DIRECTOR'S RESPONSIBILITY STATEMENT ON INTERNAL FINANCIAL CONTROLS

Clause 134 (5) of the Companies Bill 2012 requires that Directors, in the case of a listed entity, shall disclose that they have laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

This amendment recognises the globally acknowledged practice of "internal controls over financial reporting" and is expected to improve the quality of financial reporting control procedures in India. This amendment has greater depth than the existing requirements of Clause 49 (V) of the Listing Agreement.

IIA Bombay Chapter Research Foundation
Research Partner Verita Management Advisors Pvt. Ltd

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INDEX

Point of View:

"Independent Directors have the onerous responsibility of exercising oversight to ensure that the Company follows the norms of corporate governance both in law and in spirit. Clause 134(5) of Companies Bill 2012 only further enhances that responsibility. Since independent directors are not involved in the day to day management of the company, they necessarily need to rely on the internal financial controls. The menace of window dressing and fraudulent financial reporting often goes undetected as independent directors are either not truly independent or do not truly understand finance and the controls and processes behind financial reporting. This paper contributes towards the crying need of improving corporate governance and the need for independent directors to play a more effective and proactive role."

- Shariq Contractor, Senior Partner Contractor, Nayak & Kishnadwala

1. Background

There is an increasing trend in the instances of fraudulent financial reporting. Any event of fraudulent financial reporting brings investor confidence and market sentiment crashing down and impacts not only the stakeholders but the society at large. To develop a credible deterrence against fraudulent financial reporting and unintended material misstatements regulators and audit bodies have introduced several legislations and auditing pronouncements in the past. There has been a global awakening on the subject and renewed calls for action to counter and develop sustainable mechanisms.

Recognising the global regulatory amendments and the increasing trend of financial reporting frauds in India our legislature has recently framed new provisions under the Companies Bill 2012. Chapter IX on Accounts of Companies of the Companies Bill 2012 adopted in the Lok Sabha on 18th of December 2012 introduces provisions that are similar to the requirements of the Sarbanes Oxley Act of US.

Despite the existing layers of supervision, management review and audits it was felt necessary by regulators to introduce the concept of collective Board Responsibility and oversight over the financial statements of the company. The clause 134 (5) of the Companies Bill 2012 introduces the concept of **"internal financial controls"**. The term "**internal financial controls**" shall mean and include:

- 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**;

The above provisions, if enacted as the new law shall have a significant and wide reaching impact on listed entities in India. It will certainly increase the complexity and cost of compliances, however, is a welcome step as this will strengthen the internal control environment of listed entities, Corporate Governance disclosures and ensure transparency. If implemented in spirit could be a credible deterrence to fraudulent financial reporting.

It is expected that the quality of financial reporting control procedures shall improve in India as the onus of disclosure on controls over financial reporting would now rest with the Board as a result of the new amendment.

2. Comparative regulatory analysis

EXISTING REQUIREMENTS OF CLAUSE 49 (V)	CLAUSE 134 (5) OF THE COMPANIES BILL 2012	SOX REQUIREMENTS
a. 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 they have reviewed financial statements and the cash flow statement these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading. Further, these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations. There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct. b. They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit 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 these deficiencies.	The Directors' Responsibility Statement referred to in clause (c) of sub-section (3) shall state that— (a) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures; (b) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period; (c) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities; (d) the directors had prepared the annual accounts on a going concern basis; and (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.**	Summary of Section 302 Periodic statutory financial reports are to include certifications that: • The signing officers have reviewed the report • The report does not contain any material untrue statements or material omission or be considered misleading • The financial statements and related information fairly present the financial condition and the results in all material respects • The signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings • A list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities • Any significant changes in internal controls or related factors that could have a negative impact on the internal controls Summary of Section 401 Financial statements are published by issuers are required to be accurate and presented in a manner that does not contain incorrect statements or admit to state material information.

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EXISTING REQUIREMENTS OF CLAUSE 49 (V)	CLAUSE 134 (5) OF THE COMPANIES BILL 2012	SOX REQUIREMENTS
i. They have indicated to the auditors and the Audit committee significant changes in internal control over financial reporting during the year; i. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and 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 the company's internal control system over financial reporting.	**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; (f) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.**	These financial statements shall also include all material off-balance sheet liabilities, obligations or transactions. Summary of Section 404 Issuers are required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. This statement shall also assess the effectiveness of such internal controls and procedures. The registered accounting firm shall, in the same report, attest to and report on the assessment on the effectiveness of the internal control structure and procedures for financial reporting.

In India, the Statutory Auditor has to comment on the existence and effectiveness of the internal control system as part of the CARO 2003 requirements. There is no need to comment specifically on the design and effectiveness of internal financial controls. In the backdrop of the Companies Bill 2012 it is likely that bodies exercising jurisdiction may provide guidance on "integrated auditing which would cover aspects of controls over financial reporting as a mandatory requirement for auditors to comment upon".

The term "**Internal Financial Control**" has been expressly defined in the Companies Bill 2012; however, the proposed amendment does state the minimum period for which internal financial controls should remain effective to qualify and meet the test of operative effectiveness. SOX regulations specifically require that internal controls should be effective for a minimum period of ninety days prior to the report signing date. This implies that all significant control deficiencies need to be rectified prior to closure of the financial period and thereafter internal controls should have been effective.

Under Clause 49 the onus of certification of controls over financial reporting to the Board is on the CEO/ CFO, however, the Companies Bill 2012 adds an additional disclosure requirement as part of the Directors Responsibility Statement.

3. Trends in fraudulent financial reporting

COSO sponsored a study on Fraudulent Financial Reporting during the period 1998-2007, to provide a comprehensive analysis of fraudulent financial reporting occurrences investigated by the U.S. SEC between January 1998 and December 2007. The notable findings of the study are highlighted in the Exhibit A.

EXHIBIT A

- The SEC named the **CEO and/or CFO for some level of involvement** in 89 percent of the fraud cases, up from 83 percent of cases in 1987-1997. Within two years of the completion of the SEC's investigation, about 20 percent of CEOs/CFOs had been indicted and over 60 percent of those indicted were convicted.

- The **most common fraud technique** involved **improper revenue recognition**, followed by the **overstatement of existing assets** or **capitalization of expenses**. Revenue frauds accounted for over 60 percent of the cases, versus 50 percent in 1987-1997.

- Relatively few differences in board of director characteristics existed between firms engaging in fraud and similar firms not engaging in fraud. Also, in some instances, noted differences were in directions opposite of what might be expected. These results suggest the importance of research on governance processes and the interaction of various governance mechanisms.

- Twenty-six percent of the fraud firms changed auditors between the last clean financial statements and the last fraudulent financial statements, whereas only 12 percent of no-fraud firms switched auditors during that same time. Sixty percent of the fraud firms that changed auditors did so during the fraud period, while the remaining 40 percent changed in the fiscal period just before the fraud began.

Source: COSO study on fraudulent financial reporting.

The study revealed the most commonly cited motivations for fraud included:

a. The need to **meet internal or external earnings expectations**,

b. An attempt to **conceal the company's deteriorating financial condition**,

c. The need to **increase the stock price**,

d. The need to **bolster financial performance** for pending equity or debt financing,

e. The desire to **increase management compensation** based on financial results.

In India, published statistics reveal a growing trend of falsification of financial statements in the areas of under reporting of income, use of hawala schemes, use of fictitious customers/ vendors/ employees, concealment of bribe payouts, etc. The Annual Report of the Ministry of Corporate Affairs discloses that in some cases investigated by the Serious Fraud Investigation Office (SFIO) it was found that, by following two accounting years, a company was showing losses in the Profit & Loss account filed to the Income tax department. However, huge profit was being shown in the Profit & Loss accounts filed with stock exchanges, ROC etc. The different amount of profits in the two sets of Profit & Loss Account for the same year was shown by resorting to valuation of stock at inflated value in the Profit & Loss Account that was filed with ROC, Stock exchanges following the accounting year other than financial year. In few cases, sales having heavy profit margin were recorded in those months, which were included in the accounting year followed for preparing the Profit & Loss Account filed with ROC and used for the purposes of investors or other stakeholders.

In one of the cases investigated by SFIO, it was observed that the company deferred capitalization of its fixed assets, despite starting the commercial production using the very same fixed assets, in order to achieve higher profitability and/or reducing the losses thereby, avoiding the clutches of BIFR and enjoying continued bank funding.

Based on manipulated financial performance, promoters often resort to selling their share holding in the company at manipulated prices to make illegal gain from share market and later, repurchase the same at reduced price by reversing the process in the subsequent period and thus continue to maintain their control on the company. In most of the cases investigated by SFIO, a large quantity of shares sold by promoters or entities controlled by them are found to have been allotted to them on preferential basis by adopting the method of circulation of cheques or swapping.

Intentional misstatements result in misappropriation of assets and deceit of financial statement users. The common techniques used for manipulation of financial results are listed under Exhibit B.

EXHIBIT B

Common Financial Statement Manipulations techniques
Alterations of accounting records and supporting documents from which financial statements are prepared.
Omission of events and accounting transactions.
Deliberate misapplication of accounting principles.
Recording fictitious journal entries and out of book adjustments.
Engaging in complex structured transactions to mislead stakeholders and auditors.

Point of View:

"Nothing short of a significantly improved moral climate is required to meet the goals of fraud free financial statements. With sophisticated ERP systems, big data analytics and Continuous control monitoring now possible, the enabling environment can be created but the onus on Audit Committees is becoming very challenging."

- Shailesh Haribhakti, Managing Partner Haribhakti & Co.

4. Common weaknesses - internal financial controls

a. Customer and Vendor Balance confirmation not obtained.

b. Lack of appropriate procedure for communicating revenue and business arrangements to accounting personnel for recording transactions that have financial implications.

c. Absence of documented accounting manuals and procedures.

d. Account reconciliations and journal entries not properly performed and reviewed for ensuring completeness and accuracy.

e. Foreign currency transactions and balances not valued accurately in consolidated financial statements.

f. Stock transactions and stock-based compensation expense not accurately recorded.

g. Expenditures not properly recognized in the proper reporting period.

h. The rationale for an acquisition transaction not adequately considered, documented and communicated to properly assess the fair value of the net assets acquired.

i. Absence of comprehensive centrally coordinated enterprise-wide fraud risk management program.

j. Insufficient competent personnel with an appropriate level of accounting knowledge, experience and training in the application of GAAP commensurate for financial reporting requirements.

k. Management not performing timely and complete reviews of the consolidated financial statements by personnel with knowledge sufficient to reach appropriate accounting conclusions.

l. Lacked a formalized process with adequate controls designed to ensure that the general ledger was closed properly at the end of each period.

m. Ineffective access controls identified such as unrestricted access to accounting systems, spread sheets and data, lack of periodic review and monitoring of such access, and lack of clearly communicated policies and procedures.

n. Ineffective change management controls designed to ensure that information technology program and data changes were authorized and that the program and data changes were adequately tested for accuracy and appropriate implementation.

o. Management has not maintained effective controls with respect to the process of authorizing, approving, validating and settling trades, including inadequate segregation of duties among trading, settlement and valuation activities within both treasury and trading operations.

p. The existence of a large number of manual journal entries in different processes, which increases the possibility that errors exist in the financial statements, and that these errors are not detected or corrected.

q. Weaknesses in the process of purchases and payments, related to the likelihood of registering a supplier document in duplicated form, or of annulling payments already given to the suppliers, which make the duplicated existence of registries and payments possible.

r. Inadequate segregation of functions in the assignment of users of different business processes, which increase the possibility of non-authorized transactions.

s. Lack of procedures and controls related to the preparation and review of the tax provision designed to ensure that the deferred tax provision and deferred tax asset and liability balances are accurate and determined in accordance with generally accepted accounting principles.

t. Lack of controls in (i) purchase requisitions and related vendor invoices are reviewed and approved; (ii) reconciliations of related bank accounts and accounts payable subsidiary ledgers are prepared, reviewed and approved; (iii) changes to vendor master files are reviewed and approved and (iv) adequate segregation of duties related to check signing, invoice processing and invoice approval.

u. Lack of controls in (i) employee tax deductions are complete and accurate; (ii) access to payroll system files is adequately restricted; and (iii) review and approval of changes to the payroll master and employee files.

v. Improper segregation of duties between authorized check signatories, review and approval of check registers, review and approval of bank reconciliations. Also segregation between the originator, approver and submitter of wire transfers was not appropriate.

w. No adequate review performed of the three way match between the purchase order, invoice and the receiving report.

x. No Job rotation especially in functional areas such as accounts, payables, procurement, inventory management and logistics.

5. Auditing pronouncements on controls over financial reporting

ICAI Guidance	PCAOB – AS 5	IFAC Guidance	COSO Guidance
As per the Guide to Internal Controls over Financial Reporting issued by ICAI in December 2007, Internal control over financial reporting is a process, effected by a company's board of directors, management and other personnel, designed to provide reasonable assurance regarding the reliability of published financial statements. As stated earlier, the internal control process begins with management setting financial reporting objectives relevant to the company's particular business activities and circumstances. Once set, management identifies and assesses a variety of risks to those Objectives, determines which risks could result in a material misstatement in financial reporting, and determines how the risks should be managed through a range of control activities. Management implements approaches to capture, process and communicate information needed for financial reporting and other components of the internal control system.	PCAOB Release No. 2007-005A The PCAOB defined ICOFR as a process designed by management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP. ICOFR is a subset of internal control specific to financial reporting objectives. It does not encompass the elements that relate to the effectiveness & efficiency of a company's operations or a company's compliance with applicable laws & regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements. The PCAOB's definition requires ICOFR to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. Reasonable assurance represents a high level of assurance, but it is not absolute. It recognizes that, even when ICOFR is effective, misstatements may occur, being neither prevented nor detected on a timely basis.	ISA 220, *Quality Control for an Audit of Financial Statements and* ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry	An organization needs internal controls to provide greater assurance that they will achieve their operating, financial reporting, and compliance objectives; in other words to help the organization succeed in its mission. Internal control helps ensure that the directions, policies, procedures, and practices designed and approved by management and the board are put in place and are functioning as desired. The more elaborate the organization, the more the need for internal control to counteract any loss of effectiveness sustained when adding more people and processes to transact business. In preparing financial statements, management exercises judgment in complying with External financial reporting requirements. Management considers how identified risks specified to financial reporting objectives and sub-objectives should be managed. Management's alternatives to respond to risk may be limited compared to some other Categories of objectives. That is, management is less likely to accept a risk than to reduce the risk.

ICAI Guidance	PCAOB – AS 5	IFAC Guidance	COSO Guidance
All this is done in context of the company's control environment, which is shaped and refined as necessary to provide the appropriate tone at the top of the organization and related attributes. These components are monitored to help ensure that the internal controls continue to operate properly over time.	The auditor has to document and report in writing to the audit committee and management of all the material weaknesses that were noted within the audit. The auditors must comply with these proper procedures before they report all the material weaknesses on the final audit report. When a significant deficiency has been discovered or noted by the auditor, then the auditor must notify management and the audit committee about it, so they can quickly address the risk. In either case, the auditor has to communicate with management and audit committee concerning material weaknesses and significant deficiencies, while an audit report includes the review of all the internal controls related to financial reporting that the auditor has to write.	The auditor shall obtain an understanding of internal control relevant to the audit. 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.	For instance, management may decide to mitigate a risk by outsourcing transaction processing to a third party that is better suited to perform the business process. However, management always retains responsibility for designing, implementing, and conducting its system of internal control even when outsourcing to a third party. For external financial reporting objectives, risk acceptance or avoidance should occur only when identified risks could not, individually or in aggregate, exceed the risk threshold and result in a material misstatement. COSO lays down guidance for specific considerations of external financial reporting such as compliance with applicable accounting standards, rules and regulation.

Point of View:

"As per the listing agreement, currently the CEO and the CFO (management) are responsible for evaluating and reporting on a company's internal controls and the statutory auditors are responsible for auditing management's assertion and independently coming to their own conclusion about effectiveness of the company's internal control. As per the provisions of new Companies Bill, directors of a listed company are now required to lay down internal financial controls to be followed by the company.

Control environment sets the tone for the organization, influencing the control consciousness of its people. It is the foundation for all other components of all systems. It includes elements such as management's integrity and ethical values, operating philosophy and commitment to organizational competence. The concepts of corporate governance heavily rely on the necessity of internal controls. Internal controls help ensure that processes operate as designed and that risk responses in risk management are carried out in timely way. With the onus now being on the Board of Directors as regards reporting of the effectiveness of the internal controls, it will not only strengthen the internal control environment of listed entities and its disclosures relating to governance, but also will keep a tab on the standard operating procedures and policies followed by the companies including a review of relevant documentation of the design and reporting mechanism. The cost of compliance, no doubt will increase. However, in long run this will be more than compensated by value addition to the organisation and to the people working there"

- **Mahendra N. Shah,** Group Head, Secretarial & Governance and Senior Advisor Taxation, IDFC

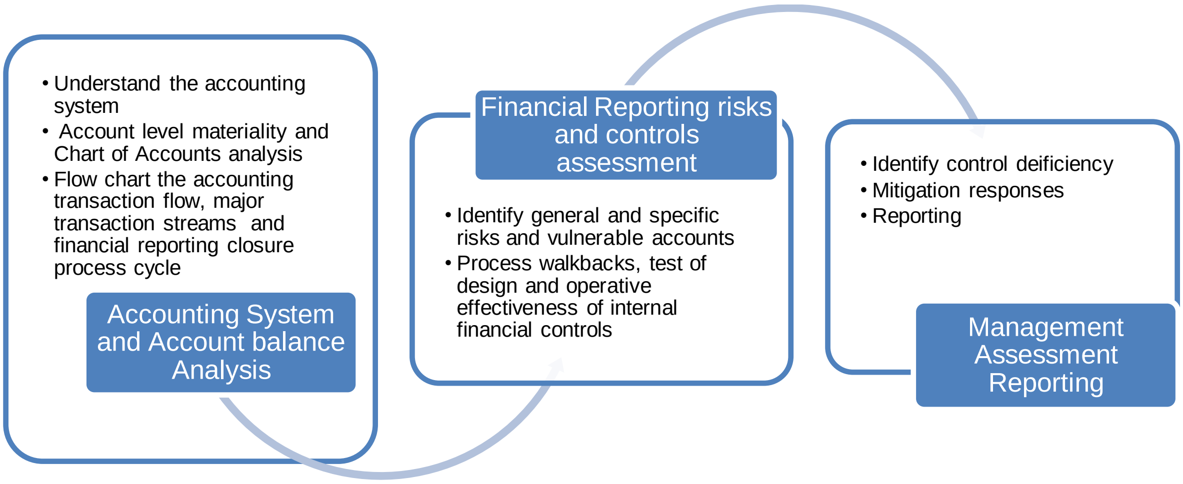
6. Assessment of Internal Financial Controls

a. Role of Board & Audit Committees

The responsibility of designing and implementing internal control system lies with the management and controlling authorities and that of monitoring and evaluation of controls rests with the auditors of the company. The proposed annual disclosure on internal financial controls is expected to add an additional mandatory layer of oversight and control viz., assessment of controls over financial reporting. This would result in greater scrutiny of the financial reporting closure procedures by the Board and Audit Committees. It is envisaged that Board shall be required to perform a management review of financial reporting control procedures at least once a year to determine the existence and operating effectiveness of the internal financial controls. In addition all material and significant control deficiencies shall be evaluated and assessed for their impact on the financial statements by the Directors of the company.

Internal controls have inherent limitations therefore Board/ Audit Committee shall be expected to assess the additional substantive procedures performed by the management and auditors to rule out the possibility of frauds and errors.

EXHIBIT C – ACTIVITY FLOW FOR PERFORMING THE ASSESSMENT OF IFC



b. Role of Auditors

The existence of an Internal Audit department is one of the factors that external auditors take into account in assessing the strength of the entity's system of internal control. The external auditors document their assessment of the internal control systems and the quality of the Internal Audit department while they formulate their audit opinion on the financial statements. The Internal Auditors can play a significant role in evaluating and monitoring the Financial Reporting Closure Processes. Internal Auditors generally adopt methodologies based on the recognised framework for testing controls over financial reporting such as COSO.

As the onus of accurate financial reporting shifts to the Boards and Audit Committees it is quite likely that the internal audit programs and audit schedules may undergo modifications to include the review of internal financial controls as a new audit scope item to existing year round internal audit programs.

It is also envisaged that external auditors shall be required to perform integrated audits covering the design and operating effectiveness of internal financial controls.

7. Conclusion

a. Enabling rules that codify the “how” and implementation aspects of internal financial controls shall facilitate and smoothen the implementation of the proposed provisions. It would be useful if the regulators notify rules along with the new amendment.

b. The proposed provisions on Internal Financial Controls as and when notified as the new law may perhaps face implementation hurdles on account of increase in cost of compliances, uncertain economic environment and poor moral climate in the country.

c. Aside of above hurdles there could be other challenges such as limited resources, inability to prioritise on competing compliance requirements, impact on financial reporting turnaround times, availability of skilled manpower, etc. It is quite likely that the management assessment of internal financial controls may become a “tick in the box” exercise for the purpose of demonstrating compliance. Use of technology to automate internal financial controls can play a significant role in reducing the cost of compliances and meeting the challenges stated above.

d. The law makers have shown their intent and once the provisions are notified it would be the responsibility of the Boards and Audit Committees to change the general perception by implementing robust and effective internal financial controls.

e. In the long term scenario, benefits of implementing robust internal financial controls are far greater than the costs of implementation as failure to do so can severely impact the reputation and image of the company. A new beginning has been made and there is a strong case to adopt global practices that have resulted in better Corporate Governance regimes and efficient Capital markets that can attract higher levels of Investments.

8. References

a. ICAI website and publications

b. PCAOB website and publications

c. IFAC website and publications

d. COSO website and publications

e. Annual reports of Companies

f. MCA and SFIO

9. Important disclosures

a. The material is prepared with due care; however, any reliance should be placed only after consultation with the publication team. The contents of this material are for information purposes only and should not be construed as solicitation or advice in any manner whatsoever. No one should act upon the information provided in this material without appropriate professional advice. While IIA Bombay Chapter Research Foundation (IIAF) and Verita Management Advisors Pvt. Ltd. ("Verita") strives to ensure that the information contained herein is accurate, timely and reliable, IIAF and Verita makes no warranties or representations, express or implied, including the warranty of merchantability and fitness for a particular purpose, or assumes any liability or responsibility for the accuracy, completeness, reliability, timeliness or usefulness of the information provided in this material.

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