STANDARD ON INTERNAL AUDIT (SIA) 120
INTERNAL CONTROLS*

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This Standard on Internal Audit (SIA) 120, "Internal Controls," issued by the Council of the Institute of Chartered Accountants of India (ICAI) should be read in conjunction with the "Preface to the Standards on Internal Audit", "Framework Governing Internal Audits" and "Basic Principles of Internal Audit" issued by the Institute.

***Note:** This Standard on Internal Audit (SIA) supersedes Standard on Internal Audit (SIA) 12, *Internal Control Evaluation*, issued in February 2009.

1. Introduction

1.1 Internal Controls is a key concept in Internal Audit and this Standard seeks to clarify the concept and the responsibility of the Internal Auditor, Management and other stakeholders, with respect to Internal Controls, keeping in mind their legal, regulatory and professional obligations.

1.2 Internal Controls are systemic and procedural steps adopted by an organisation to mitigate risks, primarily in the areas of financial accounting and reporting, operational processing and compliance with laws and regulations.

1.3 The definition of Internal Audit (refer Para 3.1 in the "Framework Governing Internal Audits") and SIA 230, "Objectives of Internal Audit", indicate providing independent assurance on the effectiveness of Internal Controls as a basic expectation from Internal Audit. The definition on Internal Audit elaborates on the term "Internal Controls" by clarifying how these are integral to the management function and business operations.

1.4 Scope: This Standard applies to all internal audits conducted where internal controls are subject of audit review, and are being assessed, evaluated and reported upon.

2. Objectives

2.1 The purpose of this Standard is to:

(a) Provide a common terminology on Internal Controls to prevent ambiguity or confusion on the subject matter;

(b) Define Internal Controls, how they mitigate risks, and also how they are viewed from a legal perspective;

(c) Explain the responsibilities of management and auditors with regard to Internal Controls, as mandated by law and regulations; and

(d) Specify certain requirements which need to be met to be able to provide an independent assurance on Internal Controls in the organisation under review.

2.2 The overall objective of this Standard is to clarify the responsibilities of management and auditors over Internal Controls and how certain requirements need to be met to assess, evaluate, report and provide an independent assurance over Internal Controls.

3. Definition of Internal Controls

3.1 Internal Controls (ICs) are essentially risk mitigation steps taken to strengthen the organisation's systems and processes, as well as help to prevent and detect errors and irregularities. The actual steps of mitigation (e.g., review, approval, physical count, segregation of duty, etc.) are referred to as "Control Activities". When ICs mitigate the risk of financial exposure, they are also referred to as Internal Financial Controls (IFCs) and when they mitigate operational risks, they are also referred to as Operational Controls (OCs). ICs generally operate with human intervention (Manual Controls), but in an automated environment, computer controls are deployed to secure the systems and called IT General Controls (e.g., access controls) or check transaction processing at an application level and called Application Controls (e.g., sequential numbering of invoices, etc).

3.2 Internal Controls can be broad-based covering the whole entity (e.g., Code of Conduct), or focused to a specific process or area (e.g., Order processing or Payroll, etc.). In the former case they are generally referred to as "Entity Level Controls (ELCs)" as part of the "Control Environment". In the case of latter, they are also referred to as "Process Level Controls (PLCs)".

3.3 In the Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" issued by the ICAI, Internal Control is defined as follows:

"The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control".

3.4 ICAI has issued a "Guidance Note on Audit of Internal Financial Controls over Financial Reporting" which defines internal financial controls over Financial Reporting quite narrowly as follows:

"A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Generally Accepted Accounting Principles. A company's internal financial control over financial reporting includes those policies and procedures that

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

(ii) 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

(iii) 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."

3.5 Section 134 (5) of Companies Act, 2013, (applicable to listed companies) concerning Directors' Responsibility Statement vide clause (e) thereof, defines the term "Internal Financial Controls" as follows:

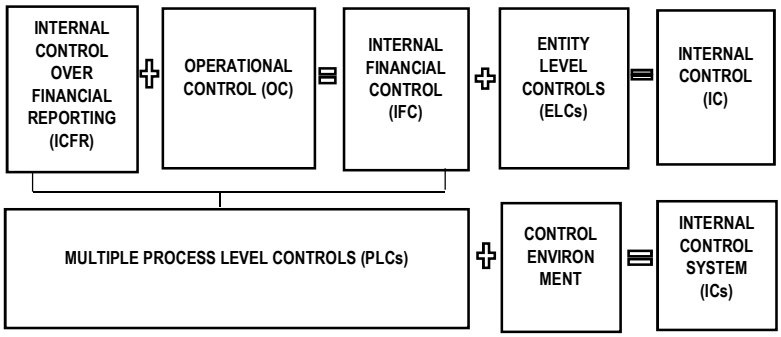
"the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information".

3.6 Internal Controls is a broader term of the legal definition of Internal Financial Controls (refer para 3.4 and 3.5) and goes beyond the financial areas and also covers a wide range of operational areas of an entity. It includes all the policies and procedures, systems and processes adopted by the company to assist in achieving its objective

of ensuring an orderly and efficient conduct of its business and operations, the safeguarding of assets, the prevention and detection of frauds and errors, but also covers the accuracy and completeness of the company records and the timely preparation of reliable financial and management information.

3.7 The term "Internal Controls System" is an all-encompassing term generally used to refer all types of controls put together, covering ELCs, IFCs and OCs. The Control Environment (ELCs) includes the overall culture, attitude, awareness and actions of Board of Directors and management regarding the internal controls and their importance to the organisation. The control environment has an influence on the effectiveness of the overall Internal Control System since it provides the basis for establishing and operating process level controls (such as IFC and OCs) in the organisation.

3.8 A pictorial depiction of the various controls, defined above, is as follows:



3.9 "Internal Controls Framework", is a pre-defined benchmark Internal Control System, based on suitable criteria, which can be used by management or auditors to assess the design, adequacy and operating effectiveness of the overall internal control system. In the Indian context, for example, Appendix 1 to Standard on Auditing (SA) 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" issued by the ICAI, provides the necessary criteria for Internal Financial Controls over Financial Reporting as per Companies Act, 2013. Globally, there are similar frameworks, such as the COSO (Committee of Sponsoring Organisations) Internal Control – Integrated Framework which help to serve the same purpose.

4. Responsibility of the Board and Management

4.1 The Companies Act, 2013 imposes overall responsibility on the Board of Directors with regard to Internal Financial Controls. Clause (e) of Section 134 (5) requires the Directors' Responsibility Statement to 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."

4.2 In addition, Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 (applicable to all companies) requires the Board of Directors' Report to include "the details in respect of adequacy of internal financial controls with reference to the Financial Statements".

4.3 For listed companies, as per The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR"), the Management of the company has additional responsibilities on Internal Controls for Financial Reporting. Regulation 17(8) of LODR mandates a Compliance Certificate, signed by the CEO and CFO to indicate that "They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the listed entity 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".

4.4 Also, Section 143(3)(i) of the Companies Act, 2013 (applicable to all companies) requires the statutory auditor to report on "whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls".

4.5 Hence, the overall responsibility for designing, assessing the adequacy, implementing and maintaining the operating effectiveness of Internal Controls rests with the Board of Directors and the Management.

5. Responsibility of the Internal Auditor

5.1. As indicated in SIA 230, "Objectives of Internal Audit", the Internal Auditor derives the audit mandate from those charged with governance, which in the case of listed entities, is generally the Audit Committee. In line with the definition of internal audit and as per the objectives defined for internal audit, the Internal Auditor is expected to include Internal Controls as a key part of the scope and approach.

5.2. The Internal Auditor shall ensure that the entity has designed, implemented and maintains effective and efficient Internal Controls. The audit procedures shall be sufficient to allow the Internal Auditor to check the design, proper implementation and operating effectiveness of the Internal Controls. Any shortcoming shall result in recommendations for improvement and suggestions on how to make the Internal Controls more efficient and effective in line with the objectives.

5.3. The Internal Auditor shall review the risk assessment exercise undertaken at the time of planning the audit assignment to establish a basis of evaluating whether adequate and appropriate Internal Controls are in place to address the risks identified. Audit procedures to be conducted would primarily be directed over high and medium risk Internal Controls and adequate documentation (e.g., a Risk Control Matrix) should be in place to confirm the linkage of the audit procedure with the respective risks.

5.4. Where the Internal Auditor is required to provide an independent opinion over the presence, design, implementation and/or operating effectiveness over Internal Controls, this shall be consistent with the requirements of SIA 110, "Nature of Assurance", especially with regard to the need to have a clear understanding of the Internal Controls Framework which shall form the basis of the assurance. Also, in such situations where a written assurance report is being issued, the Internal Auditor shall consider the following (as a basis for the opinion):

(a) An evaluation of the system of Control Self-Assessment by owners of Internal Controls to support the CEO/CFO certification process.

(b) Availability of Compliance Certificates from owners of Key Controls to support a continuous system of compliance.

5.5. In situations where the Statutory Auditor is expected to rely on the work of the Internal Auditor as per Standard on Auditing (SA) 610, "Using the Work of Internal Auditors", issued by ICAI, regarding their audit of Internal Financial Controls over Financial Reporting, the Internal Auditor shall document the objectives and agreed scope and approach of the internal audit, over which the reliance is to be placed by the Statutory Auditor.

6. Effective Date

6.1. This Standard is applicable for internal audits beginning on or after a date to be notified by the Council of the Institute.