditors and auditing standards, requires the auditor's report to state whether the organisation has adequate IFCs system in place and to confirm the operating effectiveness of such controls. This places **onerous responsibilities on the statutory auditors,** as various audit principles and audit procedures which have been in vogue in the past, **do not cover situations where the auditors are required to express an opinion over the effectiveness of internal controls**.

The statutory auditor is now required to report **on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements.**

In the case of components which are included in the consolidated financial statements of the parent company, attesting on the adequacy and operating effectiveness of IFCs over financial reporting **now applies for the respective components, only if this is a company, as defined in the Act.**

Accordingly and in consonance with the approach adopted for reporting on the consolidated financial statements as per the clauses of section 143 (3) and reporting on the Companies (Auditor's Report) Order, 2015 notified under section 143 (11) of the Act, the reporting on adequacy of internal financial controls are required to be on the basis of the reports on section 143 (3) (i) as submitted by the statutory auditors of components that are Indian companies under the Act.

So what really has changed

There has been and possibly will remain an irony in the transparency agenda that is being demanded of stakeholders in India - **the more things change, the more they remain the same**.

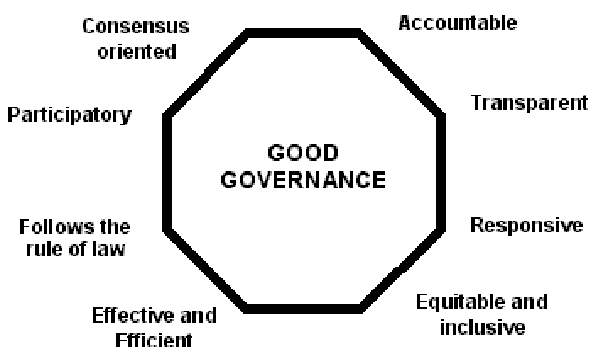
CARO v/s IFCs

So what really has changed, since the concepts of IFCs and EWRM are not alien to the corporate sector in India. After all auditors were required to report on internal controls in the Companies (Auditor's Report) Order, 2003 ("CARO") report. The fact is that under CARO, the reporting on internal controls was limited to the adequacy of controls over the purchase of inventory and fixed assets and sale of goods and services. **CARO did not cover all controls relating to financial reporting** and did not require reporting on the "**adequacy and operating effectiveness"** of such controls.

EWRM v/s IFCs

Secondly, the latest guidance note from the ICAI establishes that while internal controls are an integral part of and EWRM framework, there are **some key differences between IFCs and EWRM, such as**:

- EWRM is applied in strategy setting while internal financial controls operate more at the process level; &
- EWRM is applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk while **IFCs are for the processes which contribute to financial reporting.**



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So, what really has changed - and do we need this transformation

Interim financial statements
This apart, reporting on IFCs **is not applicable to interim financial statements**, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Clause 49 v/s section 143
In the case of listed entities, clause 49 of their respective listing agreement, required and continues to require the certification by the CEO / CFO on establishing, maintaining and evaluating the effectiveness of IFCs over financial reporting, in addition to disclosures to the auditors and the audit committee with steps to address rectify the deficiencies.

The auditor is now required to report on adequacy and operating effectiveness of IFCs in the case of unlisted companies *(as well)* since Clause (i) of Sub-section 3 of Section 143 does not specifically state that it is applicable only in the case of listed companies.

Effectively, the **limits of the listed entities have been pushed to go beyond what they had been doing** *(which was previously confined to the assessment of internal controls of financial reporting)*, to **cover other aspects across the length and breadth of the organisation**.

This apart, unlisted entities have been brought under the ambit, albeit in the context of the assessment of controls over financial reporting

Additional responsibilities for directors
The inclusion of the matters relating to internal financial controls in the directors responsibility statement is **in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records** in accordance with the provisions of the Act **for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities**.

Penal consequences
There are new **penal consequences** in terms of fines and penalties on defaulting companies and their officers *(which constitutes a relatively wide coverage of people engaged with the said company)* and these include the potential imprisonment of the latter.

IFCs & EWRM for all
Not just the auditors, but other stakeholders as well, now need to collectively prepare for another new litmus test - with **all companies now being brought under the compliance requirements for IFCs and EWRM**.

Finally, a boon or a bane
The benefits of ongoing assessments of IFCs, institutionalization of a robust EWRM framework and implementation of good governance practices go **beyond the boundaries** of legislative reforms. Simply put, these seek to **enhance the capability of the stakeholders to steer their organisations towards the realisation of its mission, while effectively implementing its strategy and meeting its objectives**.

Companies who seek to comply with the new requirements in spirit and form, by **treating the same as a practical necessity rather than a holy grail, will be better placed to develop and maintain a competitive edge** - the rest will get left behind.

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