# INSIGHTS

# ON

# INTERNAL FINANCIAL CONTROLS

# OVER

# FINANCIAL REPORTING


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## INTERNAL FINANCIAL CONTROLS OVER FINANCIAL REPORTING

- **Introduction of ICFR in Companies Act, 2013**

ICFR was introduced in the Companies Act, 2013. However, it was not made mandatory for the Year 2014-15. The applicability of the ICFR was prescribed from the year 1st April, 2015 i.e. for the year 2015-16.

- **What is IFC?**

Clause (e) of Sub-section 5 of Section 134 explains the meaning of the term, “internal financial controls” as
“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.”

- **What is ICFR?**

Under Sec 143(3)(i) , “**Internal Financial Controls Over Financial Reporting**” shall mean

“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 authorizations of management and directors of the company; and

iii. provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements."

- **<u>IFC and Operational Control</u>**

It may be noted that Internal Controls and policies can be applied by the management for various operational activities of the Company.

A question arises whether auditor is required to comment on all the controls of the Company or only those which are related to Financial Controls. A close review of above definitions suggests that only the Financial Controls as required to be reported in SA 315 is the auditor's responsibility for reporting. This is also termed as "Internal controls relating to financial reporting'.

Management on the other hand may have more controls relating to various operations of the Company viz. Shop Floor management etc. Unless they impact financial reporting they would not come under preview of above section.

- **<u>Scope of Reporting on IFC</u>**

  - <u>U/s 143(3)(i)</u>: Auditors are required to report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.
  - <u>U/s 134(5)(e):</u> Requires Directors of Listed cos. to state that IFC to be followed by the Company were laid down & were adequate and operating effectively.
  - <u>Rule 8(5)(viii):</u> of the Companies (Accounts) Rules, 2014 requires the Board of Directors' report of **All** companies to state the details in respect of adequacy of internal financial controls with reference to the "financial statements". Consequently, even if a specific statement of responsibility of the directors over internal financial controls is not made in the board's report to the members of unlisted companies, ensuring adequacy and operating

effectiveness of the internal financial controls system still remains with the management and the persons charged with governance in the company.

Therefore, **this guidance also applies for reporting on internal financial controls in respect of unlisted companies and small companies and one person companies as defined in the Companies Act, 2013.**

Further, a small or a one person company typically possesses qualitative characteristics such as:

a. Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and
b. One or more of the following:
    i. Straightforward or uncomplicated transactions;
    ii. Simple record-keeping;
    iii. Few lines of business and few products within business lines;
    iv. Few internal controls;
    v. Few levels of management with responsibility for a broad range of controls; or
    vi. Few personnel, many having a wide range of duties.

It may, however, also be noted that these qualitative characteristics are not exhaustive, nor are they exclusive to small or one person companies. Also, all small and one person companies need not necessarily display all of these characteristics.

- **Applicability on Reporting**

Section 143(3) applies to the statutory auditors of all the companies.

Thus, it seems that Auditors of even Unlisted Cos. are required to report on the IFC over Financial Reporting.

- **<u>CARO and IFC</u>**

  - Reporting on ICFR has a significantly wider scope than Reporting on Internal Controls under CARO.
  - Under CARO the reporting on internal controls is limited to the “adequacy” of controls over purchase of inventory and fixed assets and sale of goods and services.
  - ICFR, on the other hand, is inline with the International Reporting Formats. It requires reporting on all controls relating to financial reporting and also require reporting on the “adequacy and operating effectiveness” of such controls.

- **<u>When this will be applicable and for the Financial Statements of which period?</u>**

  Another aspect which required clarification was whether the comments in the auditor’s report should describe the existence and effective operation of ICFR during the period under reporting of the financial statements or as at the balance sheet date.
  The guidance note clarifies that auditors will have to report whether a company has an adequate ICFR system in place and whether the same was operating effectively as at the balance sheet date of 31 March 2016. In practice, this will mean that when forming its audit opinion on ICFR, the auditor will surely test transactions during the financial year ending 31 March 2016 and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher. If control issues or deficiencies are identified during the interim period and are remediated before the balance sheet date, then the auditor may still be able to express an unqualified opinion on the ICFR. For example, if deficiencies are discovered, the management may have the opportunity to correct and address these deficiencies by implementing new controls before the reporting date. However, sufficient time will need to be allowed to evaluate and test controls, which will again depend on the nature of the control and how frequently it operates. This will be a matter of professional judgement. This is particularly important for companies for the current year ending 31 March 2016, as it will be the first year when auditor validation of ICFR will be required.

It may also be noted that auditor's reporting on internal financial controls over financial reporting is a requirement specified in the Companies Act, 2013 and therefore will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143, which is for Statutory Auditors.

THUS, Reporting on ICFR will not apply to interim financial statements, such as quarterly or half-yearly, unless such reporting is required under any other law or regulation.

- **Management's Responsibility**

The management has the primary responsibility for the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error. Consequently, the responsibility of designing, implementing and maintaining appropriate internal financial controls also rests with the management.

The approach of new Companies Act is of self-governance and in case of non-governance, stringent penalties are provided in the Act. Management should therefore, be cautious to take following steps to ensure that there exist a proper internal control system.

a. Review existing process and map them with risks & controls and ensure that they are adequate.

b. Improve the process and controls wherever it is observed that process is slack.

c. Assess Fraud Risk and built processes around the same so that risk is minimised.

d. Test Internal controls so formed on regular basis and ensure that processes are working effectively.

In-house team may be assigned this task or a consultant may also be appointed in the first year of implementation.

- **<u>Key concepts / definitions :</u>**

**Design Effectiveness :** The right person, using the right information to make the right decision in a timely manner, to mitigate identified key risks.

**Operational effectiveness :** The consistent application, without exception, of an effectively designed control.

- **<u>Auditor's Responsibility</u>**

Paragraph A1 of Standard on Auditing (SA) 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states, "The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework."

BUT,

**<u>"The auditor's opinion does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity."</u>**

**<u>SA 200 further states</u>**, "In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions." **Thus, it may be noted that even if the auditor performs his or her audit in accordance with the Standards on Auditing, the auditor will not be able to express an opinion on the adequacy or effectiveness with which management has conducted the affairs (business) of the entity.**

Globally, auditor's reporting on internal controls is together with the reporting on the financial statements and such internal controls reported upon relate to only internal controls over financial reporting. Example, In US, Sec 404 of Sarbanes-Oxley (SOX) Act, 2002, prescribes that the registered public accounting firm (auditor) of the specified class of issuers (companies) shall, in addition to the attestation of the financial statements, attest the internal controls over financial reporting. This is a relief as it removes unnecessary ambiguity by excluding from the scope operational controls, i.e. those facilitating the effectiveness and efficiency of company's operations, and also differentiates ICFR from enterprise risk management and risk management policies which boards of companies have to maintain.

Thus, **ICFR audit is done generally along with audit of FS itself.**

Consistent with the practice prevailing internationally, the term 'internal financial controls' stated in Section 143(3)(i) would relate to 'internal financial controls over financial reporting' in accordance with the objectives of an audit stated in SA 200.

Considering the above, **the auditor needs to obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.**

For this purpose, Internal Financial Controls Over Financial Reporting would mean as described u/s 143(3)(i), as described above.

- **Benefits of ICFR –**

**To the Auditor**

- Providing assurance (audit level 95%) is much easier when you can assess the consistency with which transactions/events are processed.
- Auditing on Purely substantive basis is costly, and not auditing at all can be even more so in the long run.
- Assessing the effectiveness of internal controls provides the starting point to providing any level of assurance.

**To the Management**

- Business process designing
- Rationalizing number of controls & moving to smart and automated control

- Standardizing procedures for multi-location / multi-business companies
- Fostering a control conscious work culture
- Providing assurance to the CEO/CFO
- Improving business performance
- Base for blue prints of optimal procedures [ERP]
- Identifying cost containment opportunities & driving growth

**To the Reader of FS**

- ICFR provides to the reader of Financial statements with an assurance that:
- Financial statements fairly reflect all financial transactions.
- All transactions are recorded in accordance with applicable policies, directives and standards.
- Transactions are carried out in accordance with delegated authorities.
- Financial resources are safeguarded against material loss due to waste, abuse, mismanagement, errors, fraud, omission and other irregulatities.

- **Criteria for Internal Financial Controls Over Financial Reporting**

The reporting by the auditor is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

The following criteria is prescribed in guidance note :

- To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the financial reporting framework.

  e.g The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014).

- A benchmark internal control system, based on suitable criteria, is essential to enable the management and auditors to assess and state adequacy of and compliance with the system of internal control.
  e.g. Appendix 1 "Internal Control Components" of SA 315 provides the criteria for the same, which are similar to the COSO Principles discussed

- **COSO 2013 Framework**

  - 1985- Committee Of Sponsoring Organisation (COSO) of the Treadway Commission was formed to identify the Casual Factors that can lead to fraudulent financial reporting.

- **Definition of Internal Control As per COSO**

A process effected by an entity's BOD, Management & other personnel, designed to provide reasonable assurance regarding achievement of Objectives related to Operations, Reporting and Compliance.

- **17 Principles Of Controls (POCs) embedded in the Original Framework**

✓ Control Environment :

**1)** Demonstrates Commitment to Integrity and Ethical values
**2)** Exercises Oversight Responsibility
**3)** Establishes Structure, Authority and Responsibility
**4)** Demonstrates Commitment to Competence
**5)** Enforces Accountability

✓ Risk Assessment :

**6)** Specifies relevant objectives
**7)** Identifies and analyses risk
**8)** Assesses fraud risk
**9)** Identifies and analyses significant change

✓ Control Activities :

**10)** Selects & develops control activities

**11)** Selects & develops general controls over technology

**12)** Deploys through Policies & procedures

- ✓ Information & Communication :

**13)** Uses relevant information

**14)** Communicates internally

**15)** Communicates externally

- ✓ Monitoring Activities :

**16)** Conducts ongoing and/or separate evaluations

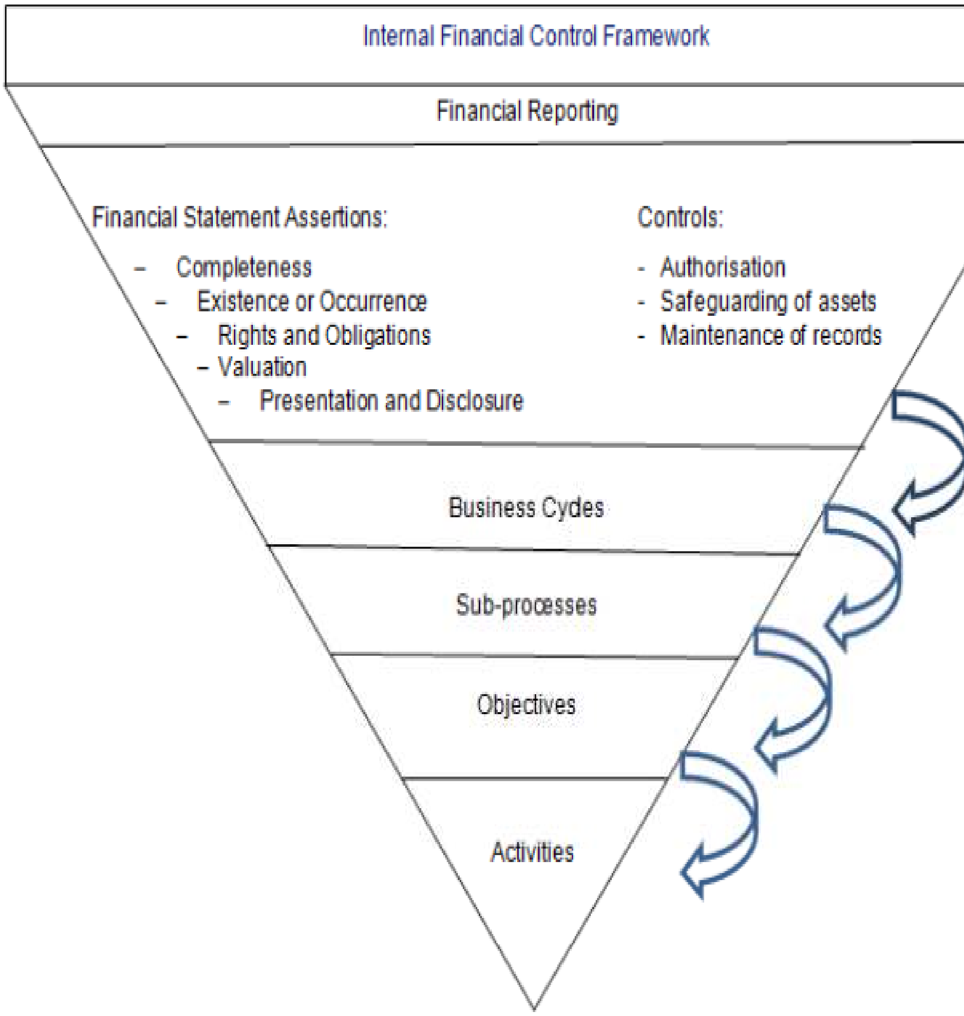
**17)** Evaluates and communicates deficiencies

- **<u>Using a Top-down Approach</u>**

  - The auditor should use a top-down approach to the audit of internal financial controls over financial reporting to select the controls to test.
  - A top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal financial controls over financial reporting.
  - The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions.
  - This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures.
  - The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

**Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.**

**Top-Down Approach to Internal Financial Controls Over Financial Reporting**




- **<u>Categorization of Control & Importance of each</u>**
  - Entity Level Controls
  - Transaction Level Controls
  - IT General Controls

  - <u>Entity Level Controls</u>

    The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal financial controls over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

Some of these can be direct control while others can be indirect.

Direct controls –

Direct Entity Level Controls monitor specific business and financial risks, and operate at the level of precision necessary to detect breakdowns in the application of an organization's policies and procedures.

Indirect controls –

Indirect entity level controls help define the control consciousness of an organization without directly mitigating any one specific financial or operational risk. These are controls more of preventive type rather than detective type.

Benefits from leveraging effective ELC –

- Reduce the extent of reliance on transaction level controls.
- Increase the effectiveness of internal controls through leveraging senior and experienced personnel.
- Better define and communicate the expectations of management across the organization.
- Reduce redundancy in controls performed across the organization at different levels.

▪ <u>Transaction Level Controls</u>

Transaction Controls regulate transactions that can be processed to a project/task/award by specifying which expenditure categories (resource groups) or expenditure types (resources) are chargeable or non chargeable.

Transaction controls can be established on a project or task and can be exclusive or inclusive. Transaction controls can be established for an expenditure category (resource group) or expenditure type (resource). If established for an expenditure category, the controls apply to all expenditure types within the category. If established for an expenditure type, the controls apply just to the specific expenditure type.

TLCs can be Inclusive or Exclusive

There are two types of transaction controls that define which expenditure will be included or excluded when transactions are processed.

Exclusive Transaction Controls –

Exclusive transaction controls allow all transactions to be processed except (excluding) those transactions in expenditure categories (resource groups) and expenditure types (resources) listed in the transaction control section. Exclusive transaction controls define all of the "unallowed" expenditure categories and expenditure types.

Inclusive Transaction Controls –

Inclusive transaction controls allow only transactions to be processed that are listed (included) in the transaction control section as Chargeable and with the box Limit to Transaction Controls checked. Inclusive transaction controls define all of the "allowed" expenditure categories and expenditure types.

Note: When inclusive transaction controls are used, the resource of F&A Costs or Agency Fees must be included for appropriate indirect costs to be applied.

TLC Approach –

- The starting point for assessing the effectiveness of the transaction level controls is defining what business processes are in scope.
- In order to assess the ICFR, you need to work backwards from the end objective, which, in this case, is the financial statements
  - Step 1 – identify the significant accounts
  - Step 2 – associate the significant business processes
  - Step 3 – perform a detailed risk assessment

- <u>IT General Controls</u>

In business and accounting, information technology controls (or IT controls) are specific activities performed by persons or systems designed to ensure that business objectives are met. They are a subset of an enterprise's internal control.

IT control objectives relate to the confidentiality, integrity, and availability of data and the overall management of the IT function of the business enterprise.

IT controls are often described in two categories:

- IT general controls (ITGC) and
- IT application controls.

ITGC include controls over

- the Information Technology (IT) environment,
- computer operations,
- access to programs and data,
- program development and program changes.

IT application controls refer to transaction processing controls, sometimes called "input-processing-output" controls. Information technology controls have been given increased prominence in corporations listed in the United States by the Sarbanes-Oxley Act.

ITGC represent the foundation of the IT control structure. They help ensure the reliability of data generated by IT systems and support the assertion that systems operate as intended and that output is reliable. ITGC usually include the following types of controls:

- Control environment, or those controls designed to shape the corporate culture or "tone at the top."
- Change management procedures - controls designed to ensure the changes meet business requirements and are authorized.
- Source code/document version control procedures - controls designed to protect the integrity of program code
- Software development life cycle standards - controls designed to ensure IT projects are effectively managed.
- Logical access policies, standards and processes - controls designed to manage access based on business need.
- Incident management policies and procedures - controls designed to address operational processing errors.
- Problem management policies and procedures - controls designed to identify and address the root cause of incidents.
- Technical support policies and procedures - policies to help users perform more efficiently and report problems.
- Hardware/software configuration, installation, testing, management standards, policies and procedures.
- Disaster recovery/backup and recovery procedures, to enable continued processing despite adverse conditions.
- Physical security - controls to ensure the physical security of information technology from individuals and from environmental risks.

- **Sampling**

| Frequency of control activity | Minimum Sample Size<br>Risk of failre | |
|---|---|---|
| | Lower | Higher |
| Annual | 1 | 1 |
| Quarterly (including period-end, i.e. +1) | 1 + 1 | 1 + 1 |
| Monthly | 2 | 3 |
| Weekly | 5 | 8 |
| Daily | 15 | 25 |
| Recurring manual control (multiple times per day) | 25 | 40 |

**Note:** Although +1 is used to indicate that the period–end control is tested, this does not mean that for more frequent control operations the year-end operation cannot be tested.

- **Inherent limitations in an audit of internal financial controls over financial Reporting**

  Because of the inherent limitations of internal financial controls over financial reporting, including

  a. The possibility of collusion or improper management override of controls,
  b. Material misstatements due to error or fraud may occur and not be detected.
  c. Projections of any evaluation of the internal financial controls over financial reporting to future periods are subject to the risk that
     a. the internal financial control over financial reporting may become inadequate because of changes in conditions, or
     b. that the degree of compliance with the policies or procedures may deteriorate.

- **Reporting on internal financial controls over financial reporting in case of consolidated financial statements**

  Section 129(4) of the 2013 Act, states that the provisions of the 2013 Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements.

  As such, on a strict reading of the aforesaid provision in the 2013 Act, it appears that the auditor will be required to report under Section 143(3)(i) of the 2013 Act on the adequacy and operating effectiveness of the internal financial controls over financial reporting, even in the case of consolidated financial statements.

  In the case of components included in the consolidated financial statements of the parent company, reporting on the adequacy and operating effectiveness of internal financial controls over financial reporting would apply for the respective components only if it is a company under the 2013 Act. Accordingly, in line with the approach adopted in case of reporting on the consolidated financial statements on the clauses of section 143(3) and reporting on the Companies (Auditor's Report) Order, 2015 notified under section 143(11) of the 2013 Act, the reporting on adequacy and operating effectiveness of internal financial controls would also be on the basis on the reports on section 143(3)(i) as submitted by the statutory auditors of components that are Indian companies under the Act. The auditors of the parent company should apply the concept of materiality and professional judgment as provided in the Standards on Auditing and this Guidance Note while reporting under section 143(3)(i) on the matters relating to internal financial controls over financial reporting that are reported by the component auditors.

- **<u>How the Audit & Reporting is to be done?</u>**

**1) SAs to be followed:**

Though the SAs don't fully describe the auditing requirements for reporting on IFC, the relevant portions of Various Standards on Auditing which governs the Audit of Financial Statements will apply to reporting in relation to ICFR also.

For example,

SA 200 ―OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH STANDARDS ON AUDITING‖,

SA 230 ―AUDIT DOCUMENTATION‖,

SA 315 ―IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT‖,

SA 610 ―USING THE WORK OF INTERNAL AUDITORS‖ - apply in a combined audit of internal financial controls over financial reporting and financial statements. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the auditor when expressing an opinion on financial statements and internal financial controls over financial reporting. The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor‘s use of the work of the internal auditors.

The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work.

**2) Audit Report:**

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

**3) Contents of Audit Report:**

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

a. A title that includes the word independent.
b. A statement that management is responsible for maintaining adequate and effective internal financial controls over financial reporting and for assessing the adequacy and effectiveness of internal financial controls over financial reporting as per the meaning of internal financial controls provided in the Act.
c. An identification of the benchmark criteria used by the management for establishing internal financial controls over financial reporting.
d. A statement that the auditor's responsibility is to express an opinion on the company's internal financial controls over financial reporting based on his or her audit.
e. A statement that the audit was conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and the Standards on Auditing, to the extent applicable to an audit of internal financial controls over financial reporting, both issued by the Institute of Chartered Accountants of India.
f. A statement that the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and Standards on Auditing require that the auditor plan and perform the audit to obtain reasonable assurance about whether

adequate and effective internal financial controls over financial reporting were maintained in all material respects.

g. A statement that an audit includes obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the adequacy and operating effectiveness of internal control over financial reporting based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstance.
h. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion.
i. A paragraph stating that, because of inherent limitations, internal financial controls over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.
j. The auditor's opinion on whether the company maintained, in all material respects, adequate internal financial controls over financial reporting and whether they were operating effectively as of the balance sheet date, based on the control criteria.
k. The signature of the auditor with firm name, where applicable.
l. The place and date of the audit report.

**NOTE**: In an audit of financial statements, it is presumed that the going concern assumption for the company is appropriate and the auditor evaluates the appropriateness of such assumption. In case such assumption is not appropriate or a material uncertainty exists, the auditor is required to comply with the requirements of SA 570 “Going Concern”. Correspondingly, in an audit of internal financial controls over financial reporting, the auditor needs to make appropriate disclosures to state the inherent limitations on internal financial controls over financial reporting and the limitations in consideration of such controls operating as at the balance sheet date for the future operations of the company.

4) **Report Date:**

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the auditor's opinion. Because the auditor's reporting on internal financial controls over financial reporting is specified in the same Section as that of the opinion on financial statements viz. Section 143(3) of the Act, the date of the audit report on internal financial controls over financial reporting should be the same as that of the date of the audit report on the financial statements.

5) **Consequences:**

What are the consequences when auditor concludes that internal controls were not effective?

1. The Auditor report will include a qualified opinion. Not only merely for internal control, but also under section 143(3)(f) of the Act as non-existence of appropriate internal control can also have adverse effects on the functioning of the Company.

2. It can be safely concluded that non-existence of internal control would imply that existence of Fraud cannot be effectively monitored and the financial statements would lack credibility.

3. Credit rating agencies will take it negatively also it may affect negotiation power of the entity with borrowers.

- **Conclusion**
  **The requirement of internal control is now legally mandated. In respect of the listed companies, it is by virtue of Section 134(5) of the Companies Act, 2013. Private limited companies are covered by inclusion of Standard on Auditing, in the Companies Act and reporting requirement by auditors. It is therefore, suggested that all the companies should re-visit the existing internal controls and strengthens them to ensure that whenever they are tested will not fail.**

**Appendices:**

**I. Top 100 controls**

| No. | Top 100 Controls |
|---|---|
| | **Policies & Procedures** |
| 1 | Company wide policies on following aspects are defined & reviewed on a periodic basis: |
| | a) Sales policy |
| | b) Purchase policy |
| | c) Insurance policy |
| | d) Policy on Capital expenditure |
| | e) Inventory policy |
| | f) Credit control policy |
| | g) Discount policy |
| | h) Receivables Management & Credit Risk policy |
| | i) Sales Return policy |
| | j) Logistics & Distribution policy |
| | k) Outsourcing policy |
| | l) Forex policy |
| | m) Investment policy |
| | n) MIS policy |
| | o) Insurance policy |
| | p) IT policy |
| | q) Records management policy |
| | r) Gifts & Entertainment policy |
| | s) HR policies |
| | t) Professional Ethics policy |
| | u) Policy on Corporate Communication & Disclosure |
| | v) Change Management policy |
| | w) Fraud Mitigation |
| | x) Whistle blower policy |
| 2 | Company wise Risk Management process is defined as regards the following: |
| | a) Risk Policy |
| | b) Departmetn-wise Risk identification |
| | c) Maintenance & updation of Risk Register |
| | d) Process of Inter departmental tranfer of risks |
| | e) Risk Mitigation measures / plans |
| | f) Management reporting on Risk Management & Risk Mitigation |
| 3 | Risk tolerance & risk appetite is defined & a list of risks to be insured is prepared & approved by appropriate authority. Timely renewal of insurance policies are renewed & all additions / deletions to assets, etc are timely endorsed for insurance. |
| 4 | Compamy wide Delegation of Autority for various financial & operational aspects is defined. |
| 5 | Basis of budgeting is defined & department-wise budgets are accordingly prepared and approved by appropriate authority. |
| 6 | Seggregation of duties is ensured for various functions such as: |
| | a) Cash handling & posting of cash entries in system |
| | b) Requesting for material procurement & preparation of purchase orders |
| | c) Preparation of POs & authorisation / release of POs |
| | d) Preparation of PO & acceptance of materials received (preparation of GRN) |
| | e) Acceptance of materials received & quality confirmation of materials |
| | f) Preparation of Material Issue Slips & actual issue of materials to shop floor |
| | g) Preparation & approval of journal entries |

| | |
|---|---|
| | h) Updation & approval of various masters |
| | i) Inventory / asset verification & adjustment of discrepancies |
| | j) Sales price maintenance & invoicing |
| | g) Invoicing & dispatches |
| | h) Preparation of GRN & processing vendor payments |
| | i) Vendor creation & release of payments thereof |
| | j) Verification of bills & release of payments thereof |
| | **Financial Controls** |
| 7 | Accounting manual detailing the following aspects is in place: |
| | a) Chart of accounts |
| | b) Accounting procedures |
| | c) Process for allocation of common expenses |
| | d) Reconciliation procedures (Inter company, bank reconciliaiton, debtors reco., etc.) |
| | e) Cut off procedures |
| | f) Processes to be followed for accounts closure |
| | g) Time frame for completion of closing procedures |
| 8 | Accounting policies on the following aspects are defined & adhered: |
| | a) Revenue Recongnition & Accruals |
| | b) Accounting for Investments |
| | c) Capitalisation procedures & asset valuation |
| | d) Inventory valuation |
| | d) Deprecitation accounting |
| | e) Provisioning, write off & write back |
| | f) Accounting for Employee benefits |
| | g) Accounting for Research & Development expenditure |
| | h) Defferred revenue expenditure & its ammotrisation |
| | i) Income & expenses in foreign exchange |
| | j) Accounting for assets on lease |
| | j) Intangible assets |
| | j) Accounting for Impairment of assets |
| | k) Identification & disclosure of contingent liabilities & contingent assets |
| 9 | Guidelines for physical verification of Fixed Asset defining the following is in place & is duly adhered to: |
| | a) Coverage & periodicity of verification |
| | b) Authorised personnel to conduct verification |
| | c) Identification, reporting & dealing with old/ obsolete / unused assets |
| | d) Reporting structure & process for delaing with variance as per book reords |
| | e) Authorities for approving adjustments based on physical verification |
| | f) Records maintenance |
| 10 | Guidelines pertaining to physical verification of cash defining the periodicity, person responsible & maintenance of records are defined & duly adhered. |
| 11 | Standard costing is prepared for each product. Variances to standard cost are reviewed by management & the standards are reviewed & revised on a periodic basis. |
| 12 | Revenue is recognised in the books in accordance with Accounting Standard 9 on issued by ICAI i.e. revenue is accounted for in the books only when proof of delivery (acknowledged LR copy) has been received from the customer. |
| 13 | Authority to open a new bank account is restricted to appropriate authority as per Board Resolution & any new bank account created is approved by appropriate authority as per Bank Mandate. |
| 14 | All bank accounts are reconciled on a monthly basis & stale cheques appearing in the reconciliation for more than six months are reviewed & reversed. |
| 15 | Periodic ‘Cash flow statement’ is prepared & authorised by appropriate authority. |

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| 16 | Continuous monitoring of bank balances is done to initiate timely transfer of idle balances for repayment of overdrawn balances in Cas Credit / Over draft accounts. |
| 17 | Periodic reconciliation of outstanding Bank Guarantees (BGs) & Margin Money held as Short-Term Deposit Receipts (STDRs) with banks is done. |
| 18 | Periodic review & revision of interest rates on Term Loans / CC / OD facility availed from Banks is ensured on an annual basis in line with market rates. |
| 19 | Validation of bank charges & interest on loan is done on a regular basis. |
| 20 | Safeguards over the physical custody of Cash are ensured through: |
| | a) Storage of cash in safe |
| | b) Keys to safe are held with the cashier and designated persons only. |
| | c) Daily verification of physical cash balance. |
| | d) Daily reconciliation of physical cash balance with the book balance in SAP. |
| 21 | Maintenance of Fixed Assets Register as per CARO requirement is ensured & assets are capitalised as per relevant Accounting Standard. |
| 22 | Perpetual inventory verification system is in place & is duly documented. Variances are analysed for reasons and appropriate adjustment entries are passed after approval of appropriate authority. Write offs of obsolete & damage stocks are authorised. |
| 23 | Stock valuation is reviewed by management to ensure that it is in line with the Company policy & applicable Accounting Standards. |
| 24 | Details of all outstanding advances including employee advances are generated on a periodic basis (quarterly) & follow-up is undertaken with the concerned departments / employee for recoveries & appropriate action. |
| 25 | All accounting entries (accruals, journal entries, payment vouchers, etc.) are reviewed & approved by appropriate authority. |
| 26 | Three way matching of PO, invoice & goods receipt quantity is ensured during bill passing. Necessary deductions are made from the bill for any excess quantity billed for as compared to the GRN. |
| 27 | Payment run generated & authorised by Chief Accountant in SAP is reconciled to the payment files uploaded / sent to the Bank for salary disbursements. |
| 28 | Management review, authorise & evidence the calculation of other creditors / payables (amounts owed to inter companies, taxes payable, deffered income, etc.). |
| 29 | Quarterly ledger scrutiny is conducted and old debit / credit balances including old advances / deposits are reviewed periodically & appropriate action is initiated for recovery / write off / write back. |
| 30 | Balance confirmations from third parties / job workers, debtors & creditors are obtained annually and reconciled with the accounts balance in financial records. Discrepancies are discussed & resolved & necessary adjustment entries are passed after obtaining neccessary approvals. |
| 31 | Reconciliation of Inter Company / branches balances carried out on quarterly basis. Old unadjusted balances are investigated & adjusted by passing necessary adjustment entries in either books. |
| 32 | Financial Statements are prepared in line with the applicable Laws & Group Reporting Standards. |
| | **HR & Admin Controls** |
| 33 | Organisational structure is defined with job responsiblities & reporting lines. |
| 34 | Annual manpower budget is prepared & approved by appropriate authority. Variances from budget are monitored & approved by appropriate authority. |
| 35 | Checklist of activities to be performed including documents & certificates to be verified & obtained prior to recruitment is maintained & adhered to. Exceptions are authorised by appropriate authority. |
| 36 | Reference checks are conducted for new joinees & appointment letters are given only on satisfactory completion of standard medical tests defined by the Company. |

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| 37 | Confidentiality agreements / NDAs are entered into with key employees at designated / positions. |
| 38 | KRAs are defined by appropriate authority & performance is measured accordingly. |
| 39 | *Salary / payroll data sent to the Bank is password protected and is accompanied with hard copy data in a sealed envelope which is authorized by appropriate authority.* |
| 40 | Department-wie head count of employees across locations is done on a periodic basis to ensure that only actual employees on payroll are being paid. |
| 41 | Exit interview is conducted for all resigned employees. Reason-wise analysis is prepared for employee resignations & submitted to the Management on a quarterly basis & appropriate actions are initiated accordingly. Attrition rate is benchmarked with the Industry & reasons for variations analysed. |
| 42 | Succession plan for critical functions is defined & reviewed periodically. |
| 43 | Full & Final (F&F) settlement is calculated after receipt of No Due Certificate from all departments. F&F is calculated after deducting the outstanding loans & advances recoverable from the employees, short notice pay / waiver of short notice & tax liability upto the date of resignation.Maker-checker system exists to verify the F&F calculation. |
| 44 | Timely information is sent by HR to Finance & Secretarial department as regards any change in power of attorney holder & cheque signing authority due to resignations / terminations. |
| 45 | Details of resigned employees are timely sent by HR to IT department for appropriate deletions from SAP user database & deactivation of email ids. |
| 46 | Employee loans & advances including various reimbursements & allowances are in accordance with the Company policy. Deviations are approved by appropriate authority. |
| 47 | Contract workers are rotated on a periodic basis to avoid permanency claims. |
| 48 | Attendance of contract workers maintained by the Security & respective departments is reconciled with the billig details prior to releasing payments. |
| | **Operational Controls** |
| 49 | Purchase plan is prepared based on the sales plan / forecast. Periodic review and revision in Purchase Plan is done & documented based on changes in the Sales Plan. |
| 50 | Comparative quotes are invitied from different vendors to ensure availment of competitive prices. Comparative Quotation Analysis is done for selectino of L1 party. Selection of L2 or other parties is justified & approved. |
| 51 | Approved Master List is maintained & timely updated for new vendors. |
| 52 | POs are raised on approved vendors & are backed by approved purchase requisitions. POs are authorized by appropriate authority & any amendment to the PO is reviewed & authorised. |
| 53 | Periodic compilation of list of open POs, and remedial action taken for short-closure / blocking. In addition, validity date for PO is incorporated in SAP system. |
| 54 | Goods Received Not Invoiced accruals are reviewed & long out standing items are investigated & cleared. |
| 55 | Vendor performance is evaluated & documented at periodic intervals. Action is taken against low rated vendors. |
| 56 | Material is accepted only on the presence of a PO & GRN is timely prepared (within 48 hours) on receipt of materials. |
| 57 | Items eligible for input credit are identified & CENVAT credit is timely availed on receipt of goods. |
| 58 | Quality parameters are defined & adhered for various items. Logs of QC checks conducted are maintained & deviations are approved by appropriate authority. |
| 59 | Rejected materials is timely followed up with the Purchase department for arranging necessary replacements / recoveries. |
| 60 | Minimum, maximum & re-order levels at item level are defined & reviewed on a periodic basis. Stocks are monitored visa-vis the defined levels. |

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| 61 | Slow / non-moving / obsolete are reviewed on a periodic basis & necessary corrective actions are initiated for liquidation / alternate use / transfer to other locations. |
| 62 | Adherence to scheduled process orders is monitored on a regular basis. Reasons for variations in schedule are analyzed and discussed with Central Planning for corrective actions initiated/to be initiated. |
| 63 | The Production department ensures that only QC passed raw/packing materials are used for production process. |
| 64 | Production Head reviews raw material consumption variances for the actual production of finished goods on a monthly basis. Any irregularity in consumption & postings are timely corrected. |
| 65 | Yield of the batch produced is monitored. Yield loss more than std yield is reported to Works Manager & Management along with the corrective actions initiated. |
| 66 | Root Cause Analysis Report for customer complaints pertaining to quality of products, defective production, etc. is prepared and promptly communicated to Production department, Central Quality Assurance (CQA), Central Technical Department and Management. |
| 67 | Annual maintenance contract exists for the machines stating the details and frequency of preventive maintenance; breakdown maintenance and the respective personnel monitor the AMC as per the schedule. |
| 68 | Periodic cross-verification of power consumption vis-à-vis the billing demand is done to avoid penal payments. Power Factor is monitored on a periodic basis to avoid penal payments for low power factor maintenance & ensure rebate benefits on maintaining higher power factor. Power bill is verified with the meter readings & discrepancies are followed up with the Electricity Board. |
| 69 | Stage-wise & item-wise scrap generation records are maintained & timely updated. |
| 70 | Scrap is sold to the highest bidder based on comparative quotes invited from parties. Sale to other parties are justified & approved. |
| 71 | Reconciliatoin of scrap sale vis-a-vis scrap generated is done on a periodic basis. |
| 72 | Sales budget / sales plan is compiled & approved. In addition, variance analysis of budgeted / planned sales vis-à-vis actual sales is done & action plans prepared on a monthly / quarterly basis. |
| 73 | Credit limits are assigned to debtors based on the credit risk assessment. Billings & outstandings are restricted upto the credit limit beyond which stop dispatch policy is ensured. Exceptions are justified & approved by appropriate authority. |
| 74 | Age-wise analysis of debtors are generated on a monthly basis & communicated to the respective divisions for recovery & appropriate action. Overdue debtors are timely communicated to the Legal department for filing of legal cases. |
| 75 | Other receivables (all amounts owed to Company by associates / recoverable taxes / prepayments / upfront payments) are reviewed, authorised & evidenced by the Management. |
| 76 | Field force expenses are reviewed & monitored on a periodic basis in line with the entitlements & Company policy. |
| 77 | Monitoring over Advance licenses is done to ensure: |
| | (a) Timely enhancement / extension / closure |
| | (b) Quantity & value-wise export obligation / import entitlement on FIFO basis. |
| 78 | Quotations are invited from various CHA agents at periodic interval. Justification for selecting other than lowest is documented. In addition, exhaustive agreement is entered into with CHA covering all clearing and forwarding expenses and reimbursement. |
| 79 | Destination-wise comparative quotes for Full Truck Load & Part Truck Loads including other transportation charges (detention, door to door delivery charges, loading charges, etc.) are invited from adequate number of transporters. Selection of transporters is based on comparative cost evalaution. |

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| 80 | Transporter evaluation is done on a periodic basis based on parameters such delivery, price, transit damage, etc. |
| | **IT Systems** |
| 81 | Role based access rights to various ERP modules / transaction codes / Network systems are given to apporpiate authority after obtainig approval of the respecive HOD. |
| 82 | All Master are maintained & timely updated by designated authority for any ammednmets / changes thereto. Access to the Masters is restricted only to the authorised personnel. |
| 83 | Log of changes to the all Masters is maintained & reviewed by designated authority on a monthly basis. |
| 84 | Necessary software licenses based on the Users are obtained & inventory of software licenses is maitnained & updated on a periodical basis. |
| 85 | ERP / email systems are configured to mandatorily require first logon password change. Passwords beyond a defined time limit are prompted to be mandatorily changed by the ERP system, failure to which the User is blocked. |
| 86 | IT procedures such as back up, Disaster Recovery, Business Continuity Planning, firewall, internet security, antti virus, network maintenance, etc are in place & are duly adhered. |
| 87 | System change management process is defined w.r.t impact analysis, User Acceptance Testing & sign off. |
| | **Legal & Compliance** |
| 88 | Comprehensive compliance checklist is maintained to ensure compliances with applicable Acts / Statutes / Rules/ provisions & timely payment of statutory dues. |
| 89 | Changes in applicable Acts / Statutes / Rules / provisions are timely identified & compliance checklist is preiodically reviewed & updated for changes / additions to the applicable Acts / Statutes / Rules / provisions. |
| 90 | Compliance champions are identifed at each location to monitor compliances of applicable Acts. Timely action is initiated for non-compliance observed. |
| 91 | Central monitoring of all applicable licenses for factories & depots, etc & their timely renewal is ensured. |
| 92 | Proof of payment of PF & ESIC dues by contractors is received & verified prior to releasing payments to the contractors. |
| 93 | Exception report is prepared for non compliances observed & is submitted to the Management on a periodic basis. Follow-up is done for non compliance observed. |
| 94 | Compliance certificate is given to the Board on a quarterly basis. |
| 95 | All agreements / contracts / Power of Attorney / Guarantees entered are centrally vetted by the Legal department. |
| 96 | Status of litigation cases lodged against / by the Company is reported to the Board on a quarterlty basis. |
| | **MIS** |
| 97 | MIS reporting structure, reporting format & periodicity is defined for various functions for reporting to: |
| | a) Board level |
| | b) Senior Management Level |
| | c) Financial Head Level |
| 98 | Custody & confidentiality of MIS reports & related working papers is defined & adhered. |
| 99 | MIS prepared is valdiated by an independent authority. |
| 100 | Periodic review meetings are held to discuss various MIS reports wherein MIS is analysed for variances from comparative / budgted figures. Unusual deviations / exceptional items are investigated & corrective actions are initiated accordingly. |