Seminar on Companies Act, 2013

Tri Nagar CPE Study Circle

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SYNOPSIS

Depreciation

Internal Financial Control Over Financial Reporting

Depreciation

APPLICABLE PROVISIONS

- Section 123 of the Companies Act, 2013
- Schedule II of the Companies Act, 2013

  (Effective from 1st April, 2014 as per notification by MCA dated 26th March, 2014)
- Notifications by MCA dated 29th August, 2014 & 31st March, 2014

DEPRECIATION RELATED PROVISIONS-KEY HIGHLIGHTS

(*Useful Life vis-a-vis rates of depreciation*)

- Schedule II of the Companies Act, 2013 provides the useful life as against the minimum rates of depreciation which were there in the Schedule XIV of the Companies Act, 1956.
- In case of Plant and Machinery, Schedule II of the Companies Act, 2013 gives the industry specific useful life.
- Schedule XIV of the Companies Act, 1956 contained the minimum rates of depreciation. No Company was allowed to charge depreciation at the rates lower than the rates prescribed in Schedule XIV.
- However, the Companies Act, 2013 does not have any such restriction. This is a significant change in the approach of the regulator and will bring the Indian companies at par with international practice.

Useful Life & Residual Value:

			Companies Act, 2013	***Companies Act, 1956***
All Companies (except for government regulated entities)	***Useful Life***	*Can it be higher*	Yes, if the justification for the difference is disclosed in the financial statements	No
		Can it be lower		Yes
	Residual Value	*Can it be higher than 5% of the original cost of the asset*		No such provision*
		Can it be lower than 5% of the original cost of the asset		No such provision*

*Residual value was inbuilt in depreciation rates prescribed under Schedule XIV

Rates applicable to Intangible Assets

For Intangible assets, there is no specific provision in the Schedule XIV of the Companies Act, 1956 except that in the case of toll road, amortization was done using the amortization rate arrived at by dividing actual revenue for the year with total estimated revenue.

Now, no separate depreciation rate is prescribed for intangible assets in the Schedule II of the Companies Act, 2013. Rather, the same will be governed by the notified AS (i.e., AS 26).

In practice, we do not expect a change for Intangible assets.

Useful life of Continuous process plant

Useful life of Continuous process plant for which no special rate has been prescribed [NESD] is increased from 8 to 25 years by the notification by MCA dated 31st March, 2014.

Extra Shift Depreciation

Earlier, the extra shift depreciation rates were given for the categories of assets for which extra shift depreciation was allowed. Now, no separate rates are prescribed for extra shift depreciation. A blanket statement is provided that the period of time an asset is used in double shift, depreciation will increase by 50% and by 100% in case of triple shift working.

Example-1

From the following information, compute the depreciation as per the provisions of Schedule XIV of the Companies Act, 1956 and Schedule II of the Companies Act, 2013 and show the difference in both.

Purchase cost of the Reactors	Rs.40,00,000
Cost of installation	Rs.1,50,000
Residual Value	Nil
Estimated Useful Life	25 Years
Useful Life prescribed in Schedule II	20 years

Statement showing computation of depreciation

Particulars	Single shift Depreciation	Double shift Depreciation	Triple shift Depreciation
Under Schedule XIV (1956)			
(Rs.40,00,000+Rs.150,000)* 4.75% (Rs.40,00,000+Rs.150,000)* 7.42% (Rs.40,00,000+Rs.150,000)* 10.34% As per the minimum rate	Rs.1,97,125	Rs. 3,07,930	Rs. 4,29,110
Under Schedule II (2013)			
(Rs.40,00,000+ Rs.150,000)* 5.00%	Rs.2,07,500	Rs.2,07,500 (NESD)	Rs.2,07,500 (NESD)
Difference (Extra Depreciation under Schedule II)	Rs.10,375	(Rs. 1,00,430)	(Rs. 2,21,610)

According to the Schedule II of the Companies Act, 2013, entities may charge a lower depreciation than the rate envisaged in Schedule II on disclosing justified reasons of the differences. In case the entity goes with the option of charging depreciation at the rates lower than the prescribed rates, the difference would be as follows:

*(Single shift rate : (1*100/25= 4%))*

Particulars	Single shift Depreciation	Double shift Depreciation	Triple shift Depreciation
Under Schedule XIV (1956)			
(Rs.40,00,000+Rs.150,000)* 4.75%	Rs.1,97,125		
(Rs.40,00,000+Rs.150,000)* 7.42%		Rs. 3,07,930	
(Rs.40,00,000+Rs.150,000)* 10.34%			Rs. 4,29,110
As per the minimum rate			
Under Schedule II (2013)			
(Rs.40,00,000+ Rs.150,000)* 4.00%	Rs.1,66,000	Rs.1,66,000 (NESD)	Rs.1,66,000 (NESD)
Difference (Extra Depreciation under Schedule XIV)	Rs.31,125	Rs. 1,41,930	Rs. 2,63,110

Example-2

A Ltd. is using Roll Grinder (falling in category of Plant and Machinery used in manufacture of non-ferrous metals in Schedule II) in its operation process. Details are as follows:

Capitalised value of the Roll Grinder	Rs. 5,00,000/-
Useful Life	40 Years
Residual Value	Rs. 25,000/-
Useful Life prescribed in Schedule II	40 years

Required:

Calculate depreciation as per the provisions of schedule XIV of the Companies Act, 1956 and Schedule II of the Companies Act, 2013, if the machine is used for:

a)Single shift

b)Double shift

c)Triple shift

Statement showing computation of depreciation

Particulars	Single shift Depreciation	Double Shift Depreciation	Triple Shift Depreciation
Under Schedule XIV (1956)			
(Rs. 5,00,000)* 4.75% (Rs. 5,00,000)* 7.42% (Rs. 5,00,000)* 10.34% As per the minimum rate	Rs. 23,750	Rs. 37,100	Rs. 51,700
Under Schedule II (2013)			
(Rs. 5,00,000-Rs. 25,000)* 2.50% (Rs. 5,00,000-Rs. 25,000)* 3.75% (Rs. 5,00,000-Rs. 25,000)* 5.00%	Rs.11,875	Rs.17,813	Rs.23,750
Difference (Extra Depreciation under Schedule XIV)	Rs.11,875	Rs. 19,287	Rs.27,950

Major Impact on Depreciation relevant items: Single Shift

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
I. Buildings [NESD]				
(a) Buildings (other than factory buildings) RCC Frame Structure	60	1.67	1.63	0.04
(b) Buildings (other than factory buildings) other than RCC Frame Structure	30	3.33	1.63	1.70
(c) Factory buildings	30	3.33	3.34	(0.01)
(d) Fences, wells, tube wells	5	20	1.63	18.37
(e) Others (including temporary structure, etc.)	3	33.33	100	(66.67)

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
II. Bridges, culverts, bunders, etc. [NESD]	30	3.33	1.63	1.70
III. Roads [NESD]				
(a) Carpeted roads				
(i)Carpeted Roads-RCC	10	10	1.63	8.37
(ii) Carpeted Roads-other than RCC	5	20	1.63	18.37
(b) Non-carpeted roads	3	33.33	1.63	31.70

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
IV. Plant and Machinery				
(i) General rate applicable to plant and machinery not covered under special plant and machinery				
(a) Plant and Machinery other than continuous process plant not covered under specific industries	15	6.67	4.75	1.92
(b) continuous process plant for which no special rate has been prescribed under (ii) below [NESD]	8	~~12.50~~ 4	5.28	~~7.22~~ (1.28)

Increased to '25 years' by the amendment

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
(ii) Special Plant and Machinery				
(a) Plant and Machinery used in manufacture of pharmaceuticals and chemicals [NESD]				
1. Reactors	20	5	4.75	0.25
2. Distillation Columns	20	5	4.75	0.25
3. Drying equipments/Centrifuges and Decanters	20	5	4.75	0.25
4. Vessel/storage tanks	20	5	4.75	0.25

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
V. Furniture and fittings [NESD]				
(i) General furniture and fittings	10	10	6.33	3.67
VI. Electrical Installations and Equipment [NESD]	10	10	4.75	5.25
VII. Laboratory equipment [NESD]				
(i) General laboratory equipment	10	10	4.75	5.25
(ii) Laboratory equipments used in educational institutions	5	20	4.75	15.25
VIII. Office equipment [NESD]	5	20	4.75	15.25

		SLM BASIS		
Nature of Assets	**Useful Life (Co. Act, 2013)**	**Rate (Co. Act, 2013) (1)**	**Rate (Co. Act, 1956) (2)**	**Impact Increase/(decrease) (1)-(2)**
	(Years)	*(%)*	*(%)*	*(%)*
IX. Computers and data processing units [NESD]				
(i) Servers and networks	6	16.67	16.21	0.46
(ii) End user devices, such as, desktops, laptops, etc.	3	33.33	16.21	17.12
X. Motor Vehicles [NESD]				
1. Motor cycles, scooters and other mopeds	10	10	9.5	0.50
2. Motor buses, motor lorries and motor cars other than those used in a business of running them on hire	8	12.50	11.31	1.19
3.Electrically operated vehicles including battery powered or fuel cell powered vehicles	8	12.50	7.07	5.43

Component Accounting made mandatory:

Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part should be determined separately.

This requirement will be voluntary in respect of the financial year commencing on or after the 1st April, 2014 and mandatory for financial statements in respect of financial years commencing on or after the 1st April, 2015. *(Notification by MCA dated 29th August, 2014)*

Example

X Ltd., a steel company is in the process of enhancing its production capacity. The company has got another furnace commissioned. Based on its historical experience, the company determines the life of furnace to be 30 years. The cost of the furnace is Rs. 90 crores. The break-down of the cost is as below:

	Cost (Rs. in crores)	**Useful life**
Structure	45	30
Internal lining of refractory	11	5
Heating components	14	7
Motors & other operating parts for controlling tem	20	10
Total	**90**	

Give the impact of component accounting on replacement of components after introduction of the Companies Act, 2013 and compare with the earlier situation under the Companies Act, 1956. Residual value may be assumed to be nil.

Treatment under the Companies Act, 1956

The component accounting was not mandatory under the Companies Act, 1956. The replacement cost was charged to the Statement of Profit and loss in the year in which it was incurred.

Annual depreciation of the furnance =Rs. 90 crore/30 = Rs. 3 crores

Replacement cost of various components will be charged to the statement of Profit and loss.

Treatment under Companies Act, 2013

Statement showing component wise annual depreciation

Furnance	**Depreciable amount (Rs. in crores) (A)**	**Useful life (B)**	**Depreciation (Rs. in crores)(SLM) (A)/(B)**
Structure	45	30	1.5
Internal lining of refractory	11	5	2.2
Heating components	14	7	2
Motors & other operating parts for controlling tem	20	10	2
Total			**9.7**

When at the end of the respective useful lives of the components, the components will be replaced, the replacement cost should be capitalised because by that time, they are fully depreciated and the carrying value at the end of their respective useful lives is nil.

Thus, although the overall amount that will be charged to the statement of Profit and loss will be same during the entire life of the furnance, the annual charge to the statement of profit and loss will differ significantly.

There is no specific requirement of 100% depreciation on assets whose actual cost does not exceed Rs. 5,000 in the Companies Act, 2013. However, under the Companies Act, 1956, assets whose actual cost does not exceed Rs. 5 thousand are depreciated @ 100%.

There is no significant change in pro-rata basis of providing depreciation and in the concept of residual value.

Transitional Provisions

From the date the Schedule II comes into effect, the carrying amount of the asset as on that date:

(a) should be depreciated over the remaining useful life of the asset as per Schedule II;

(b) after retaining the residual value, **may** be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.

Example-1

A company acquired a building (other than factory building and RCC Frame Structure) at a cost of Rs. 10 crores. The company was depreciating the building according to Schedule XIV SLM rate, i.e., 1.63% (rate computed assuming useful life to be approximately 60 years). Now, in April, 2014, Schedule II of the Companies Act, 2013 became effective, useful life specified in which is 30 years.

Explain how the transitional provision effect will be accounted for:

A. If the building is acquired on 1st April, 2000

B. If the building is acquired on 1st April, 1980

A. Transition effect in case the building is acquired on 1st April, 2000

Depreciation charged till FY 2013-14, i.e., depreciation on SLM for 14 years

Rs. 10 crores*1.63%*14 yrs

Rs. 2,28,20,000

Carrying Value as on 1st April, 2014

Cost less accumulated depreciation till FY 2013-14

Rs. 10,00,00,000 – Rs. 2,28,20,000

Rs. 7,71,80,000

The carrying value as on 1st April, 2014 will be depreciated over the remaining useful life of the asset as per Schedule II of the Companies Act, 2013. The remaining useful life as per new Schedule is (30-14) 16 years. Accordingly, depreciable amount of Rs. 7,71,80,000 will be depreciated over 16 years. So, annual depreciation to be charged to Profit and loss account from FY 2014-15 onwards would be Rs. 7,71,80,000/16 yrs , i.e., Rs. 48,23,750.

Impact

After 16 years from FY 2014-15, i.e., from FY 2030-31 onwards no depreciation would be charged

For 16 years, i.e., from FY 2014-15 to FY 2029-30, higher depreciation would be charged. If Schedule II would not have been introduced, depreciation charged annually would have been Rs. 10 cr. * 1.63% = Rs. 16,30,000. After the introduction of Schedule II of the Companies Act, 2013, depreciation charged for these 16 years would be Rs. 48,23,750 which is higher by Rs. 31,93,750.

B. Transition effect in case the building is acquired on 1st April, 1980

If the building would have been purchased on 1st April, 1980, then as on 1st April, 2014, useful life of 30 years as per new Schedule has already expired.

Scenario 1

If the company exercises the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Scenario 2

If the company does not exercise the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Scenario 1

If the company exercises the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Depreciation charged till FY 2013-14, i.e., depreciation on SLM for 34 years

Rs. 10 crores*1.63%*34 yrs

Rs. 5,54,20,000

Carrying Value as on 1st April, 2014

Cost less accumulated depreciation till FY 2013-14

Rs. 10,00,00,000 – Rs. 5,54,20,000

Rs. 4,45,80,000

Carrying value as on 1st April, 2014 of Rs. 4,45,80,000 would be recognised in the opening balance of retained earnings. (assuming residual value to be nil)

Impact

Opening balance of retained earnings would reduce by the carrying amount.

No depreciation from FY 2014-15 onwards shall be charged to the profit and loss account, which otherwise would have been charged if Schedule II would not have come into force.

Note: In case, there is a residual value, say, Rs. 10,00,000 then Rs. 4,35,80,000 would be recognized in the opening balance of retained earnings and Rs. 10,00,000 will remain in the carrying amount of asset.

Scenario 2

If the company does not exercise the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Carrying value as on 1st April, 2014 of Rs. 4,45,80,000 (computed in para (i) above) would be recognised in the statement of profit and loss. (Assuming residual value to be nil)

Impact

- In the FY 2014-15, amount of carrying value reduced by the residual value would be recognized in the statement of profit and loss which otherwise would have not been charged if Schedule II would not have come into force.
- There would be no effect on retained earnings.
- No depreciation from FY 2014-15 onwards shall be charged to the profit and loss account, which otherwise would have been charged if Schedule II would not have come into force.

Note: *In case, there is a residual value, say, Rs. 10,00,000 then Rs. 4,35,80,000 would be recognized in the statement of profit and loss and Rs. 10,00,000 will remain in the carrying amount of asset.*

Example-2

A company acquired a reactor used in the manufacture of pharmaceuticals and chemicals at a cost of Rs. 40 lakhs on 1st April, 2005. The reactor worked for triple shift. The company was depreciating the reactor according to Schedule XIV triple shift SLM rate, i.e., 10.34%. Now, in April, 2014, Schedule II of the Companies Act, 2013 became effective, useful life specified in which is 20 years.

Explain how the transitional provision effect will be accounted for:

A. If the reactor is acquired on 1st April, 2005

B. If the reactor is acquired on 1st April, 1993

Notes:

Reactor was not specifically covered under the Schedule XIV of the Companies Act, 1956, so rate is taken to be the rate applicable to 'general plant and machinery (not being a ship) other than a continuous process plant for which no specific rate has been prescribed'.

Reactor is specified as NESD under the Schedule II of the Companies Act, 2013, i.e., under new schedule, no extra shift depreciation would be applicable. However, under old schedule extra shift depreciation was applicable as earlier it was covered under the category of 'general plant and machinery (not being a ship) other than a continuous process plant for which no specific rate has been prescribed' and it was not specified in the items of general plant and machinery (for which no specific rate has been prescribed) to which extra shift depreciation is not applicable.

A. If the reactor is acquired on 1st April, 2005

Depreciation charged till FY 2013-14, i.e., depreciation on SLM for 9 years

Rs. 40 lakhs*10.34%*9 yrs

Rs. 37,22,400

Carrying Value as on 1st April, 2014

Cost less accumulated depreciation till FY 2013-14

Rs. 40,00,000 – Rs. 37,22,400

Rs. 2,77,600

The carrying value as on 1st April, 2014 will be depreciated over the remaining useful life of the asset as per Schedule II of the Companies Act, 2013.

The remaining useful life as per new Schedule is (20-9) 11 years. Accordingly, depreciable amount of Rs. 2,77,600 will be depreciated over 11 years. So, annual depreciation to be charged to Profit and loss account from FY 2014-15 onwards would be Rs. 2,77,600/11 yrs , i.e., Rs. 25,236. (assuming residual value to be nil)

Impact

After 11 years from FY 2014-15, i.e., from FY 2025-26 onwards no depreciation would be charged

If Schedule II would not have been introduced, the reactor would have been fully depreciated (except residual value) in 10th year itself. On the other hand, under Schedule II, depreciation will continue upto FY 2024-25.

B. If the reactor is acquired on 1st April, 1993

If the reactor would have been purchased on 1st April, 1993, then as on 1st April, 2014, useful life of 20 years as per new Schedule has already expired.

Scenario 1

If the company exercises the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Scenario 2

If the company does not exercise the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Scenario 1

If the company exercises the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

The reactor would have been fully depreciated by the end of 10th year from 1st April, 1993. Accordingly there would be no carrying value as on 1st April, 2014.

Impact

- There would be no effect on retained earnings.
- No depreciation from FY 2014-15 onwards shall be charged to the profit and loss account, which would have been the same if Schedule II would not have come into force. Hence, there would be no effect on the Statement of Profit and Loss as well.

Scenario 2

If the company does not exercise the option of recognizing the carrying value as on 1st April, 2014 in the opening balance of retained earnings

Carrying value as on 1st April, 2014 would be recognised in the statement of profit and loss. Since, the carrying value is nil, there would be no impact on the statement of profit and loss. (Assuming residual value to be nil)

Impact

- There would be no effect on retained earnings.
- No depreciation from FY 2014-15 onwards shall be charged to the profit and loss account, which would have been the same if Schedule II would not have come into force. Hence, there would be no effect on the Statement of Profit and Loss.

Other provision relating to depreciation

Dividend should be declared by a company for any financial year at a general meeting out of the profits for that year or any previous year or years arrived at after providing for depreciation.

The section also provides that the depreciation shall be provided in accordance with Schedule II.

(Section 123 of the Companies Act, 2013)

GUIDANCE ON INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING

AUDITORS' REPORT

Auditor's report should additionally state whether the company has adequate **internal financial controls system in place and their operating effectiveness.**

(Section 143(3)(i) of the Companies Act, 2013)

Based on the definition of internal financial controls, the auditor's role is significantly widened. There seems to be greater focus on policies and procedures, operational controls, and propriety of financial transactions. Such requirement was not there in the Companies Act, 1956.

SCOPE OF REPORTING

- The auditor's responsibility is to express an opinion on the effectiveness of the company's internal financial controls and the procedures in respect thereof are carried out along with an audit of the financial statements
- The scope for reporting on internal financial controls is significantly larger and wider than the reporting on internal controls under the Companies (Auditor's Report) Order, 2003("CARO").
- Under CARO, the reporting on internal controls was limited to the adequacy of controls over purchase of inventory and fixed assets and sale of goods and services.
- CARO did not require reporting on all controls relating to financial reporting and also did not require reporting on the "adequacy and operating effectiveness" of such controls.

DIRECTORS RESPONSIBILITY STATEMENT

- The directors' responsibility statement should state that 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**.
- **"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**.

(Section 134(5)(e) of the Companies Act, 2013)

Board's Report should also include:

Details in respect of **adequacy of Internal financial controls with reference to the financial statements**

(Rule 8(5)(viii) of Companies (Accounts) Rules, 2014)

- The inclusion of the matters relating to internal financial controls in the directors' responsibility statement is in addition to the requirement for the directors to state that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act and for preventing and detecting fraud and other irregularities.

Auditor's Responsibility

- Auditors are required to express an opinion on:
  - the effectiveness of an entity's internal controls over financial reporting,
  - the financial statements
- The objectives of the audit of ICFR and audit of financial statements are not identical, the auditor plans and performs the work to achieve the objectives of both the audits in an integrated manner.
- To form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain sufficient appropriate evidence to obtain reasonable assurance about whether material weakness exists
- A material weakness in internal financial controls may exist even when the financial statements are not materially misstated.

Applicability of reporting in the case of unlisted companies

- Directors' Statement of Responsibility under Section 134 (5)(e) over establishing adequate internal financial controls and asserting operating effectiveness of such controls of the company only in case of listed companies.

Applicability of reporting in the case of unlisted companies

It may however be noted that Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of following companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements". *

- Every listed company; &
- Every other public company having a paid up share capital of twenty five crore rupees or more calculated at the end of the preceding financial year *(Rule 8(4) of the Companies (Accounts) Rules, 2014)*

**Pending clarification from MCA, it appears that the auditor is required to report on adequacy and operating effectiveness of internal financial controls even in the case of unlisted companies.*

Reporting Requirements for Interim & Consolidated financial statements

- Reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

- Reporting on internal financial controls are not intended to apply in the case of the consolidated financial statements.

Internal Financial Control over Financial Reporting

A company's internal financial control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements."

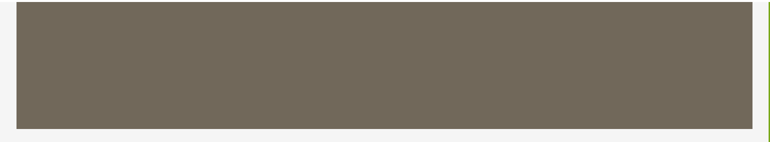
Clause 49 Vs. Internal Financial Controls

- The concept of Internal financial controls is not new in India for listed companies.
- Clause 49 of the Equity Listing Agreement requires certification by the CEO / CFO stating that
  - they accept responsibility for establishing and maintaining internal controls for financial reporting
  - that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting
- In IFC auditor also has to give his opinion on the operating effectiveness of internal controls.

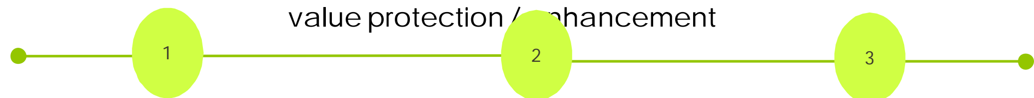
Framework for developing, establishing and reporting on internal controls

- Frameworks enable organisation to effectively and efficiently develop systems of internal control.
- Adopting any one or a combination of benchmark framework of internal control is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control.
- Some of the common international frameworks are:

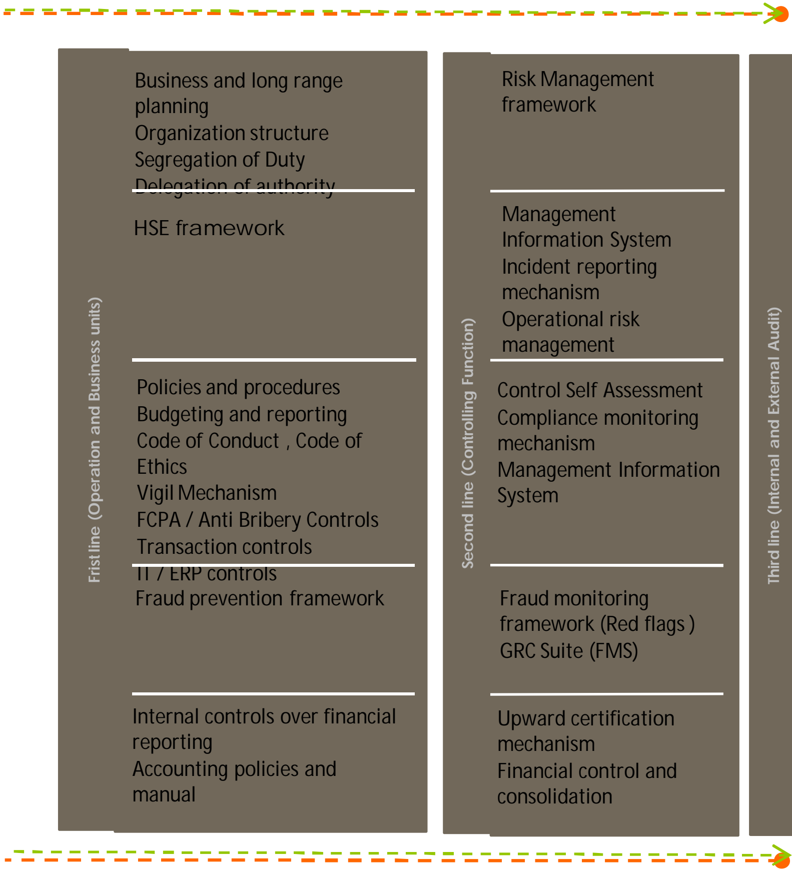
- COSO Framework
- Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants
- Report published by the Institute of Chartered Accountants in England & Wales “Internal Control: Guidance for Directors on the Combined Code”



Three Lines of defense model towards value protection / enhancement



IFC Components



IFC Components	Fristline (Operation and Business units)	Second line (Controlling Function)	Third line (Internal and External Audit)
Orderly and efficient conduct of business	Business and long range planning Organization structure Segregation of Duty Delegation of authority	Risk Management framework	Internal Audit External Audit
Safeguarding of its assets	HSE framework	Management Information System Incident reporting mechanism Operational risk management	HSE Audits Other regulatory audits
Adherence to company's policies	Policies and procedures Budgeting and reporting Code of Conduct , Code of Ethics Vigil Mechanism FCPA / Anti Bribery Controls Transaction controls IT / ERP controls	Control Self Assessment Compliance monitoring mechanism Management Information System	Internal Audit External Audit ISO Audits Other operational / regulatory audits
Prevention and detection of frauds and errors	Fraud prevention framework	Fraud monitoring framework (Red flags) GRC Suite (FMS)	Internal Audit External Audit
Accuracy and completeness of the accounting records AND Timely preparation of reliable financial information	Internal controls over financial reporting Accounting policies and manual	Upward certification mechanism Financial control and consolidation	Internal Audit External Audit

Integrated reporting on Design and Operating effectiveness of internal financial controls

COSO Overview

- COSO stands for the Committee of Sponsoring Organizations which includes the American Institute of CPAs (AICPA), the American Accounting Association (AAA), the Institute of Internal Auditors (IIA), the Institute of Management Accountants (IMA), and the Financial Executives Institute (FEI). The group published Internal Control—Integrated Framework in 1993
- SOX 404 requires that a structured and generally accepted internal controls framework be adopted and followed
- COSO is the standard framework for SOX 404 (Internal Control)
- SEC and PCAOB both specifically state that COSO is an acceptable framework

Key provisions of SOX Act, 2002

SOX Act, 2002

Section 302

Expanded representations by certifying officers

Section 409

Disclosure of material changes on a "rapid and current basis"

Section 906

Focused representations by certifying officers linked to criminal provisions of the Act

Section 404

Assessment of the effectiveness of internal controls and attestation from independent public accountants

COSO – Definition of Internal Control

Meaning of internal control under COSO Framework:

"Internal control is a process, **designed to provide reasonable assurance** regarding the achievement of objectives relating to operations, reporting, and compliance."

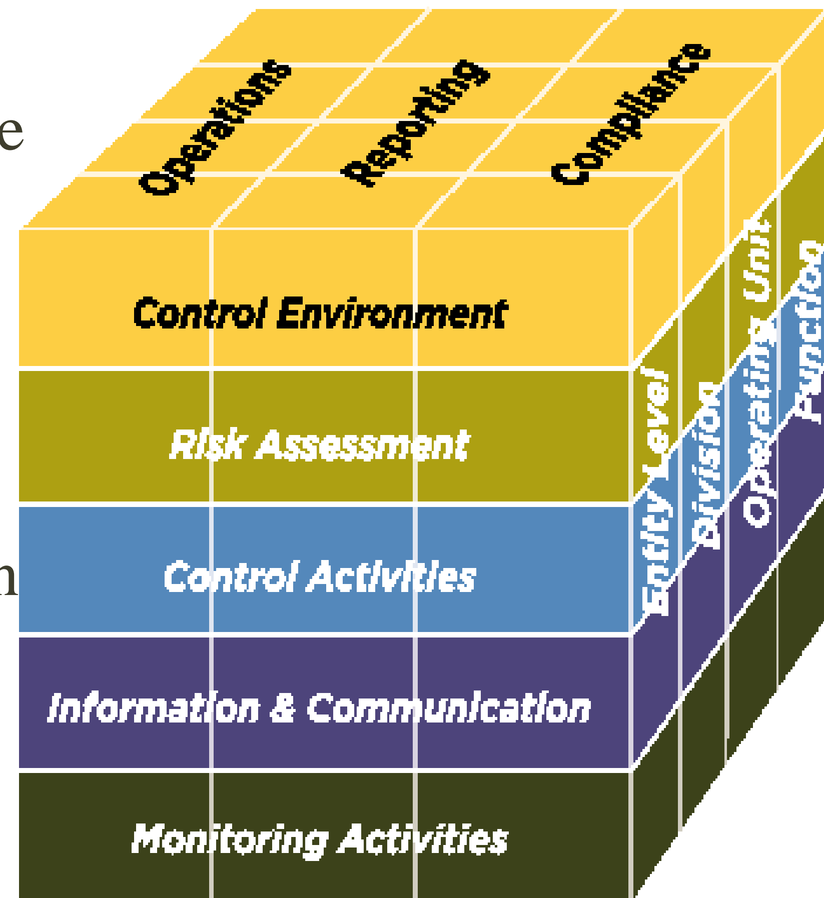
The COSO Framework provides for three categories of objectives:

- **Operations Objectives** - These pertain to effectiveness and efficiency of the entity's operations
- **Reporting Objectives** - These pertain to internal and external financial and non-financial reporting
- **Compliance Objectives** - These pertain to adherence to laws and regulations to which the entity is subject.

COSO Framework

Supporting the organisation in its effort to achieve objectives are five components of internal control:

a) control environment,
b) risk assessment,
c) control activities,
d) information and communication and
e) monitoring activities.



Control Environment

- Set of standards, processes, and structures that provide the basis for carrying out internal control across the organisation.
- The BOD and senior management establish the tone at the top regarding the importance of inter-nal controls
- The control environment comprises:
  - the integrity and ethical values of the organization
  - the organisational struc-ture and assignment of authority and responsibility
  - the process for attracting, develop-ing, and retaining competent individuals
  - The rigor around performance measures, incentives, and rewards to drive accountability for performance

Risk Assessment

- Risk is defined as the possibility that an event will occur and adversely affect the achievement of objec-tives
- Risk may be from internal and external sources
- Risk assessment forms the basis for determining how risks will be managed.
- A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity.
- Risk assessment also requires management to consider the impact of pos-sible changes in the external environment and within its own business model

Control Activities

- The actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives
- May be preventive or detective in nature
- May encompass a range of manual and automated activities
- Control Activities are:
  - Authorisations and approvals,
  - Verifications,
  - Reconciliations,
  - Busi-ness Performance Reviews, and
  - Segregation of duties.

Information and communication

- Management obtains or generates and uses relevant and quality information from both **internal and external sources** to support the functioning of other components of internal control
- Communication is the continual process of providing, sharing, and obtaining necessary information.
- Internal communication is the means by which information is disseminated throughout the organisation, flowing up, down, and across the entity.
- External communication is twofold: it enables inbound communication of relevant exter-nal information, and it provides information to external parties in response to require-ments and expectations.

Monitoring Activities

- Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control is present and functioning
- Ongoing evaluations, built into business processes at different levels of the entity, provide timely information.
- Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations
- Findings are evaluated against criteria established by regulators, recognised standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of direc-tors as appropriate.

Entity Level Controls

COSO is applied at two levels – at the entity level and at the process or activity level.

Entity Level Controls (Company level controls)

- These are controls that management relies on to establish the appropriate "tone at the top" relative to financial reporting.
- Entity level controls have a pervasive impact on the effectiveness of controls at the process, transaction or application level. At the entity level, each of the 5 COSO components should be considered.

Entity Level Controls

Examples (Entity Level Control):

- Code of conduct/ethics – Control Environment
- Adequate training - Control Environment
- Established risk identification practices - Risk Assessment
- Reliable IT systems - Information & Communication
- Whistle-blowing program - Information & Communication
- Internal audit function – Monitoring
- Self assessments - Monitoring

Process Level Controls

- The COSO framework is also applied at the activity or process level in same manner at entity level. At the process level, each of the 5 COSO components is considered, though from a practical standpoint it would consist mostly of **control activities** and **monitoring**.

- **Control activities** are embedded within the process and they provide assurance that that the processes are preventing and detecting errors and irregularities as close as possible to the source and that relevant assertions are being met.

- **Monitoring** provides assurance that control activities are being performed as intended. Example – Bank reconciliation review

Key Examples

Entity Level Controls

- Company M has a number of operations throughout the country. The CEO recently announced the rollout of a new code of conduct program throughout the organization.
- Yearly, the strategic business development plan is reviewed and updated.
- An organization has extensive employee orientation programs. They include communication of the company's mission statement, courses on the benefits of a sound internal control system, and details of procedures to follow when an employee suspects fraudulent behavior.
- A steering committee is responsible for evaluating and balancing the level of skills and outside resources required to complete IT projects satisfactorily.

Key Examples

Process Level Controls

- The accounting manager at Company Y reviews, on a weekly basis, the aged receivables report to determine that items are being collected on a timely basis.
- On a quarterly basis, the group controller reviews a report of all vendors contained in the vendor master file and compares the vendor lists against the list of approved vendors.
- Upon receiving raw materials, all receipts are checked against an authorized purchase order to ensure that the product received was ordered.
- Physical inventory is counted periodically by individuals independent of day-to-day custody or recording of inventory.

Customising The Audit

- The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives.
- The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks.
- Customising is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies.
- Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.

Multi-location Scoping Decision

When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions based on the financial statements of the company as a whole:

- Risk of material misstatement associated with the location should be assessed.
- The amount of audit attention should be correlated with the risk associated
- **In lower risk locations auditor to evaluate ELC**
- **Auditor can also take work performed by others (Location can be divided with Internal Auditor)**
- **Locations should be varied year to year**
- **Audit scope should include acquisition and discontinued operations**

Understanding likely sources of misstatement

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorised, processed, and recorded
- Identify the controls that management has implemented to address these potential misstatements
- Identify the controls that management has implemented over the prevention or timely detection of unauthorised transactions
- The auditor also should understand how Information Technology (IT) affects the company's flow of transactions
- Auditor to perform process walkthrough

Assertions - Understanding "What can go Wrong"

Question	Explanation
What is it?	Risks or errors that could occur related to the internal control assertions for the related cycle (i.e. what could go wrong in the processing stream)
Why do we need them ?	To identify the points where controls are needed To assist with identifying all the relevant risks of errors or fraud, and the mitigating controls To help formulate the additional questions we need to ask to help identify the appropriate controls
How do we develop them ?	By identifying those points within the flow of transactions where there could be a failure (including a failure due to fraud) to achieve the internal control assertions for the related cycle By considering the entire flow of the transaction from initiating to reporting in the general ledger, including both manual and automated aspects

Assertions - Understanding "What can go Wrong"

Question	Explanation
Factors that affect how many you should identify	Complexity of the process Number of opportunities in the process for errors to occur and remain undetected
IT related WCGW are very important	Need to consider IT related WCGWs for significant processes Start by thoroughly understanding process flows including automated aspects Significant automated processing steps will have associated WCGWs.
Outsourced processes	Management is still responsible to ensure that activities outsourced will not generate exposures to the business. WCGW list must include those processes.

Assertions - Understanding "What can go Wrong"

Considerations for WCGW	Explanation
Existence	Assets and liabilities actually exist and transactions as well as accounting events have actually occurred.
Completeness	All assets, liabilities, transactions, and accounting events that should be included have been recorded.
Valuation	The assets and liabilities are presented at appropriate valuations.
Allocation	Transactions and accounting events are recorded at their appropriate valuations, and income and expenses are allocated to the appropriate time periods.
Presentation and Disclosure	Transactions and accounting events are properly presented.
Rights and Obligations	An assertion that an asset or liability pertains to the company at a point in time.

Examples of "What can go Wrong"

- Orders are processed and sales made to fictitious customers resulting in inaccurate sales.
- Invoices are generated/ processed at the time of delivery/ dispatch of product resulting into sales being recorded in incorrect period
- Price master may be set up incorrectly or with unauthorised details leading to incorrect invoicing
- Incorrect inventory adjustments reserve calculated for obsolete/ short dated material
- Adjustment amount for loss on impairment testing is not updated in SAP as per approved calculations

Examples of "What can go Wrong"

- Provision for goods in transit for goods sold is not computed and recorded accurately
- Incorrect/ unauthorised disclosures in the financial statements
- Liabilities for Product Recalls are not computed accurately.
- Deferred Tax Assets/ Liabilities are inaccurately computed impacting the completeness and valuation.

Performing Walkthroughs

- Walkthroughs means:
  - Obtain or update understanding of the entity's flows of transactions.
  - Identify controls that are relevant to the audit and gain an understanding of those controls.
- In performing a walkthrough, the auditor generally follows a single transaction from its origination through the procedures or steps in the process to the transaction's ultimate recording in the general ledger
- Walkthrough help auditor's understanding of how transactions are initiated, authorised, processed, and recorded.
- It is important to differentiate between process and control.
  - A **process** describes the action of taking a transaction or event through an established and usually routine set of procedures or steps.
  - A **control** is an action or activity taken to prevent or detect misstatements within the process

Process flow diagrams

- Understanding process flows – Auditor to understand the information system relevant to the financial reporting, includes:
  - The classes of transactions in the company's operations that are significant to the financial statements
  - The procedures, within both automated and manual systems;
  - The related accounting records, supporting information, and specific accounts
  - The period-end financial reporting process

Process flow diagrams

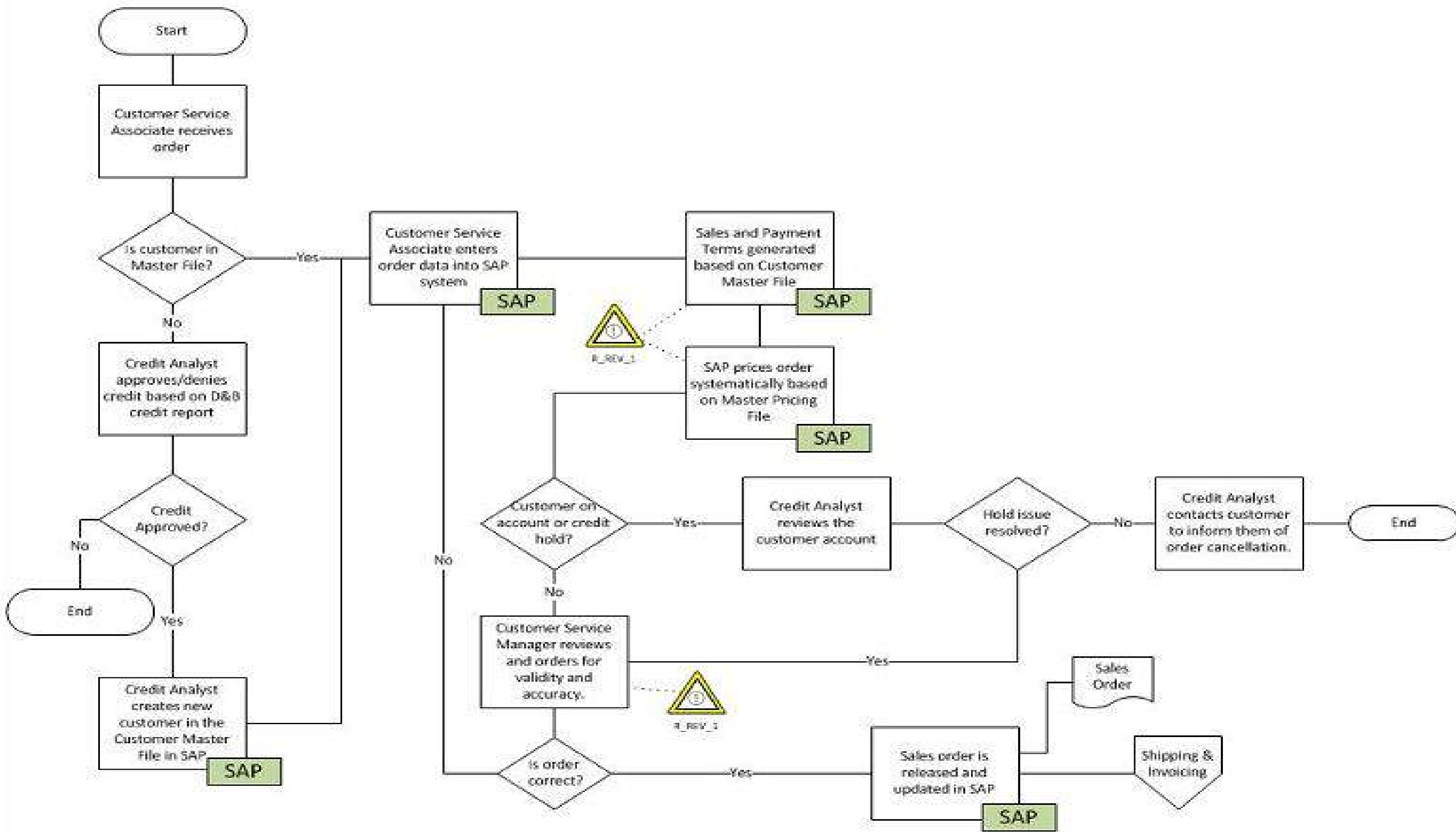
Process flow diagrams – May be helpful in the following questions:

- Who Involves in the process;
- **Are there any SODs;**
- Does the process involve, or impact, multiple locations. etc.

Additional detail may be added to represent the audit-specific elements

- Insert symbol for risk of material misstatement
- use different symbols for significant and normal risk
- Automated and manual control symbols may be used as necessary

Diagram – Order Processing

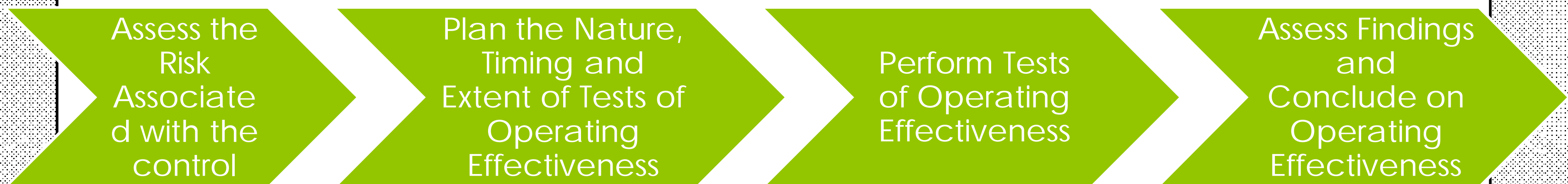


Testing Design Effectiveness

- The objective of testing the design of a control is to determine if a deficiency in design exists
- **A deficiency in design exists when:**
  - **A control necessary to meet the control objective is missing**
  - **An existing control is not properly designed**
- The auditor should test the design effectiveness that controls can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.
- To appropriately evaluate the design of relevant controls, the auditor considers the following elements:
  - The nature and significance of the risks of material misstatement addressed by the control.
  - The characteristics or details of the control.
  - Factors to determine whether the control is appropriately designed to address the identified risk.

Testing controls - testing operating effectiveness

- The auditor should test that the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.
- If a control is not designed properly, it cannot operate effectively
- If the control does not operate effectively then it is a "deficiency in operating effectiveness."
- **Process Flow for testing operating effectiveness**



Assess the risks associated with the controls

Factors that affect the risk associated with a control include:

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions;
- Whether the account has a history of errors;
- The effectiveness of entity-level controls, especially controls that monitor other controls;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (ITGC)
- The competence of the personnel who perform the control

Plan the nature, timing, and extent of tests of operating effectiveness of controls

Plan the Nature of controls:

- The planning for tests of operating effectiveness begins with the detailed description of the control procedure i.e., how the control is performed e.g., who, what, and when
- Planning the nature of the operating effectiveness tests that the auditor is going to perform, depends on two considerations:
  - the risk associated with the control
  - the availability of evidence

Plan the nature, timing, and extent of tests of operating effectiveness of controls

Timing of the test controls:

- The period that is to be covered by the tests
  - **Testing performed closer to the Balance Sheet date provides more evidence than testing performed earlier in the year**
  - **Testing controls over a greater period of time provides more evidence of the effectiveness of controls than would be provided by testing the controls over a shorter period of time**

Perform tests of operating effectiveness of controls

Considerations when performing tests of operating effectiveness include:

- Clearly defining the test objective, including establishing a clear understanding of what constitutes a deviation.
- Identifying the population to be sampled.
- Selecting the sample such that all items in the population have a chance of selection.
- Obtaining sufficient and appropriate audit evidence, including related to Information Provided by Entity upon which the control is dependent.
- Applying professional scepticism when evaluating the persuasiveness of the evidence obtained, including what constitutes a deviation or exception

Evaluating Identified Deficiencies

- A 'significant deficiency' is a deficiency, in internal financial control over financial reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
- A **deficiency in design** exists when
  - a control necessary to meet the control objective is missing
  - an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met
- A **deficiency in operation** exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively

Material Weakness

- **A ‘material weakness’ is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.**
- Indicators of material weaknesses in internal financial controls over financial reporting include:
  - Identification of fraud, whether or not material, on the part of senior management;
  - Errors observed in previously issued financial statements in the current financial year;
  - Ineffective oversight of the company's external financial reporting and internal financial controls over financial reporting by the company's audit committee.

Definitions of deficiencies

Significant Deficiency

- A significant deficiency is a deficiency or a combination of deficiencies in internal controls over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
- **To be communicated by management and the auditor in writing to the Audit Committee**

Material Weakness

- A material weakness is a deficiency or a combination of deficiencies in internal controls over financial reporting such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.
- **Externally reportable in assertion (by management) and in attestable opinion (by external auditor). Existence of a material weakness precludes an unqualified opinion**

Wrapping-up (Forming an opinion)

- The auditor should form an opinion on the effectiveness of internal financial controls by evaluating evidence obtained from all sources
- After forming an opinion on the effectiveness of the company's internal financial controls, the auditor should evaluate the presentation of the elements that management and BOD is required
- The auditor may form an opinion on the effectiveness of internal financial controls only when there have been no restrictions on the scope of the auditor's work.
- A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement.

Obtaining written representations From Management

- Management's responsibility for establishing and maintaining effective internal financial controls;
- Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal financial controls and specifying the control criteria / framework;
- Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal financial controls based on the control criteria as of the Balance Sheet date;
- Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal financial controls identified as part of management's evaluation,

Obtaining written representations From Management

- Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal financial controls;
- The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit.

Communicating certain matters

- The auditor must communicate, in writing, to management and those charged with governance all significant deficiencies identified during the audit
- The written communication should be made prior to the issuance of the auditor's report on internal financial controls.
- If the auditor concludes that the oversight of the company's external financial reporting and internal financial controls by the company's audit committee is ineffective, the auditor must communicate that conclusion in writing to the board of directors
- The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are significant deficiencies
- The auditor also should communicate to management, in writing, all deficiencies in internal financial controls

Reporting on internal financial controls

The auditor's report on the audit of internal financial controls must include the following elements:

- A title that includes the word *independent*;
- A statement that management is responsible for maintaining effective internal financial controls;
- An identification of management's framework on internal control;
- To express an opinion on the company's internal financial controls;
- A statement that the audit was conducted in accordance with the Guidance Note on Audit of Internal Financial Controls;

Reporting on internal financial controls

The auditor's report on the audit of internal financial controls must include the following elements:

- A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;
- A paragraph stating that, because of inherent limitations, internal financial controls may not prevent or detect misstatements
- The auditor's opinion on whether the company maintained, in all material respects, effective internal financial controls as of the Balance Sheet date, based on the control criteria / framework;

Separate Audit Reports

- The auditor may issue separate reports on the company's
- Financial statements and on internal financial controls over
- Financial reporting.

Report date

- The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion.

- The auditor’s reporting on internal controls over financial reporting is specified in the same Section as that of the opinion on financial statements viz. Section 143(3) of the Act, date of report should be the same as that of the date of the audit report on the financial statements.

Audit documentation

The auditor should document the work performed on internal financial controls such that it provides:

- A sufficient and appropriate record of the basis for the auditor's report;
- Evidence that the audit was planned and performed in accordance with this guidance, applicable Standards on Auditing and applicable legal and regulatory requirements.

Responsibilities

Management's	Auditor's
Accept responsibility for the effectiveness of internal control over financial reporting	Design of control over all relevant financial statement assertions relating to significant accounts and disclosures
Evaluate the effectiveness of the company's internal control over financial reporting	Information about how significant transactions are initiated, authorized, recorded, processed and reported
Support its evaluation with sufficient evidence including documentation	To assess controls designed to prevent and detect fraud
Present a written assessment of the effectiveness of the Company's internal control over financial reporting as of the end of the company's most recent fiscal year	To assess controls over period-end financial reporting process
	To test the results of management's testing and evaluation

THANK YOU