Internal controls over financial reporting

A **process designed by**, or under the supervision of, the company's principal executive and **principal** financial **officers**, or persons performing similar functions, **and effected by** the company's **board** of directors, management and other personnel, **to provide reasonable assurance regarding:**

__reliability__ of financial reporting ; and
the __preparation__ of financial statements for __external purposes__
in accordance with __GAAP__ and includes
those policies and procedures that:

* pertain to maintenance of records that in **reasonable details** accurately and fairly reflect the transactions and dispositions of assets of the company.
* provide reasonable assurance that transactions are **recorded as necessary** to permit preparation of financial statements in accordance with GAAP's, and that **receipts and expenditures** of the company are being made only in accordance **with authorizations** of management and directors of the company.
* provide reasonable assurance regarding **presentation or timely detection** of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Annual report must include Internal Control Report of the management that should contain
****

A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting.
Management's 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, including a statement as to whether or not the company's internal control over financial reporting is effective.
A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting."

the above statement is highlighted to show how stringent are laws for internal controls and how important IT is in this context

Who is responsible for implementing internal controls ?

As per SOX, the company's **CEO and CFO are personally and criminally labile** for the quality and effectiveness of their organization's internal controls. Part of process is to **attest to the public** that an organization's internal controls are effective.

* *Internal controls can be expected to provide only a reasonable assurance, not an absolute assurance;*
* *Organization must ensure that its financial statements comply with AS, local rules via policy enforcement and risk avoidance methodology called "Internal controls"*
* *There must be a system of checks and balances.*

Internal Control as per COSO framework

Background

COSO is joint initiative of five private sector organizations, established in the US, dedicated to providing thought leadership to executive management and governance entities on critical aspects of organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting

Internal Control definition by COSO

COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories

* *Effectiveness and efficiency of operations*
* *Reliability of financial reporting*
* *Compliance with applicable laws and regulations.*
* *Safeguarding of Assets (MHA)*

Internal control is comprised of 5 inter-related components

Control environment- S**ets the tone of an organization,** influencing the control consciousness of its people. It is the **foundation for all other components** of internal control, providing discipline and structure.

Risk assessment - Risks **from external and internal sources** that be assessed. Risk assessment is a **prerequisite** for determining how the risks should be managed.

Control activities - This component ensures that necessary actions are taken to address the risks that may hinder the achievement of the **entity's objectives**. They **include a range of activities such** as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and communication - These enable an organization to capture and exchange the information needed to conduct, manage, and control its business processes.

Monitoring - the internal control process must be continuously monitored with modifications made as warranted by changing conditions.

The Sarbanes - Oxley Act of 2002

Background

The Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting reform and Investor protection Act of 2002 and commonly called SOX, **is a US federal law** passed in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco Int. & WorldCom.

These resulted in a decline of public trust in accounting and reporting practices.

Some important provisions of SOX are as follows:

* More independence to be given to Audit Committee and auditor.
* Ban on personal loan to Directors/ Executive Officers of a Company.
* Strict reporting by an auditor on insider trading.
* Additional disclosures imposed on financial reporting.
* The Audit committee is empowered to resolve any conflict between company and its auditor.
* Higher penalties and criminal prosecution on financial frauds, etc.

Laws in India emphasizing internal controls / risk management

Clause 49 of listing agreement has requirements similar to SOX regulation and mandates among other things:

- the implementation of enterprise risk management and internal controls;
- holds the senior management legally responsible for such implementation;
- Most importantly it provides for certification of these aspects by the external auditors;