Guide to Internal Controls over Financial Reporting

Committee on Internal Audit

The Institute of Chartered Accountants of India

(Set up under an Act of Parliament)

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The basic draft of this publication was prepared by CA Satyavati Berera, Gurgaon. The views expressed in this guide are those of the author and may not necessarily be the views of the organisation she represents.

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Foreword

The Indian economy is on the move and passing through a transformation phase. In this dynamic environment, a multitude of proactive measures including adopting international best practices in the realm of governance such as Clause 49 put forward by regulators in the recent past have acted as catalyst in augmenting the growth of Indian corporate sector. In this context, internal controls prevalent in an organisation over financial reporting framework assume special significance. Adherence to regulations and guidelines for internal controls over financial reporting poses a major challenge for many organizations.

I congratulate CA. Abhijit Bandyopadhyay, Chairman, Committee on Internal Audit and his Committee members on the issuance of the Guide to Internal Control over Financial Reporting on a very timely basis which shall also demystify the process of internal control over financial reporting.

I hope that this guide would provide guidance to the auditors as well as the management to understand setting and evaluation process for the CEO/CFO Certification in respect of internal controls over financial reporting.

December 1, 2007
Ahmedabad

CA. Sunil H. Talati
President, ICAI

Preface

Clause 49 issued by the Securities Exchange Board of India requires all listed companies to include in their annual report a certificate of the CEO/CFO in respect of the internal controls over financial reporting. Such report must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting evaluating the effectiveness of such controls, disclosure of deficiencies, if any, including proposed steps for rectification to auditors and audit committee and significant changes in internal control over financial reporting during the year.

In view of the above, the Committee on Internal Audit is issuing the Guide to Internal Control over Financial Reporting to help the members as well as others to understand not only the fundamental concept of the internal control but also the concept of the internal controls over financial reporting.

The Guide is divided into five chapters with a view to provide the guidance regarding the internal control on financial reporting to all the readers. Chapter 1 unfolds the responsibility of CEO/CFO in respect of internal controls as per Clause 49 while the next chapter elucidates elements of internal control. Chapter 3 aims to help the reader to understand the components of the internal controls. Chapter 4 explains the major dimensions to create the internal control framework. This chapter also describes the procedure to evaluate the design of controls. Chapter 5 explains the different phases for process of the CEO & CFO certification. The Guide also contains a Case Study on Sample Documentation and Illustrative CEO/CFO Certificate for the easy understanding of the readers.

I am grateful to CA. Satyavati Berera, a Special Invitee on the Committee, for squeezing the time to prepare the draft of the Guide to help the readers in having an understanding of the concepts of internal control and internal control over financial reporting. My special thanks are due to CA. Harinderjit Singh as a constant source of encouragement in giving final shape to this publication.

I am also thankful to CA. Sunil H. Talati, President and CA. Ved Kumar Jain, Vice President for their continuous support. I also wish to thank all the members of the Committee, CA. Charanjot Singh Nanda, CA. Rajkumar S. Adukia, CA. Atul Chunilal Bheda, CA. Sanjeev Krishnagopal Maheshwari, CA. Mahesh Pansukhlal Sarda, CA. Shanti Lal Daga, CA. J. Venkateswarlu, CA. Anuj Goyal, CA. Amarjit Chopra, Shri Manoj K. Sarkar, CA. Prashant S. Akkalkotkar, CA. Shyam Lal Agarwal, CA. Vivek R. Joshi and CA. Krishan Lal Bansal for their valuable support. My special thanks are also due to CA. Brij Bhushan Gupta and CA. Anil Jain, Special Invitees on the Committee.

I am sure that this will help the readers in setting and evaluating the process of internal control framework over financial reporting.

December 1, 2007
Kolkata

CA. Abhijit Bandyopadhyay
Chairman, Committee on Internal Audit

Contents

1 Background

1.1 Clause 49 of the Listing Agreement has been an important instrument in promoting and strengthening sound governance practices in the companies listed on the recognized stock exchanges in India. From time to time the clause has been revised to not only reflect the growing expectations of the investors as well as the regulators from the listed companies, changes in local laws and regulations but also to help the Indian companies, now spreading wings in even the most developed international economies, benchmark with the international governance best practices. In this line, the clause 49 was revised by the Securities and Exchange Board of India (SEBI) vide its circular No. SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004.

1.2 The revised clause 49 requires the Chief Executive Officer (CEO)/ Chief Financial Officer (CFO) of a listed company to certify their responsibility for and continued existence and operation of ***internal controls*** in the company. They are also required to certify that they had disclosed any deficiency in the design or operation of internal controls to the audit committee and the auditor and that adequate steps have been taken to do away that deficiency.

1.3 The provisions of the revised clause 49 were to be implemented as per the following implementation schedule:

a) For entities seeking listing for the first time, at the time of seeking in-principle approval for such listing.

b) For existing listed entities which were required to comply with the erstwhile clause 49 (i.e. those having a paid up share capital of Rs. 30 million and above or net worth of Rs. 250 million or more at any time in the history of the company), by April 1, 2005.

1.4 Though the abovementioned requirements of the so revised clause 49 were apparently analogous to the similar requirements of section 404 of the Sarbanes Oxley Act of 2002 in existence in the United States of America, there was a significant and critical difference between the two. Whereas the revised clause 49 envisaged the CEO/ CFO certificate in respect of the entire system of ***internal controls*** in the company, section 404 envisaged the same only in respect of ***internal controls over financial reporting***. The provisions of revised clause 49 were, therefore, much larger in scope. SEBI, however, vide its another circular No. SEBI/CFD/DIL/CG/1/2006/13 dated January 13, 2006) did away with the anomaly as follows:

"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:

a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

   i. These statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

   ii. 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.

b) 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.

c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the ***effectiveness of the 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. (emphasis added).

d) They have indicated to the auditors and the Audit committee:

   i. Significant changes in internal control over financial reporting during the year;

   ii. Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

   iii. 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."

1.5 This Guide provides guidance in respect of sub clauses c and d (i) above as they relate to establishment and assessment of internal controls over financial reporting.

2 Introduction

2.1 For a fuller understanding of the requirements of sub clauses (c) and (d)(i) of the revised clause 49 of the Listing Agreement, it is necessary to understand the concept of internal controls and internal controls over financial reporting[1]. *Internal control*[2] is defined 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:

a) Effectiveness and efficiency of operations.

b) Reliability of financial reporting.

c) Compliance with applicable laws and regulations.

2.2 Internal control comprises of five interrelated components as follows[3]:

a) Control environment.

b) Entity's risk assessment process.

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1. The concepts of "internal control" and "internal control over financial reporting" have been discussed in details in Chapter 3.
2. International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment.*
3. International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment.*

c) Information and communication.

d) Control activities, and

e) Monitoring.

2.3 From the above, internal control over financial reporting (ICFR) may be defined as a process effected by a company's board of directors, management and other personnel, designed to provide reasonable assurance regarding the reliability of the financial reporting process and the preparation of the financial statements of the company in accordance with the generally accepted accounting practices.

2.4 The following key implications of clause 49 should also be appreciated:

a) That internal controls relating to financial reporting are adequately designed and operating.

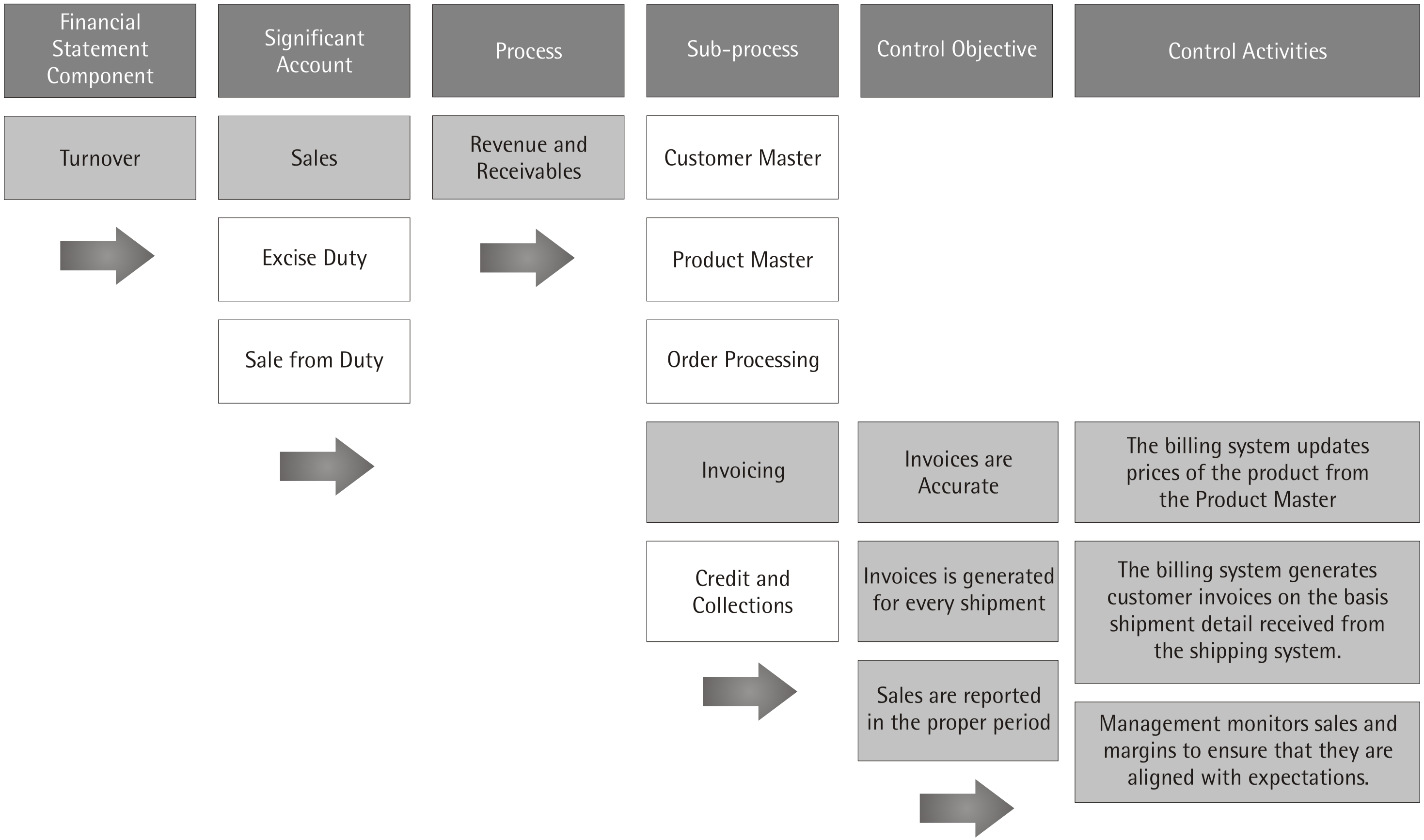
b) That management is required to demonstrate that for key elements of the financial statements, there are adequate controls built into the underlying processes to ensure reliable financial reporting.

c) That management is able to demonstrate, by a process of verification, that the controls built are operating throughout the year.

d) That once this process has been set up and internal control framework created, the CEO/ CFO would be in a position to issue the internal controls certificate.

e) That determining whether a particular internal control system is "effective" is a subjective judgment resulting from an assessment of whether the five components of Internal Control as defined by ISA 315 are present and functioning effectively.

2.5 Although all the above five criteria must be satisfied, this does not mean that each component should function identically, or even at the same level, in different entities. Since controls serve a variety of purposes, controls in one component can serve the purpose of controls that might normally be present in another component. These key concepts along with the linkage to revised clause 49 are elucidated through the means of the following illustration.



A financial statement component is mapped to process/ sub process to establish the relevant internal controls over that financial component. By further establishing the control objective for each sub-process, relevant key internal control are identified. Certification is provided post evaluation of design and operating effectiveness of the internal controls over financial reporting.

For the purposes of this illustration, control objectives and relevant internal controls have been documented for only one sub-process *viz.* invoicing.

2.6 Similar to the manner Accounting Standards and other generally accepted accounting practices in India that are used as benchmarks of the truth and fairness of the financial statements and which ultimately forms a basis for a statutory audit opinion, the framework of internal controls as described in International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*[4], may be used as the basis of assessing the adequacy of internal controls, which ultimately forms a basis for giving an opinion on internal controls. The Guide builds on the concepts and those principles to provide a framework to help organizations implement and evaluate internal controls over financial reporting thereby assisting them in complying with the requirements of the revised Clause 49 of the Listing Agreement.

2.7 The Guide recognizes that an entity must first have in place an appropriate set of financial reporting objectives. At a high level, the objective of financial reporting is to prepare reliable financial statements, which involves attaining reasonable assurance that the financial statements are free from material misstatement. Flowing from this high level objective, management establishes supporting objectives related to the company's business activities and circumstances and their proper reflection in the company's financial statement accounts and related disclosures. **The Guide is principles-based and, therefore, requires exercise of judgment.** Management must determine whether the organization's controls, in aggregate are designed and implemented to achieve effective internal controls over financial reporting. This Guide is aimed at helping management, external auditors as well as internal auditors in that determination.

Structure of this Guidance

2.8 The following Chapters of the Guide systematically provide guidance on how controls relating to financial reporting should be documented and assessed. The Guide begins with the definition of internal control and discusses its fundamental concepts. It then explains the concept of internal controls over financial reporting. In setting out the process to be followed for creating the

4 Issued by the International Auditing and Assurance Standards Board (IAASB) in December 2006. The I S A 315 is largely based on the COSO Integrated Framework for Internal Controls, issued by the Committee of Sponsoring Organistaions of the Treadway Commission. The Institute of Chartered Accountants of India is also in the process of bringing out a Standard on Auditing corresponding to ISA 315.

internal control framework needed for CEO/ CFO certification on internal controls over financial reporting, this Guide articulates the need for management to identify significant accounts and determine the significant business processes and sub-processes that generate these significant accounts. This is discussed in greater detail in Chapter 4, *Creating the Internal Control Framework*.

3

Internal Controls over Financial Reporting

Definition[5]

3.1 As mentioned in Chapter 2, ***internal control*** is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of entity's objectives with regard to effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.

3.2 This definition reflects certain fundamental concepts about internal control *viz.*:

a) *It is a process* - It's a means to an end, not an end in itself.

b) *It is effected by people* - It's not merely policy manuals and forms, but people at every level of an organization.

c) *It can provide only reasonable assurance*, not absolute assurance, to an entity's management and board this is because of the certain inherent limitations of internal control.

d) *It is geared to achieve objectives* in one or more separate but overlapping categories.

Each of these concepts are explained in the following pages.

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5. The definition of internal control and concepts has been taken from Internal Control - Integrated Framework issued by the Committee of Sponsorin Organisations of the Treadway Commission.

A Process

3.3 Internal control is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions are pervasive, and are inherent in the way management runs the business. Business processes, which are conducted within or across organization units or functions, are managed through the basic management processes of planning, executing and monitoring. Internal control is a part of these processes and is integrated with them. It enables them to function and monitors their conduct and continued relevance. It is a tool used by management and not a substitute for management.

3.4 The internal control system is intertwined with an entity's operating activities and exists for fundamental business reasons. Internal controls are most effective when they are built into the entity's infrastructure and are part of the essence of the enterprise. They should be “built in” rather than “built on.” “Building in” controls can directly affect an entity's ability to reach its goals, and supports businesses' quality initiatives. The quest for quality is directly linked to how businesses are run, and how they are controlled. Quality initiatives become part of the operating fabric of an enterprise, as evidenced by:

a) Senior executive leadership ensuring that quality values are built into the way a company does business.

b) Establishing quality objectives linked to the entity's information collection and analysis and other processes.

c) Using the knowledge of competitive practices and customer expectations to drive continuous quality improvement.

These quality factors parallel those in effective internal control systems. In fact, internal control not only is integrated with quality programs, it usually is critical to their success.

3.5 Building in controls also has important implications to cost containment and response time. Most enterprises are faced with highly competitive marketplaces and a need to contain costs. Adding new procedures separate from existing ones adds costs. By focusing on existing operations and their contribution to effective internal control, and building controls into basic operating activities, an enterprise often can avoid unnecessary procedures and costs. A practice of building controls into the fabric of operations helps trigger development of new controls necessary to new business activities. Such automatic reaction makes entities more nimble and competitive.

People

3.6 Internal control is effected by a board of directors, management and other personnel in an entity. It is accomplished by the people of an organization, by what they do and say. People establish the entity's objectives and put control mechanisms in place.

3.7 Similarly, internal control affects people's actions. Internal control recognizes that people do not always understand, communicate or perform consistently. Each individual brings to the workplace a unique background and technical ability, and has different needs and priorities. These realities affect, and are affected by, internal control. People must know their responsibilities and limits of authority. Accordingly, a clear and close linkage needs to exist between people's duties and the way in which they are carried out, as well as with the entity's objectives.

3.8 The organization's people include the board of directors, as well as management and other personnel. Although directors might be viewed as primarily providing oversight, they also provide direction and approve certain transactions and policies. As such, boards of directors are an important element of internal control. The responsibility of the various people to internal controls is set out in *Appendix I*.

Reasonable Assurance

3.9 Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that human judgment in decision-making can be faulty, persons responsible for establishing controls need to consider their relative costs and benefits, and breakdowns can occur because of human error or mistake. Additionally, controls can be circumvented by collusion of two or more people. Finally, management has the ability to override the internal control system.

Objectives

3.10 Every entity sets out on a mission, establishing objectives it wants to achieve and strategies for achieving them. Objectives may be set for an entity as a whole, or be targeted to specific activities within the entity. Though many objectives are specific to a particular entity, some are widely shared. For e.g., objectives common to virtually all entities are achieving and maintaining a positive reputation within the business and consumer communities, providing reliable financial statements to stakeholders, and operating in compliance with laws and regulations.

Objectives fall into three categories:

a) *Operations*: relating to effective and efficient use of the entity's resources.

b) *Financial Reporting*: relating to preparation of reliable published financial statements.

c) *Compliance*: relating to the entity's compliance with applicable laws and regulations.

This categorization allows focusing on separate aspects of internal control. These distinct but overlapping categories (a particular objective can fall under more than one category) address different needs and may be the direct responsibility of different executives. This categorization also allows distinguishing between what can be expected from each category of internal control.

3.11 An internal control system can be expected to provide reasonable assurance of achieving objectives relating to the reliability of financial reporting and compliance with laws and regulations. Achievement of those objectives, which are based largely on standards imposed by external parties, depends on how activities within the entity's control are performed. However, achievement of operations objectives - such as a particular return on investment, market share or entry into new product lines - is not always within the entity's control. Internal control cannot prevent bad judgments or decisions, or external events that can cause a business to fail to achieve operations goals. For these objectives, the internal control system can provide reasonable assurance only that management and, in its oversight role, the Board is made aware, in a timely manner, of the extent to which the entity is moving towards those objectives.

Components

3.12 As stated earlier, internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. The components are:

Control Environment

3.13 The core of any business is its people - their individual attributes, including integrity, ethical values and competence - and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests. The following are, therefore, the important elements of the control environment:

i. Communication and enforcement of integrity and ethical values.

ii. Commitment to competence.

iii. Participation by those charged with governance.

iv. Management philosophy and operating style.

v. Organizational structure.

vi. Assignment of authority and responsibility, and

vii. Human resource policies and practices.

Risk Assessment

3.14 The entity must be aware of and deal with the risks it faces. It must set objectives, integrated with the sales, production, marketing, financial and other activities so that the organization is operating in concert. It also must establish mechanisms to identify, analyze and manage the related risks. ISA 315 describes that, from the perspective of financial reporting, the entity's risk assessment procedures normally include:

i. Management's process to identify relevant risks.

ii. Estimation of their significance.

iii. Assessment of the likelihood of their occurrence, and

iv. Decisions as to respond to them and manage them and their results.

3.15 Further, the financial reporting is also subject to risks arising from a number internal and external transactions, events or circumstances. These factors may adversely affect the company's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial statements. e.g.s of some of these risks are:

- Change in operating environment
- New personnel
- Rapid growth
- New technology
- New business models, products, or activities
- Corporate re-structurings
- Expanded foreign operations
- New accounting pronouncements.

Control Activities

3.16 Control policies and procedures must be established and executed to help ensure that the actions identified by management as necessary to address risks to achievement of the entity's objectives are effectively carried out. Control activities comprise the following:

i. Performance reviews these include comparison of actual performance *vis-a-vis* budgeted and/ or prior period performance.

ii. Information processing this involves two types of controls application controls and general IT controls. Application controls apply to the processing of individual applications, whereas general IT controls refer to policies and procedures that relate to many applications and support the effective functioning of application controls by ensuring that the information systems operate properly on a continuous basis.

iii. Physical controls these controls encompass physical security of assets, authorization for access to computer programs and data files; and verification and reconciliation of assets as shown by the control records *vis-a-vis* actuals.

iv. Segregation of duties these controls are aimed at reducing the opportunities for perpetrating and concealing frauds/ errors.

Information and Communication

3.17 Surrounding these activities are information and communication systems. These enable the entity's people to capture and exchange the information needed to conduct, manage and control its operations. Information systems relevant to financial reporting objectives include methods and records which:

i. identify and record all valid transactions.

ii. describe the transactions in relevant details and on a timely manner so as to enable proper classification.

iii. measure the value of transactions in a manner that enables recording of proper monetary value in the financial reporting.

iv. determine the time period in which the transaction occurred so that the same are recorded in appropriate accounting period.

v. ensure proper presentation and disclosures in the financial statements.

Monitoring

3.18 The management is responsible not only for establishing a system of internal controls but also for ensuring that they are effective and operate on an ongoing basis. The entire process must be monitored, and modifications made as warranted by the changing circumstances.

3.19 There is a direct relationship between objectives, which are what an entity strives to achieve, and the components, which represent what is needed to achieve the objectives. For instance, financial and non-financial data generated from internal and external sources, which is part of the information and communication component, is needed to effectively manage business operations, develop reliable financial statements and determine that the entity is complying with applicable laws.

3.20 As mentioned earlier, ***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. 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.

4

Creating the Internal Control Framework

4.1 There are three major dimensions relating to creation of an internal control framework *viz.*:

a) Materiality considerations.

b) Process level risk and control documentation.

c) Entity level considerations control environment.

Each of these is explained below.

Materiality Considerations

4.2 Just as any other aspect relating to accounting or auditing of financial statements, materiality needs to be considered for evaluation of design and operating effectiveness of internal controls. Materiality drives the decision of identifying significant accounts and related processes/ sub-processes that need to be evaluated.

4.3 The notion of materiality should not be based solely on a quantitative measure. Certain accounts may be significant on a qualitative basis or because they represent an important performance measure to investors. For purposes of determining significant accounts, management should assess the likelihood of a misstatement without giving any consideration to the effectiveness of internal control over financial reporting. Significant accounts and disclosures are identified at the consolidated financial statement level and individual account/ component or disclosure level (e.g., inventory may comprise finished goods, work-in-process, and raw materials, or revenue may comprise product revenue and service revenue).

Quantitative Considerations

4.4 In order to determine which accounts are significant, management must consider materiality. The same definition of materiality that applies to the preparation of financial statements applies to planning and reporting the effectiveness of internal control over financial reporting. Management may consider overall materiality for determining significant accounts. Overall materiality involves the risk of material misstatement of the consolidated financial statements. Applying a materiality threshold (e.g., 5 percent) against certain key metrics, such as profit before tax (loss), is useful for making an assumption about whether an item is likely to be material.

4.5 Overall materiality levels should be documented, along with the rationale behind the quantitative materiality levels and any changes in the determination of materiality that arise during the course of the project.

Qualitative Considerations

4.6 e.g.s of qualitative factors that may be considered when assessing the significance of an account are set out below:

a) Composition of the account.

b) Susceptibility to loss due to errors or fraud.

c) Volume of activity, complexity, and homogeneity of the individual transactions processed through the account.

d) Nature of the account (for e.g., suspense accounts generally warrant greater attention).

e) Accounting and reporting complexities associated with the account

f) Exposure to losses represented by the account.

g) Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account.

h) Existence of related-party transactions in the account.

i) Changes in account characteristics since the previous period (for e.g., new complexities, subjectivity, or types of transactions).

Process Level Risks and Controls Documentation

4.7 Once the significant accounts have been identified using materiality considerations, the management determines the company's significant business processes and sub-processes that generate the significant accounts. By understanding and documenting the business processes in flowcharts, management is able to identify the control activities that address the control objectives as well as potential “gaps” in the controls as well as ensure that all aspects of a process are captured.

4.8 The processes/ sub-processes so identified are mapped to the significant accounts already identified. Mapping is an exercise performed to link significant accounts to the business processes or sub-processes that generate them. This also ensures that all significant accounts have been addressed by a business process and that all significant business processes have been identified. If management fails to identify all of the processes, it is difficult to determine the corresponding control activities.

4.9 Post the mapping, control objectives for each of the sub processes are established. Key controls within each of the sub-processes to achieve the control objectives are documented and evaluated/ tested for design and operating effectiveness.

Evaluating Design and Operating Effectiveness of Internal Control

4.10 Once the internal controls have been understood and documented with focus to the components identified in ISA 315, they need to be tested for design and operating effectiveness. Management evaluates the effectiveness of the design of controls related to each component of internal control. This evaluation also includes entity level considerations, control environment and process level controls. While assessing design effectiveness, managements focus on:

a) Knowledge and experience of the people involved in performing the controls.

b) Segregation of duties relevant to the process being controlled.

c) Timeliness in addressing issues and exceptions that result from the control activity.

d) Reliability of the information used in the performance of the control.

e) Period covered by the control.

f) The alignment between the controls and the risks identified (i.e., whether the business processes and related controls appear to be effective in achieving management's stated objectives and managing its risks).

(g) In evaluating the level of assurance provided by a given control, management should consider the nature of the control, how the control is applied, the consistency with which it is applied, and who applies it.

Evaluating the Design of Control

4.11 Internal controls over financial reporting are effectively designed when the controls complied with would be expected to prevent or detect errors or frauds that could result in the material mis-statement in the financial statements. The evaluator should determine whether company has controls to meet the objectives of the control criteria by:

a) Identifying the controls objectives in each area.

b) Identifying the controls that satisfy each objective.

c) Determining if the controls can efficiently present or defect errors or frauds.

4.12 Walk through procedures are performed to evaluate the design effectiveness and they are done with a specific purpose.

Walkthrough through a control should answer the following questions:

a) Who is performing the control?
b) What is being done and what could go wrong?
c) When and where are the controls occurring or being performed?
d) Why are controls being performed?

4.13 Walkthroughs should be able to achieve the following purposes:
a) Confirm the process flow of transactions.
b) Confirm the understanding of controls design.
c) Confirm that the understanding is complete.
d) Evaluate the effectiveness of design.
e) Confirm that the controls are placed in operation.

Based on the result of walkthrough, the design of control could be assessed and rectified.

4.14 Controls designed to be effective also must operate effectively. If the controls are operating in the manner and for the purpose for which they were designed, there is reasonable assurance on the effectiveness of internal controls. This requires testing the controls over all processes, business unit and locations. The effectiveness of controls is tested at three levels, i.e., entity level controls, general computer controls and business process controls. Testing of internal controls can be viewed as a four step process:

Step 1: Identify Controls to be Tested

4.15 Organizations test the controls documented in the Internal Control Framework. These are evaluated across all business units, locations and processes. This evaluation also includes Entity Level Considerations Control Environment (explained later in this section). The evaluation of such controls generally requires judgment and qualitative analysis.

Step 2: Identify Responsibility for Testing

4.16 The management may evaluate the operating effectiveness based on procedures such as testing of controls by internal audit, testing of controls by others under the direction of management, inspecting evidence of the application of controls, or testing by means of a self assessment process.

Step 3: Develop and Execute the Test Plans

4.17 The management is responsible for determining the nature, timing and extent of its testing procedures to evaluate operating effectiveness. Formal test plans should be prepared to facilitate review and approval by the management. The test plans should document the key elements of the test and the results. Test plans should cover all controls that are selected for testing and should specify the nature and extent of testing required.

Extent of Testing

4.18 In order to decide the extent of testing the management may evaluate the control based on the control frequency and control method i.e., manual or automated as determined and documented in the in the Internal Control Framework. In determining the extent of procedures to perform, management should design the procedures to provide a high level of assurance that the control being tested is operating effectively. Following factors should be considered while defining extent of testing:

- Nature of control (manual or automated).
- Frequency of control (daily, weekly, monthly quarterly, annually).
- Importance of control (inherent risk, period end processes).

Testing Models

4.19 *Internal Audit*: Internal Audit together with the routine annual audits tests the significant controls identified and communicate to the management on their operation effectiveness.

4.20 *Management/ Cross Functional Testing*: Management personnel from one function can perform the testing for another function. Management testing is also a valuable tool to reinforce operating principles of internal controls that employees are expected to follow.

4.21 *Control Self Assessment (CSA)*: The controls documented in the Internal

Control Framework are self certified by the process owners and the report in form of certificate mentioning the operating efficiency is prepared. Such certification is carried out periodically (e.g., each quarter).

Step 4: Evaluate Test Results

4.20 Results of the testing are evaluated by management to address control gaps trough re-mediation plans and to develop alternate strategies for control testing in succeeding periods, if so required.

The process above has been explained through an illustration set out in *Appendix II.*

4.21 The above activities provide the management with an internal control framework at the process level. However, this process level internal control framework does not consider the control environment in its entirety and hence needs to be evaluated separately. The process of documenting internal controls related to 'entity level considerations control environment' is explained below.

Entity Level Considerations - Control Environment[6]

4.22 One of the key components of internal control is the control environment (also referred to as the 'tone at the top') which is the foundation upon which all other components of internal control are based, and sets the tone of an organization. The control environment has an influence on the way business activities are structured, objectives established and risks assessed. It also influences control activities, information and communication systems, and monitoring activities. It is influenced by the entity's culture and in turn influences the control consciousness of its people.

Some factors considered for control environment with indicative parameters to consider for each of them are set out below:

6. For a fuller understanding of Control Environment, please see COSO Internal Control Integrated Framework. The framework is available at COSO's website www.COSO.org

Integrity and Ethical Values

- Establishment of code of conduct and other policies and procedures.
- Processes to monitor compliance with the laid out code and other policies.
- Corrective actions for deviations from code of conduct and other policies.

Management Philosophy

- Frequency of interaction between senior management and operating management.
- Management's approach in selecting accounting principles.
- Communication of authority and responsibility.

Organizational Structure

- Existence of an organization structure with defined job descriptions for each position.

Assignment of Authority and Responsibility

- Clear objectives are set throughout the organization.
- Appropriate lines of authority, responsibility and reporting for each functional areas have been established.

Human Resources

- Extent to which policies and procedures for hiring, training, promoting and compensating employees are in place.
- Appropriateness of remedial action taken in response to departures from approved policies and procedures.
- Adequacy of employee retention and promotion criteria and information-gathering techniques (e.g., performance evaluations) and relation to the code of conduct or other behavioral guidelines.

Illustrations regarding control environment are set out in *Appendix III*.

5 Process for the CEO & CFO Certification

5.1 The revised clause 49 requires annual certification by CEO/ CFO on the design and operating effectiveness of internal control over financial reporting. The internal control framework explained in the preceding section forms the basis of this certification.

5.2 The certification process is based on a bottom-up approach. Line managers provide assurance on the design and operating effectiveness of internal control based on the internal control framework created.

5.3 The accountability starts with the CEO and CFO and then delegated to various process owners throughout the organization. Regardless of the responsibility of documentation and performance of testing for operational effectiveness, process owners take responsibility for their respective business processes and controls. Process owners provide assurance upwards periodically (e.g., each quarter) to a designated authority (e.g., Chief Risk Officer) to ensure that executive management provides assurance to the senior management on the operations of internal controls, status of deficiencies, changes in design of process and controls.

5.4 The designated authority (e.g. Chief Risk Officer) in turn provides assurance to CEO and CFO on completion of the assessment process and provides assurance to the CEO and CFO that the following have disclosed and reported to the Auditors and the Audit Committee:

a) Deficiencies in the design or operation of internal controls, if any, together with the action taken or proposed to be taken to rectify these deficiencies.

b) Significant changes in internal control during the year.

c) Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements, and

d) Instances of significant fraud of which, if any and the involvement therein, if any, of the management or an employee having a significant role in the Company's internal control system.

5.5 Based on the above, the CEO and CFO provide certification on internal controls to the Board. A sample is enclosed in *Appendix III*.

5.4 Through the SEBI circular appears to require CEO/ CFO certification to the Board on an annual basis, it is recommended that such a certification is actually given out on a quarterly basis (at the end of each quarter). Quarterly certification would ensure that the certification process remains robust and all the deficiencies are identified and remediated in a timely manner.

Appendices

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Appendix I

COSO Internal Control: Integrated Framework - A Summary

1. **Executive Summary**

   Senior executives have long sought ways to better control the enterprises they run. Internal controls are put in place to keep the company on course toward profitability goals and achievement of its mission, and to minimize surprises along the way. They enable management to deal with rapidly changing economic and competitive environments, shifting customer demands and priorities, and restructuring for future growth. Internal controls promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.

   Because internal control serves many important purposes, there are increasing calls for better internal control systems and report cards on them. Internal control is looked upon more and more as a solution to a variety of potential problems.

2. **What Internal Control Is**

   a) Internal control means different things to different people. This causes confusion among businesspeople, legislators, regulators and others. Resulting miscommunication and different expectations cause problems within an enterprise. Problems are compounded when the term, if not clearly defined, is written into law, regulation or rule.

b) This report deals with the needs and expectations of management and others. It defines and describes internal control to:
   i. Establish a common definition serving the needs of different parties.
   ii. Provide a standard against which business and other entities - large or small, in the public or private sector, for profit or not - can assess their control systems and determine how to improve them.

c) Internal control is broadly defined 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:
   i. Effectiveness and efficiency of operations.
   ii. Reliability of financial reporting.
   iii. Compliance with applicable laws and regulations.

d) The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

e) Internal control systems operate at different levels of effectiveness.

Internal control can be judged effective in each of the three categories, respectively, if the board of directors and management have reasonable assurance that:

i. They understand the extent to which the entity's operations objectives are being achieved.

ii. Published financial statements are being prepared reliably.

iii. Applicable laws and regulations are being complied with.

f) While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time.

g) Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

i. ***Control Environment*** **-** The control environment sets 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. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

ii. ***Risk Assessment*** **-** Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

iii. ***Control Activities*** - Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

iv. ***Information and Communication*** - Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

v. ***Monitoring*** - Internal control systems need to be monitoreda process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

h) There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. “Built in” controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions.

i) There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category the effectiveness and efficiency of operations, for instance all five components must be present and functioning effectively to conclude that internal control over operations is effective.

j) The internal control definition with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.

3. What Internal Control Can Do

a) Internal control can help an entity achieve its performance and profitability targets, and prevent loss of resources. It can help ensure reliable financial reporting. And it can help ensure that the enterprise complies with laws and regulations, avoiding damage to its reputation and other consequences. In sum, it can help an entity get to where it wants to go, and avoid pitfalls and surprises along the way.

4. What Internal Control Cannot Do

a) Unfortunately, some people have greater, and unrealistic, expectations. They look for absolutes, believing that internal control can ensure an entity's success that is, it will ensure achievement of basic business objectives or will, at the least, ensure survival.

However even effective internal control can only help an entity achieves these objectives. It can provide management information about the entity's progress, or lack of it, toward their achievement. But internal control cannot change an inherently poor manager into a good one. And, shifts in government policy or programs, competitors' actions or economic conditions can be beyond management's control. Internal control cannot ensure success, or even survival.

b) Internal control can ensure the reliability of financial reporting and compliance with laws and regulations.

This belief is also unwarranted. An internal control system, no matter how well conceived and operated, can provide only reasonable not absolute assurance to management and the board regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the system. Another limiting factor is that the design of an internal control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

c) Thus, while internal control can help an entity achieve its objectives, it is not a panacea.

5. Roles and Responsibilities

a) Everyone in an organization has responsibility for internal control.

i. ***Management*** - The chief executive officer is ultimately responsible and should assume "ownership" of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they're controlling the business. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the unit's functions. In a smaller entity, the influence of the chief executive, often an owner-manager is usually more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

ii. ***Board of Directors*** - Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

iii. ***Internal Auditors*** - Internal auditors play an important role in evaluating the effectiveness of control systems, and contribute to ongoing effectiveness. Because of organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

iv. ***Other Personnel*** - Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

v. A number of external parties often contribute to achievement of an entity's objectives. External auditors, bringing an independent and objective view, contribute directly through the financial statement audit and indirectly by providing information useful to management and the board in carrying out their responsibilities. Others providing information to the entity useful in effecting internal control are legislators and regulators, customers and others transacting business with the enterprise, financial analysts, bond raters and the news media. External parties, however, are not responsible for, nor are they a part of, the entity's internal control system.

6. Organization of COSO Internal Control - Integrated Framework Report

a) This report is in four volumes. The first is this Executive Summary, a high-level overview of the internal control framework directed to the chief executive and other senior executives, board members, legislators and regulators.

b) The second volume, the Framework, defines internal control, describes its components and provides criteria against which managements, boards or others can assess their control systems.

c) The third volume, Reporting to External Parties, is a supplemental document providing guidance to those entities that report publicly on internal control over preparation of their published financial statements, or are contemplating doing so.

d) The fourth volume, Evaluation Tools, provides materials that may be useful in conducting an evaluation of an internal control system.

7. What to Do ?

Actions that might be taken as a result of this report depend on the position and role of the parties involved:

a) ***Senior Management*** - Most senior executives who contributed to this study believe they are basically "in control" of their organizations. Many said, however, that there are areas of their company - a division, a department or a control component that cuts across activities - where controls are in early stages of development or otherwise need to be strengthened. They do not like surprises. This study suggests that the chief executive initiate a self-assessment of the control system. Using this framework, a CEO, together with key operating and financial executives, can focus attention where needed. Under one approach, the chief executive could proceed by bringing together business unit heads and key functional staff to discuss an initial assessment of control. Directives would be provided for those individuals to discuss this report's concepts with their lead personnel, provide oversight of the initial assessment process in their areas of responsibility and report back findings. Another approach might involve an initial review of corporate and business unit policies and internal audit programs. Whatever its form, an initial self-assessment should determine whether there is a need for, and how to proceed with, a broader, more in-depth evaluation. It should also ensure that ongoing monitoring processes are in place. Time spent in evaluating internal control represents an investment, but one with a high return.

b) ***Board Members*** - Members of the board of directors should discuss with senior management the state of the entity's internal control system and provide oversight as needed. They should seek input from the internal and external auditors.

c) ***Other Personnel*** - Managers and other personnel should consider how their control responsibilities are being conducted in light of this framework, and discuss with more senior personnel ideas for strengthening control. Internal auditors should consider the breadth of their focus on the internal control system, and may wish to compare their evaluation materials to the evaluation tools.

d) ***Legislators and Regulators*** - Government officials who write or enforce laws recognize that there can be misconceptions and different expectations about virtually any issue. Expectations for internal control vary widely in two respects. First, they differ regarding what control systems can accomplish. As noted, some observers believe internal control systems will, or should, prevent economic loss, or at least prevent companies from going out of business. Second, even when there is agreement about what internal control systems can and can't do, and about the validity of the “reasonable assurance” concept, there can be disparate views of what that concept means and how it will be applied. Corporate executives have expressed concern regarding how regulators might construe public reports asserting “reasonable assurance” in hindsight after an alleged control failure has occurred. Before legislation or regulation dealing with management reporting on internal control is acted upon, there should be agreement on a common internal control framework, including limitations of internal control. This framework should be helpful in reaching such agreement.

e) ***Professional Organizations*** - Rule-making and other professional organizations providing guidance on financial management, auditing and related topics should consider their standards and guidance in light of this framework. To the extent diversity in concept and terminology is eliminated, all parties will benefit.

f) ***Educators*** **-** This framework should be the subject of academic research and analysis to see where future enhancements can be made. With the presumption that this report becomes accepted as a common ground for understanding, its concepts and terms should find their way into university curricula.

g) We believe this report offers a number of benefits. With this foundation for mutual understanding, all parties will be able to speak a common language and communicate more effectively. Business executives will be positioned to assess control systems against a standard, and strengthen the systems and move their enterprises toward established goals. Future research can be leveraged off an established base. Legislators and regulators will be able to gain an increased understanding of internal control, its benefits and limitations. With all parties utilizing a common internal control framework, these benefits will be realized.

Appendix II

Sample Documentation

Illustration

Facts

PQR Limited's turnover for the year ended 31st March 2007 were Rs. 400 crores, with a growth of 30% from the previous year.

The company recently unveiled a document 'Plan 2012' with an objective to achieve Rs. 1,750 crore turnover in the next five years. With the unveiling of this plan, the company also announced reorganization. Till recently a wide range of employees reported to the owner and CEO. With the reorganization, three different departments were created - sales and customer service, procurement/ inventory and production - to ensure focus on the core activities of the company. Each department now has a person responsible for it, reporting to the Location Heads (Mumbai and Aurangabad) who in turn report to the CEO and CFO. Roles and responsibilities have been clearly defined and a schedule of authority has been established. An ethics policy has also been established and a program for annual self certification exists.

PQR Limited's turnover for the year ended March 31, 2007 was Rs. 400 crore. The company has plants in Mumbai and Aurangabad. While the Mumbai plant accounts for a turnover of Rs. 240 crore, Aurangabad accounts for the balance Rs. 160 crore. Sales from Mumbai plant also comprise export sales aggregating Rs. 2 crore for the same period. During the year, there were sales returns aggregating Rs. 1 crore out of domestic sales. Sales include Rs. 0.1 crore towards sale of scrap.

Under the company's process, the creation of sales orders is initiated by the receipt of a customer's order. The Sales Department creates the sales order in Sales and Accounts Receivable (SAR) module. The selling price is automatically picked from the Product Master. Simultaneously a delivery note is also generated. Goods are picked for distribution within the production department and dispatched to the customer with the delivery note and invoice. Access to Masters Price/ Customer is restricted per terms of the company's IT Policy.

The company allows 30 days credit to all customers and interest is charged at the rate of 9% pa for delayed payments. Any deviation in the credit period is required to be pre-approved by the Head of Sales and Customer Service. All payments are received at the Corporate Office. Cheques/ DDs are received in Accounts department to a designated person and banked the succeeding day. The management reviews the sales, receivables and margin status every month as part of the business review.

The internal control framework created for the illustration is set out in the following pages. This is only an illustration and the presentation here does not suggest that all matters addressed therein need to be considered in evaluating an internal control system, or that all such matters must be presented in order to conclude that a system is effective. Similarly, the internal control framework presented in the succeeding pages does not necessarily represent a complete set of criteria that a company would consider in its evaluation internal controls over financial reporting.

Materiality Considerations

At the outset, financial statement components are mapped to accounts. For instance, in the instant illustration Turnover has been mapped to Sales - Domestic, Sales Export, Excise Duty and Scrap/ Other Sales. This is followed by identifying significant accounts for which internal control framework needs to be created.

As stated earlier this is determined using qualitative and quantitative considerations. Given the facts of the above illustration, sales at both Aurangabad and Mumbai appear significant (each comprising a material amount to the total sales). However, export sales are not considered significant as they form a small percentage (0.5%) of the total sales. Similarly, scrap sales are not considered material.

Sales Return, although insignificant on a quantitative consideration appear significant from qualitative viewpoint.

Bank balances are also considered significant considering the nature of the financial statement component. Since there is no information on cash transactions, they are assumed to be insignificant.

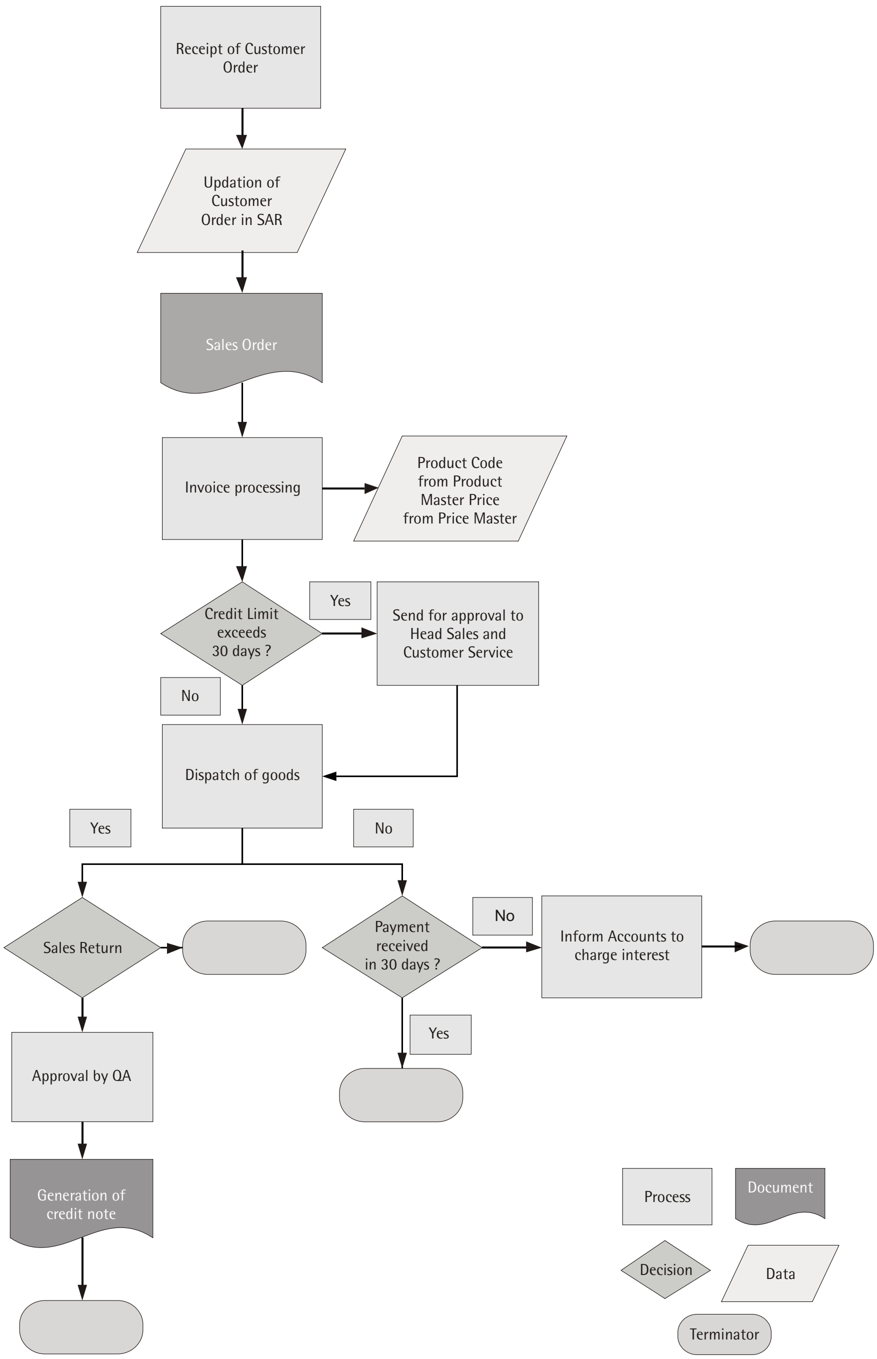
Internal Control Framework

Considering domestic sales at Mumbai and Aurangabad as significant, these are mapped to the Revenue & Receivables process. Revenue & Receivables process is further mapped to various sub-processes *viz.* customer master, order processing, invoicing, credit limits and sales return.

Similarly, Cash and Bank balances are mapped to Bank Balances and Cash Balance. Bank Balances are further mapped to the Revenue and Receivables and Procurement and Payables processes. Sub processes mapped to Revenue and Receivables process for bank balances are Collections (for sales) and Disbursements (for supplier payments).

Control objectives for each of the sub processes are established. Key controls within each of the sub-processes to achieve the control objectives are documented and evaluated for design and operating effectiveness.

Internal Control Framework Process Level
Process Flowchart



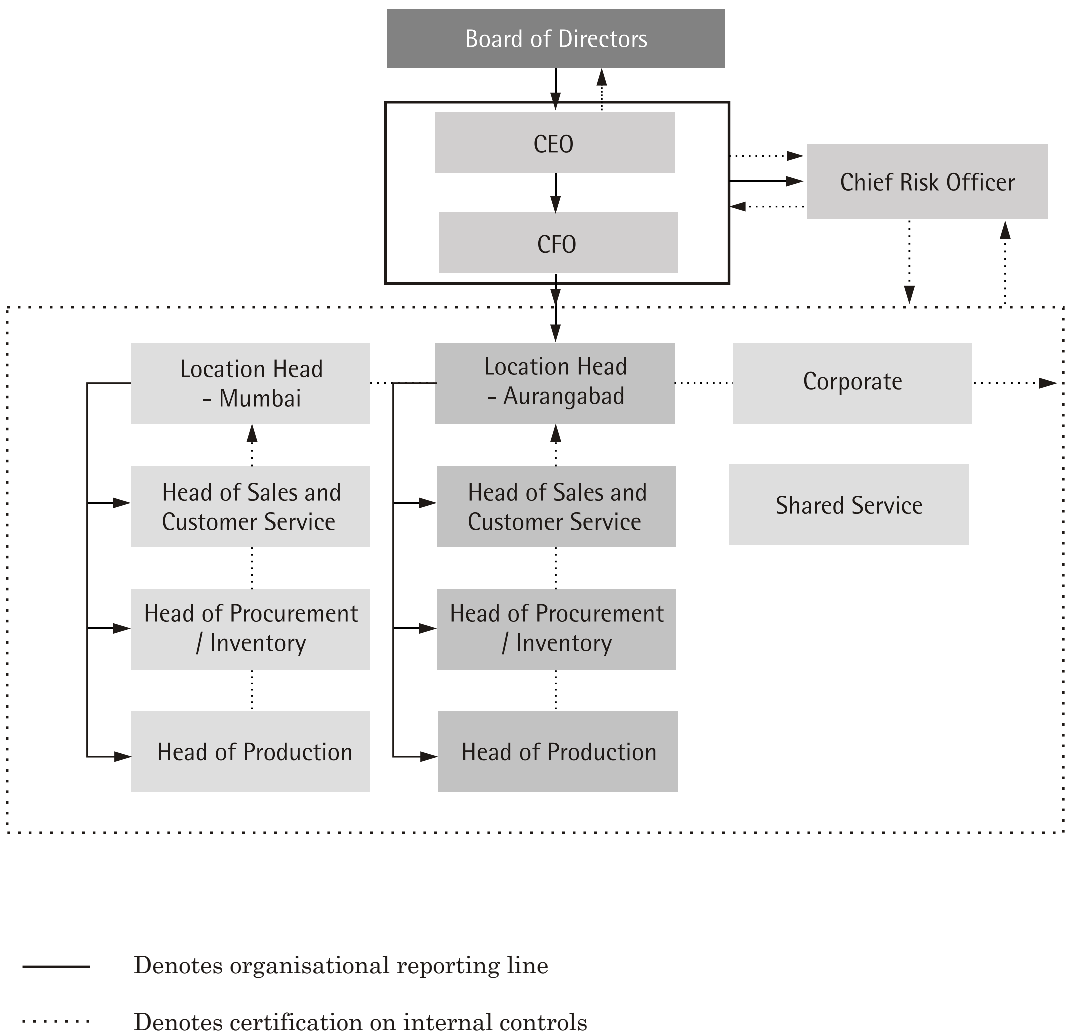
Risk and Control Matrix

Financial Statement Component	Significant Account	Process	Sub-process	Control Objectives	Control Activity
Turnover	Sales	Revenue and Receivables	Customer Master	Only authorized customer codes exist	Access to Customer Master is restricted per terms of the company policy.
			Product Master	Only the correct prices are used	Access to the Product Master is restricted
					Prices field is automatically updated from the Product Master
			Order Processing	Product are dispatched in accordance with sales order	Delivery note is generated with reference to sales order
			Invoicing	Sale Invoice are accurate	Prices field is automatically updated from the Product Master
				Sale Invoice is generated for every shipment and work order	Customer invoices are automatically generated along with delivery note.
				Sale are recorded in the proper period	Management monitors sales and margins to ensure that they are aligned with expectations.
					The finance department reconciles sales in the general ledger with shipments on a weekly basis and follows up any reconciling items. his reconciliation is signed and filed.
			Credit Limits	Credit period given are per the policy	There exists a pre-approval mechanism for deviations from the credit policy.

			Sales returns	Goods returned by customers are recorded in the appropriate period	Goods returned by customer at, before, or after end of an accounting period are scrutinized and reconciled to ensure complete and consistent recording in the appropriate accounting period.
Turnover	Sales	Revenue and Receivables	Sales Returns	Credit nots are accurately calculated and properly recorded	All credit notes are approved by senior management
			Product Master	Only the correct prices are used	Nature, volume and amount of credit notes are reviewed every month
					All returned goods are recorded in a register with customer name, nature of defect, quantity, date of receipt, quality assessment
	Excise duty collected	Revenue and Receivables	Domestic Sales	Excise duty has been correctly charged	Excise duty is defined in the Product Master and Customer Master
					Billing system automatically captures excise duty while invoicing
Cash and Bank Balances	Bank Balances	Revenue and Receivables	Collections	All collections are recorded accurately and completely	All cheques/ drafts are centrally received by a designated authority
					Bank reconciliations are prepared on a weekly basis and reviewed
					Management reviews the status of receivables each month.

Certification Process

The certification process is graphically depicted below.



Review of Internal Control Documentation

Financial Statement Assertions

At the time of review for adequacy of the documentation, the financial statement assertions form a reference point to ascertain whether all the relevant controls that apply to an assertion are documented and have been tested. The financial statement assertions are stated below:

Existence or Occurrence - This assertion addresses whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For e.g., management asserts that finished goods inventories in the balance sheet are available for sale. Similarly, management asserts that sales in the income statement represent the exchange of goods or services with customers for cash or other consideration.

Completeness - This assertion addresses whether all transactions and accounts that should be presented in the financial statements are so included. For e.g., management asserts that all purchases of goods and services are recorded and are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.

Valuation or Allocation - This assertion addresses whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts. For e.g., management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet is stated at net realizable value.

Rights and Obligations - This assertion addresses whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For e.g., management asserts that amounts capitalized for leases in the balance sheet represent the cost of the entity's rights to leased property and that the corresponding lease liability represents an obligation of the entity.

Presentation and Disclosure - This assertion addresses whether particular components of the financial statements are properly classified, described, and disclosed. For e.g., management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described.

A relevant assertion is the assertion that has a meaningful bearing on whether the account or disclosure is fairly stated. In determining whether a particular assertion is relevant, management considers the nature of the assertion, the volume of transactions or data related to the assertion and the nature and complexity of systems, including information technology systems that the entity uses to process and control information that supports the assertion.

Information Processing Objectives

Information processing objectives (completeness, accuracy, validity, and restricted access referred to as "CAVR") are a means to assess the integrity of the data that flows through a process. Information processing objectives are defined as under:

Completeness	–	All recorded transactions are accepted by the system (only once). Duplicate postings are rejected by the system. Any transactions that are rejected are addressed and fixed.
Accuracy	–	Key data elements for transactions (including standing data) that are recorded and input to computer are correct. Changes in standing data are accurately input.
Validity	–	Transactions, including the alteration of standing data, are authorized. Transactions, including standing data files, are not fictitious and they relate to the business.
Restricted Access	–	Unauthorized amendments of data are barred from the system. Confidentiality of data is ensured. Company assets are physically protected from theft and misuse. The segregation of duties is ensured.

Financial Statement Assertions *vis-à-vis* Information Processing Objectives

Although the financial statement assertions appear to be similar to the information processing objectives/ CAVR, there is not a one-for-one relationship, and they are used for different purposes. Information processing objectives (CAVR) are used to evaluate the design effectiveness of controls, particularly application controls, within a business process. Financial statement assertions are representations by management as to the fair presentation of the financial statements.

Appendix III

Illustrations on Control Environment

1. A 3,000 employee company established an ethics policy and a code of conduct. It makes employees aware of the policy and code through posters displayed in the entire work premises. Employees provide a self certification each year on compliance with the terms of the ethics policy and code of conduct. 'Living with Organization Values' is also a parameter to be assessed for each employee as part of the annual performance assessment.

2. A $ 5 billion company prepared an overarching 'Key Philosophies' document. This laid down the key philosophies of the company for each of the key functions in the company (e.g., HR - composition of the organization should reflect the cosmopolitan image of the group. Focus must also be given to maintain geographical balances; a healthy ratio of trainees, probationers and confirmed employees should be maintained). The philosophies document forms the basis of the more detailed policies and procedures.

3. Owing to significant growth and changes in the industry, management realized that roles of the personnel in middle and high level management had to be redefined. Management conducted a workshop where these were

discussed. The CEO was present in the workshop as a moderator. The results of the workshop were communicated to the entire organization. As a result of the changes, polices, procedures and delegation of authority were also aligned to the re-defined roles and responsibilities.

4. As part of interviewing prospective employees, a professional services firm puts significant attention to personal integrity and ethical values with elaborate background checks and in-depth interviews. All new hires are provided with a booklet on the code of conduct and required to self certify compliance.

Appendix IV

Illustrative CEO/ CFO Certificate

(Pursuant to Clause 49 of the Listing Agreement)

The Board of Directors
ABC LIMITED

Pursuant to Clause 49 of the Listing Agreement, this is to certify that :

1. We have reviewed financial statements and the cash flow statement for the year ended and that to the best of our knowledge and belief :
   i. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
   ii. 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.

2. There are, to the best of our 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.

3. We accept responsibility for establishing and maintaining internal controls for financial reporting and that we have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and we have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which we are aware and the steps we have taken or propose to take to rectify these deficiencies.

4. We have indicated to the auditors and the Audit committee:
   i. significant changes in internal control over financial reporting during the year;
   ii. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
   iii. 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.

CFO ____________________ CEO ____________________

Date:

Place:

Notes

Notes

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