Internal Controls Over Financial Reporting (ICFR) Framework

Approach, Methodology and Guidance

By CA Manish P.
Mukesh Manish & Kalpesh ("M2K")

Background on Internal Controls over Financial Reporting (ICFR)

Legal Requirement of IFC / ICFR

S.134 (5)(e) of Companies Act, 2013 ('the Act')	Requires the Directors of a listed company to confirm that **internal financial controls** to be followed by the Company have been laid down and that such internal controls **are adequate and operating effectively** as part of the Director's Responsibility Statement.
S.143 of the Act	Requires **the auditor** to comment whether the company has adequate internal financial controls system w.r.t financial statements in place and the operating effectiveness of such controls.
S.177 of the Act	Requires that the Audit Committee shall evaluate internal financial controls and risk management systems.
Schedule IV of the Act	Requires that the independent directors shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.
Regulation 17(8) of SEBI (LODR) Regulations, 2015	Requires certification by the CEO/ CFO stating that they accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of same.

Internal Controls Over Financial Reporting (ICFR) – An Overview

As per the **Guidance note on Internal Financial Controls Over Financial Reporting** ("the Guidance Note") issued by Institute of Chartered Accountants of India (ICAI), the meaning of **ICFR** shall mean as follows: -

- process designed to provide reasonable assurance regarding the reliability of financial reporting
- 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:

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

Requirement of ICFR

Three Dimensions of Framework

The Framework defines objectives of Internal controls, levels at which it should be evaluated and its components.

OBJECTIVES

Internal controls should provide reasonable assurance to achieve the following objectives

- Effectiveness and efficiency of operations (including safeguarding fixed assets)
- Reliability of financial reporting
- Compliance with applicable laws and regulations

EVALUATION LEVELS

Internal controls must be evaluated at two levels

- Entity level
- Process level

COMPONENTS

Components of internal controls which can be mapped to five broad heads

- Control environment
- Risk assessment
- Control activities
- Information and Communication
- Monitoring

Internal Financial Controls (IFC) – An Overview

As per Section 134 of the Act, the term “**internal financial controls**” means the policies and procedures adopted by the company for -

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

IFC – Types of Controls

The following are the types of controls as implemented by the management which are documented and tested by us, as part of the Internal Financial Controls testing. The Controls are based on the type of the Risks addressed.

Operational Controls:

Controls designed and implemented to address the operational level risks or to ensure adherence to the policies and practices of the Company.

Financial Controls:

Controls designed and implemented to address the risk of a financial reporting impact or misstatement in financial statements of the Company.

Compliance Controls:

Controls designed and implemented to address the risk of non-compliance with the relevant statutory guidelines / provisions of the applicable laws/legislations.

IFC vs ICFR

ICFR covers the controls which are designed to ensure reliability on the financial reporting process and financial statements are prepared in accordance with generally accepted accounting principles whereas IFC has a wider scope covering Financial Reporting Controls + Operational controls + Fraud Prevention.

Internal Controls Over Financial Reporting

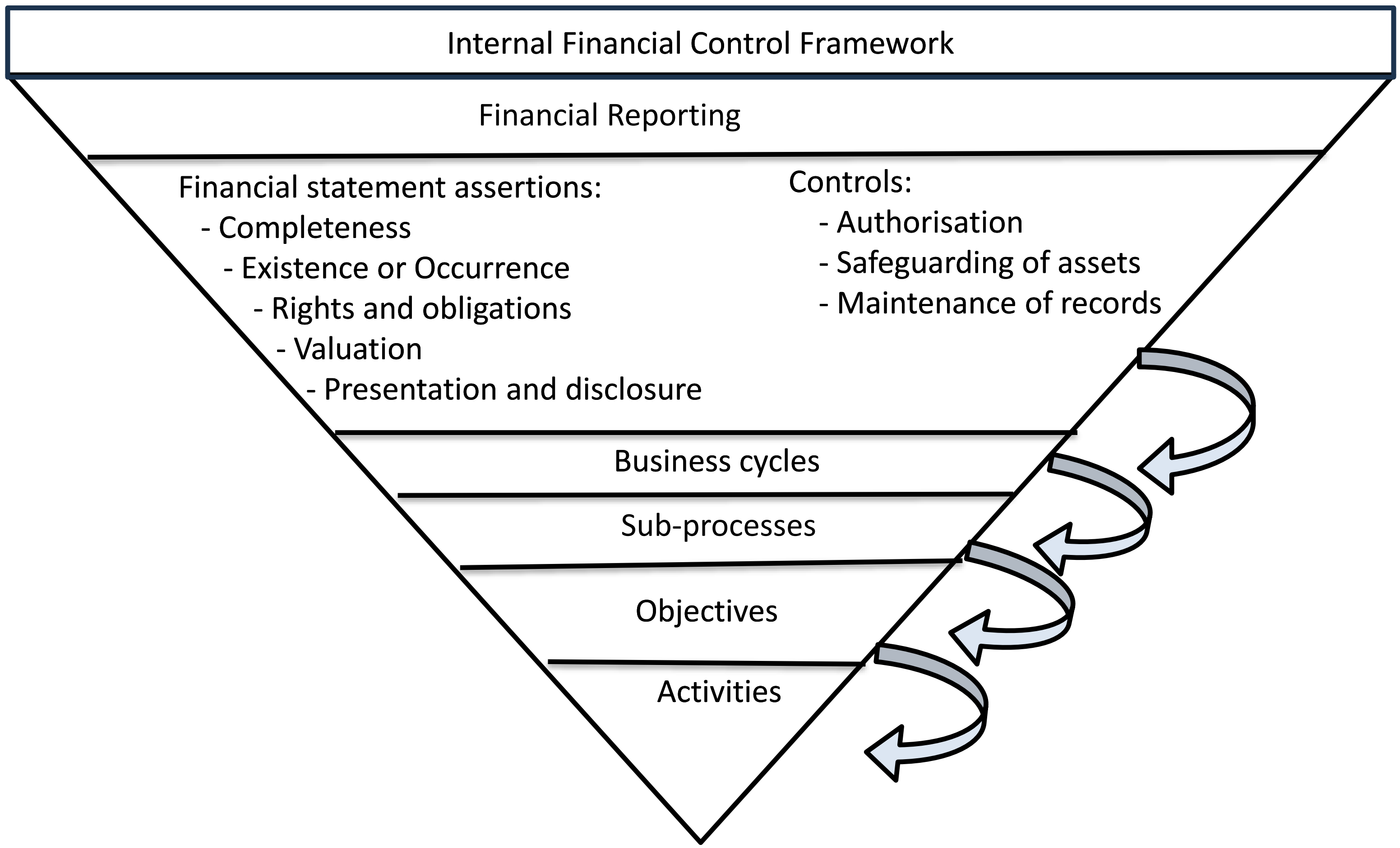
- reasonable assurance regarding the reliability of financial reporting
- Preparation of financial statements in accordance with the Generally accepted accounting principles

Internal Financial Controls

- Orderly and efficient conduct of it business, including adherence to policy
- Safeguarding of assets
- Prevention and detection of frauds and errors
- Accuracy and completeness of the accounting records
- Timely preparation of reliable financial information.

Top-Down Approach

Top-down approach to Internal Financial Controls Over Financial Reporting



Assertions related to Financial Reporting

Assertions – An Overview

SA 315 requires the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the **financial statement and assertion levels,** through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement and help the auditor to reduce the risks of material misstatement to an acceptably low level.

Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure	
Is it real? What happened? Is it true?	Did we consider / account for everything?	Do we own the asset? Do we owe another party?	Is the valuation correct? Did we account at correct value?	Did we accurately classify the asset / liability? Did we report the asset / liability?	Attributes

Assertions related to Financial Reporting and Potential misstatements

Assertion about Transactions during the year (Income Statement)	Examples of potential misstatements
Occurrence-transactions and events that have been recorded have occurred and pertain to the entity	• Fictitious or unauthorized transactions are entered on source documents or directly in to the application system(input) • Transactions are duplicated when input • Invalid inputs are captured in the subsidiary ledgers
Completeness-all transactions and events that should have been recorded	• Transactions or events that or not identified and therefore are not entered on a source document or directly into an application system(input) • Input are not captured into the subsidiary ledgers • Input that it is rejected is not resubmitted for capture in the subsidiary ledger.
Accuracy-amounts and other data relating to recorded transactions and events have been recorded appropriately	• Input is inaccurately captured into the subsidiary ledgers • Input or subsequent processing reflects amounts in excess or less than appropriate amounts • Processing of transactions is inaccurate (i.e. Summarizing, calculating, and posting) • Inaccurate adjustments are made to the subsidiary ledgers or general ledger.
Cutoff-transactions and events have been recorded in the correct accounting period	• Transactions or events that have occurred or will occur are recorded too early • Transactions or events that have occurred are recorded too late (they are recorded in a period in which they should have been recorded)
Classification-Transactions and events have been recorded in the proper accounts	• Inputs is recorded in the correct subsidiary ledger or general ledger account • Subsequent processing of a transaction results in it being reflected in the incorrect subsidiary ledger or general ledger account.

Assertions related to Financial Reporting and Potential Misstatements (Contd.)

Assertions about account balances at the period end (Balance sheet items)	**Examples of potential misstatements**
Existence - Assets, liabilities, and equity interests exist.	• A balance sheet account balance that was previously correctly recorded no longer exists and the sale/adjustment has not been recorded. • Sale of an asset with no recording of the sale. • Theft of an asset with no recording of the loss.
Rights and obligations-the entity holds or controls the rights to assets and liabilities are the obligations of the entity	• The entity no longer having the right to an asset that was previously correctly recorded • The entity no longer having an obligation to settle a liability that was previously correctly recorded.
Completeness-all assets, liabilities and equity interests that should have been recorded	• The liability that should have been recorded e.g. accrual not recorded at period end for certain liabilities.
Valuation and allocation-Assets, liabilities and other matters have occurred and pertain entity	• Impairment of assets that are not identified properly recorded. • Inaccurate adjustments that are made to an account balance at the period end that inappropriately adjust the value of that account balance. • Assets which are amortised over the incorrect period resulting in the remaining asset balance being incorrectly valued. • Fair value adjustments that are not identified and properly recorded.

Assertions related to Financial Reporting and Potential Misstatements (Contd.)

<table>
<tr><th><u>Assertions about presentation and disclosure</u></th><th>Examples of potential misstatements</th></tr>
<tr><td>Occurrence and rights and obligations –disclosed events, transactions, and other matters have occurred and pertain to the entity</td><td rowspan="4">• Fictitious or unauthorized disclosures are included in the financial statements
• Disclosure of contingent liabilities for which the entity no longer as an obligation for
• Disclosures that are not identified and therefore are not included in the financial statements
• Disclosures that are intentionally omitted from the financial statements
• The captions in the financial statements results in amounts being presented in a misleading way.
• Inputs are inaccurately captured into the financial statements
• Inputs into the financial statements reflects amounts in excess or less than the appropriate amounts.</td></tr>
<tr><td>Completeness-all disclosures that should have been included in the financial statements have been included</td></tr>
<tr><td>Classifications and understandability –financial information is appropriately presented and described , and disclosed fairly and disclosures are clearly expressed</td></tr>
<tr><td>Accuracy and valuation-financial and other information are disclosed fairly and at appropriate amounts</td></tr>
</table>

Control Characteristics

Control Characteristics

- Manual controls
- Detective controls
- Compensating controls
- Preventive controls
- IT dependant controls
- Directive controls
- Automated controls

Control Characteristics

- **Preventive:** Controls that deters errors or mitigates risks before they actually impact a business / process objective.
- **Detective:** Controls that helps identify a risk that has already impacted a business /process objective.
- **Directive:** Controls that increase the possibility of a desirable behavior to occur. Examples: training, incentive awards
- **Compensating:** Controls that mitigate the effects of an error or misstatement in the absence of a primary control or a control that is exercised by senior management at a birds' eye view level. Examples: budget to actual analysis in lieu of detail transaction review
- **Manual control:** Controls that are instituted outside any IT application. Examples of controls performed manually include a review of Debtors analysis.
- **IT Dependent control**: Controls that are manually performed, but require input based upon the results of computer-produced information.
- **Automated control:** Controls that are embedded within the application and have no manual intervention associated with it.

Potential risks and Mitigating Controls

The below provided are a few potential risks which may arise in a Non-Banking Finance Company (NBFC) and controls to mitigate such risks:

S. No	Particulars	Controls to Mitigate the Risk
1	Regulatory Risk	Compliance Controls
2	Outsourcing Risk	Operational Controls
3	Reputation Risk	Operational Controls
4	Cost Management Risk	Financial Controls
5	Cyber Risk	Operational Controls
6	Data & Privacy Risk	Operational Controls
7	Fraud Risk	Operational Controls
8	Personnel Safety Risk	Operational Controls
9	Talent Risk	Operational Controls
10	Business Continuity / Disaster Recovery Risk	Operational Controls
11	Concentration Risk	Operational Controls
12	NPA Management Risk	Financial Controls
13	Collections Risk	Financial Controls
14	Interest Rate Risk	Financial Controls
15	Project Management Risk	Operational Controls
16	Partner Risk	Operational Controls
17	Liquidity Risk	Financial Controls
18	Collection Risk	Financial Controls

Various Operational and Compliance may directly or indirectly have financial implications by way of cost overrun / revenue leakages / fines and penalties, etc. However, there is a primary operational or compliance control to mitigate such risks.

Components of Internal Controls

Components of Internal Control

The following are **components of Internal Control:**

Components of Internal Control

- Control environment
- Entity's risk assessment process
- Control activities
- Information system and communication
- Monitoring of controls

Control Environment

The control environment compasses of the following elements:

a. Communication and enforcement of integrity and ethical values
b. Commitment of competence
c. Participation of those charged with governance (TCWG)
d. Management's philosophy and operating style
e. Organisational structure
f. Assignment of authority and responsibility
g. Human resource policies and practices.

Control Environment (Contd.)

The below are the list of key entity level controls (ELC’s) in any Company:

- Established Code of conduct & Code of ethics on matters such as business practices, ethical behaviour, conflict of interest etc. and a monitoring mechanism to ensure compliance etc.
- Process for Fair projection of manpower requirement, hiring of suitable employee, training, motivating, appropriate performance assessment mechanism, back-up plan in case of vacancy in critical jobs etc.
- Internal Audit function to provide assurance on compliance to Company processes/policies, detailed discussion on issues highlighted in internal audit reports, ensuring timely & appropriate resolution of issues identified etc.
- Identification & updation of regulatory changes and ensuring compliance from effective date of such changes.
- Identification of risks impacting the operations of the Company preparation of risk mitigation plans.
- Management Information System.
- Review Mechanism of Company’s operations by the Board.
- Active participation of committee’s setup by the Board in framing policies / measures to maintain a sound control environment

Control Environment (Contd.)

The overall control environment should address the risk of management override of controls which is a significant fraud risk, which is the risk that management is in a unique position to perpetrate fraud (either due to incentive or pressure) because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Controls that might address these risks include:

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.
- Oversight controls such as whistleblower programs.

Entity's Risk Assessment Process

Entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements. Management may initiate plans, programs, or actions to address specific risks, or it may decide to accept a risk because of cost or other considerations. Risk can arise due to the following:

a) **Changes in operating environment:** Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
b) **New personnel:** New personnel may have a different focus on or understanding of internal control.
c) **New or revamped information systems:** Significant and rapid changes in information systems can change the risk relating to internal control.
d) **Rapid growth:** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
e) **Corporate restructurings:** Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
f) **New business models, products, or activities:** Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
g) **New technology:** Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

Control Activities

The control environment compasses of the following elements:

a. **Authorisations -** Whether the transactions are authorised by the appropriate levels of authority within the organisations

b. **Performance reviews** – review and analyses of performance vs budgets, forecast, and prior period performance. Correlation of operating and financial data.

c. **Information processing –**
   i. **Application controls** – processing of individual applications.
   ii. **General IT Controls** – policies and procedures that relate to many applications and support the effective functioning of application controls

d. **Physical Controls** – Physical security of assets / access to computer programs and files / Periodical physical verification of assets (Inventory / cash / fixed assets)

e. **Segregation of duties–** Assigning different people the responsibilities of authorising transactions, recording transactions, maintaining custody of assets.

Control Activities (contd.)

The following are the typical set of tasks / activities that need to be segregated from a generic perspective:

- Initiating a transaction (including developing appropriate documentation).
- Authorising the transaction.
- Recording the transaction
- Monitoring custody of the physical asset.
- Reconciling subsidiary ledgers with the general ledger.
- Processing master file transactions.
- Authorising master file transactions.
- Following up on issues or discrepancies
- Controlling systems development and daily operations in computer-based accounting systems.

Information System and Communication

Information systems consists of infrastructure (physical and hardware components), software, people, procedures and data. Many information systems make extensive use of information technology.

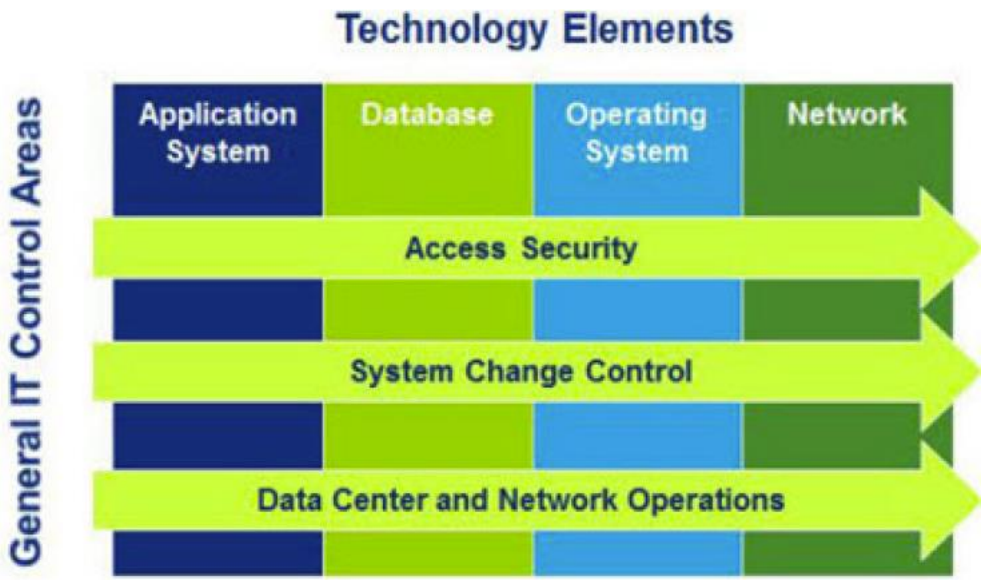
The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that

- Identify and record all valid transactions
- Describe on a timely basis the transactions in sufficient detail to permit proper classifications of transactions for financial reporting
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period
- Present properly the transactions and related disclosures in the financial statements.

Information System and Communication (contd.)

The below are the list of key Information Technology General Controls which will be covered as part of Information Systems and Communications:-

- Access to various infrastructure, software applications, data centers and servers.
- Authorization of requests for creation / change in the master data.
- Validation / User Acceptance tests w.r.t updates carried out in any applications before go-live / implementation.
- Access to premises based on appropriate authorization.
- Backup / Data recovery plan in place to ensure data safety.



Monitoring of Controls

Monitoring of controls may include activities such as,

- management's review of whether bank reconciliations are being prepared on a timely basis,
- internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and
- a legal department's oversight of compliance with the entity's ethical or business practice policies.

Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them. The overall system of internal controls also includes the following:-

1. **Internal Check System:** Internal check system implies organization of the overall system of book-keeping and arrangement of staff duties. It is part of overall system and operates basically as a built-in-device, as far as organization and job-allocation aspects of the controls are concerned. The system provides day to day transactions which operate continuously as part of the routine system whereby the work of each person is either proved independently or is made complimentary to the work of another.
2. **Internal Audit:** Internal audit may be defined as an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization.

Preparation and Documentation of ICFR Framework

Documentation of ICFR Framework

The documentation of the control framework should factor the following

Documentation of ICFR Framework (Contd.)

The Structure / Columns of the Risk Control Matrix (RCM) is as follows

- Sub-process
- Assertions
- Risk Description
- Classification of Inherent Risk (Significant/Normal)
- Risk of Material Misstatement Due to Fraud?
- Control That Addresses Risk
- Control Activity / Process Owner Department
- Type of Control – a) Operational b) Financial c) Compliance
- Control Characteristic – a) Preventive / Detective, b) Automated / Manual
- Operating Frequency (Annually, Quarterly, Monthly, Weekly, Daily, Many Times per Day, As Needed)
- Application System / ERP used by the Entity for the relevant control
- Does the control rely on computer-generated information? (Yes / No)
- Control Characteristic based on priority – Key Control / Non-Key Control
- Whether performed by a third-party service organization
- Document Evidence
- Design Conclusion (Effective/Ineffective)
- Operating Effectiveness Conclusion

Approach in preparing ICFR Framework

I

Discuss

Inquiry with appropriate personnel to start with, the Head of Department.

II

Read

Review existing documented procedures and policies.

III

Document

Understand the ‘as-is’ process and sub-processes along with associated components and document the same as part of the RCMs.

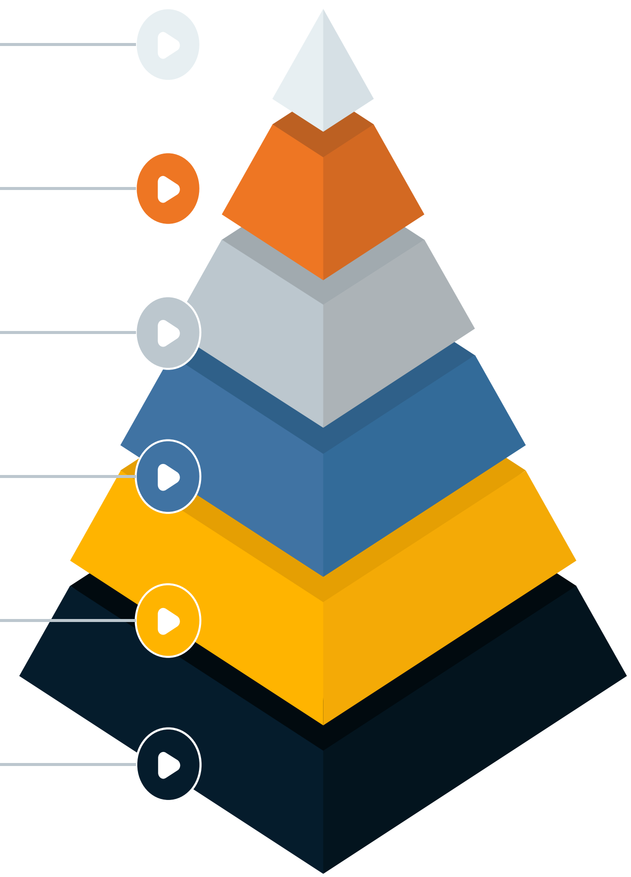
IV

Deliver

Prepare the RCMs

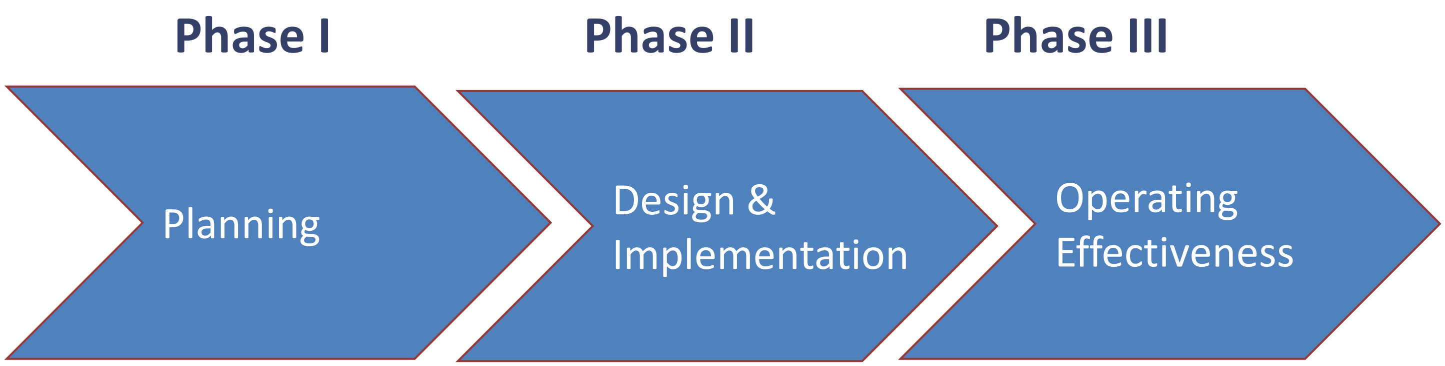
Approach in preparing ICFR Framework (Contd..)

- Focus on process understanding with appropriate personnel of relevant department at all levels of hierarchy in the Organization
- Documenting the process understandiing in the Risk Control matrix with the appropriate Risk and Control ID format
- Audit procedures inbuilt with corroboration of data from independent sources and connecting the dots with the process understanding
- Effective use of data, extensive use of analytics to provide meaningful insights
- Verification of transaction origination and accuracy of reporting
- Visiting branches if any and carrying testing at the branch and HO level

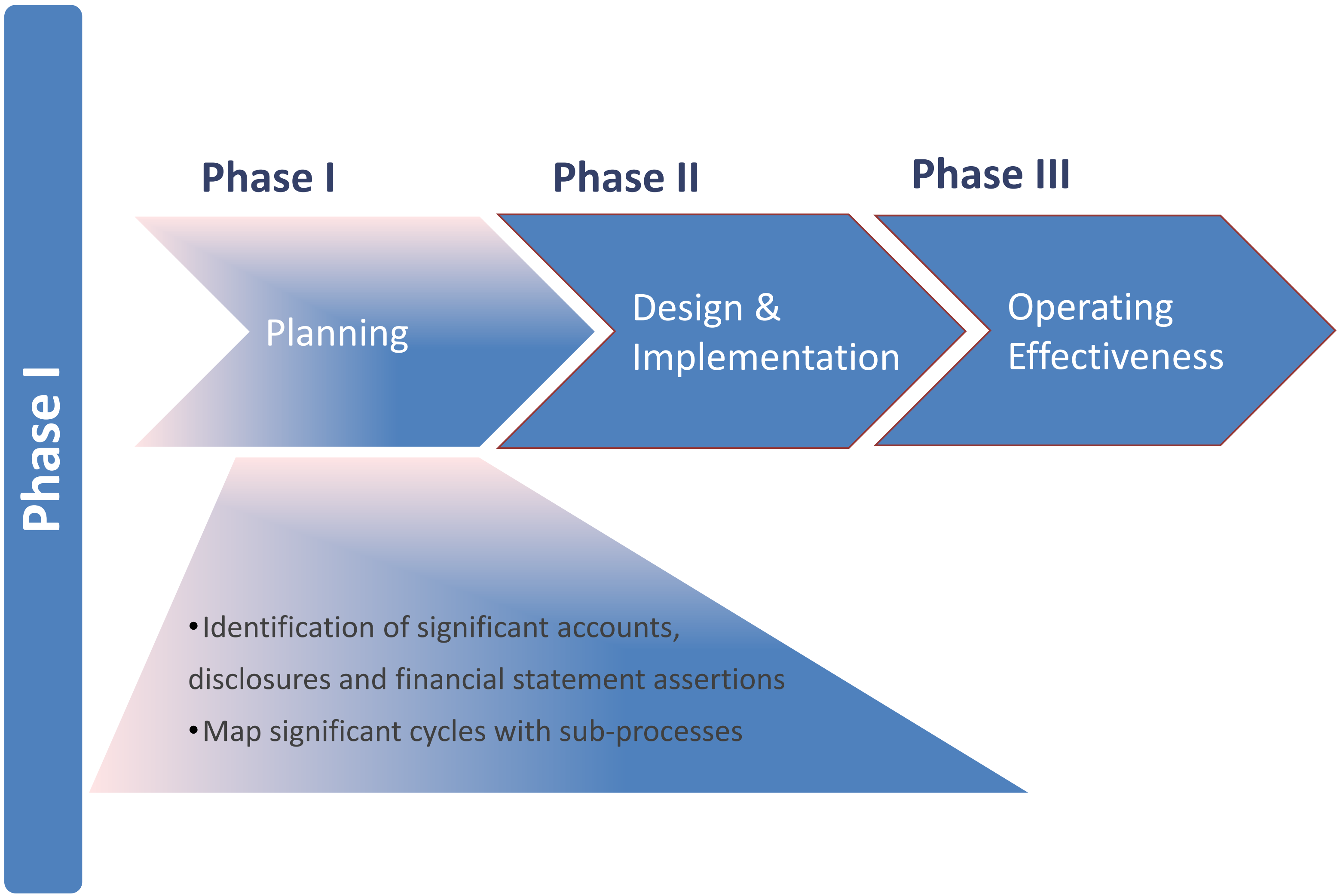


Testing of Framework

Phases of Assessment of ICFR



Phases of Assessment of ICFR (Contd.)



Phases of Assessment of ICFR (Contd.)

Phase II

Phase I — Planning

Phase II — Design & Implementation

Phase III — Operating Effectiveness

- Assessment of entity level controls
- Perform walkthroughs and enquiries to obtain understanding and document the process flow of the significant change in business processes
- Assessment of control design effectiveness
- Prepare/Update the Risk and Control Matrices (‘RCM’) to reflect the current process.

Phases of Assessment of ICFR (Contd.)

Phase III

Phase I

Planning

Phase II

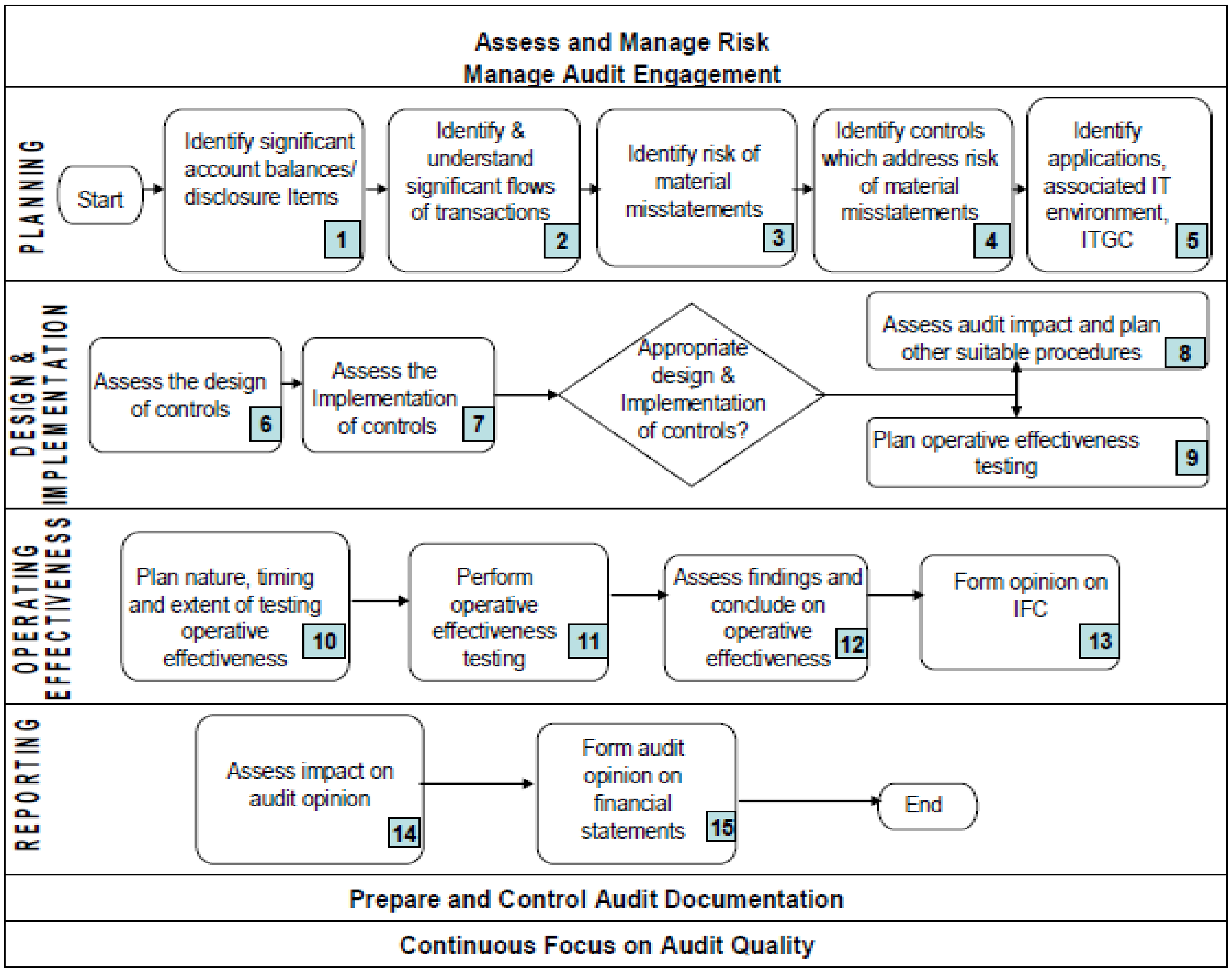
Design & Implementation

Phase III

Operating effectiveness

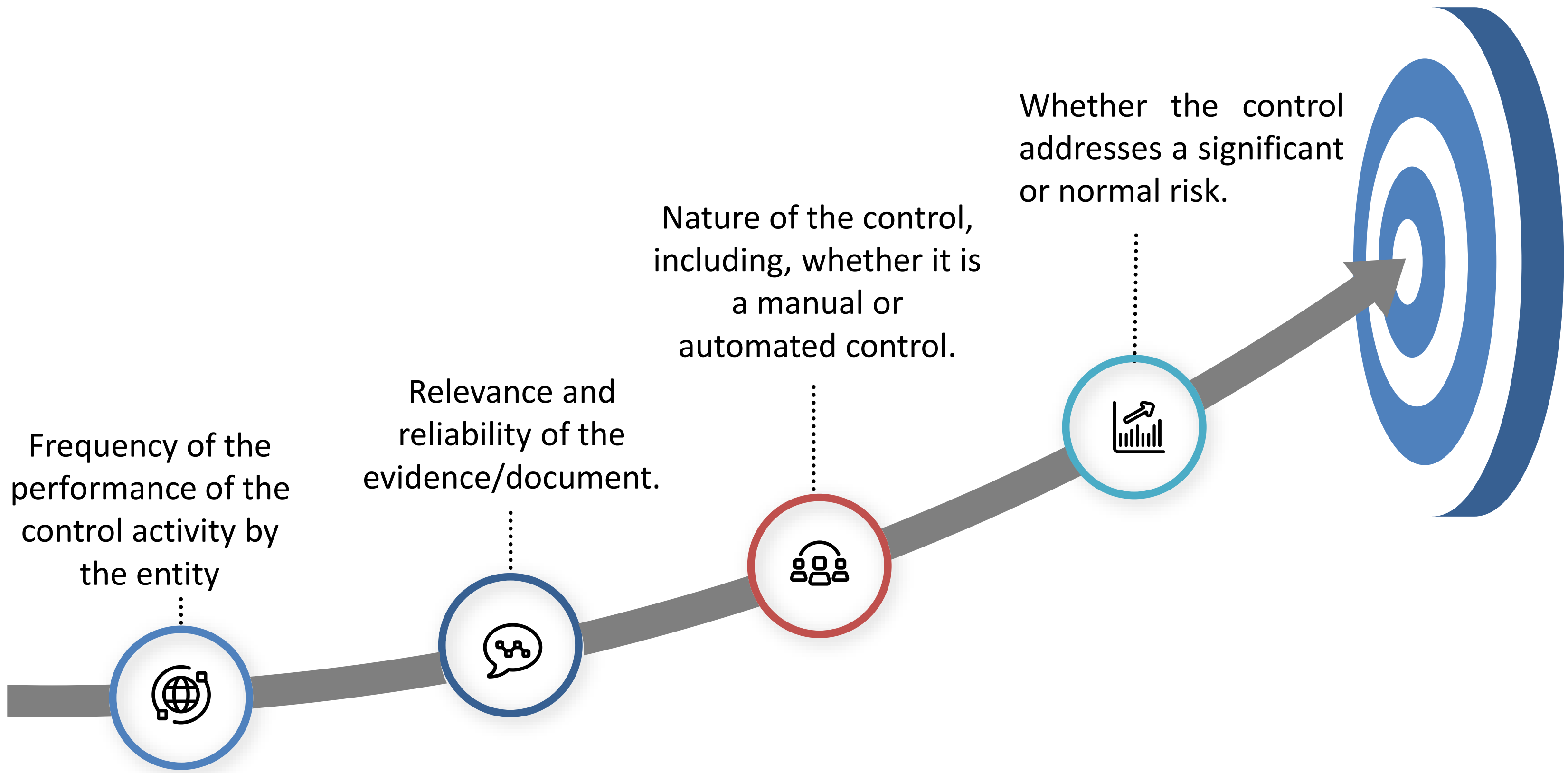
- Testing of key controls
- Assessment and conclusion of operating effectiveness of key controls
- Identification of control gaps and remediation test plan

Management and Assess Risk - Overview



Approach for Testing of Controls

Matters that may affect the necessary extent of testing of a control, in relation to the degree of reliance on a control include the following factors:-



Approach for Testing of Controls (Contd..)

Tests of controls are usually performed using the following techniques, often in combination:

Inquiry consists of seeking information from knowledgeable persons in financial or non financial roles within the company or outside the company . Evaluating responses to inquiries is an integral part of the inquiry process

Observation consists of looking at a process or procedure being performed by others

Reperformance involves the independent execution of procedures or controls that were originally performed by the company personnel

Inspection involves examining of documents, whether internal or external, in paper form, or other media, or physically examining an asset

Approach for Testing of Controls (Contd..)

The sample will be selected in accordance with the Guidance Note issued by the ICAI.

Frequency of Control	Minimum Sample size	
	Medium	High
Annual	1	1
Quarterly	1	1
Monthly	2	3
Weekly	5	8
Daily	14	25
Recurring manual control (many times a day)	25	40

Approach for Testing of Controls (Contd..)

When planning a particular audit sample for a test of controls, the auditor should consider

- The relationship of the sample to the objective of the test of controls.
- The maximum rate of deviations from prescribed controls that would support the planned assessed level of control risk.
- The auditor's allowable risk of assessing control risk too low.
- Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

Reference may be drawn to Standards on Internal Audit (SIA-5) – Sampling as elaborated in the subsequent slides.

Testing of Controls - Sampling

When designing an audit sample, the internal auditor should consider:

- Specific audit objectives
- Population of the sample
- Stratification (a process of dividing a population into sub-populations, each of which is a group of sampling units having similar characteristics)

Sample Size

- When determining the sample size, the Company should consider
  - **Sampling risk**
  - **Tolerable error**
  - **Expected error**

Selection of the Sample:

- Sample should be selected in such a manner that it can be expected to be representative of the population. This requires that all items or sampling units in the population have an opportunity of being selected.

“The lower the risk the Company is willing to accept, the greater the sample size needs to be”

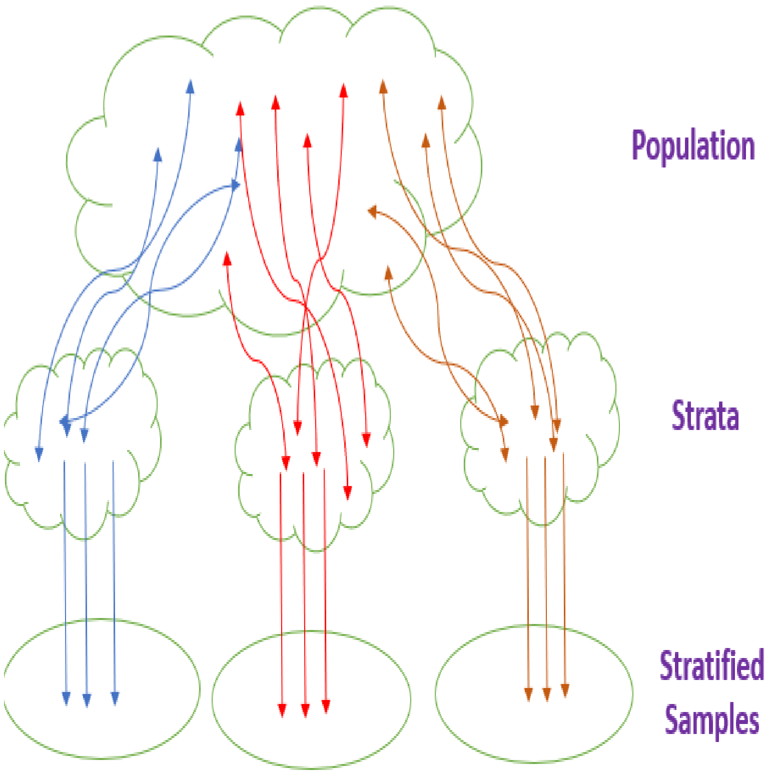
Testing of Controls – Sampling (Contd.)

Three methods of Sample selection:

- Random selection and use of CAATs
- Systematic selection
- Haphazard selection

Evaluation of Sample Results, the auditor should:

- Analyse the nature and cause of any errors detected in the sample;
- Project the errors found in the sample to the population;
- Reassess the sampling risk; and
- Consider their possible effect on the specific internal audit objective and on other areas of the internal audit engagement.



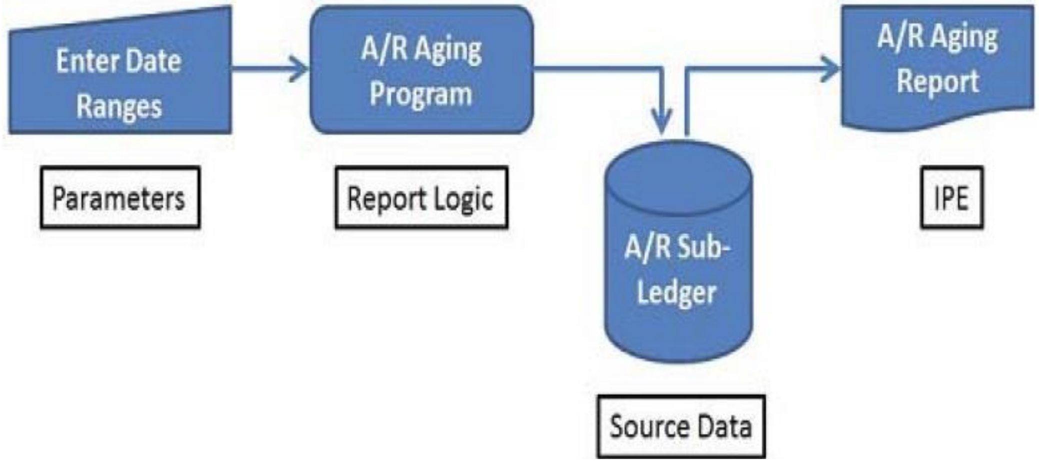
Documentation includes design of the sample, expected rate of error, sampling risk and the tolerable error, nature and cause of errors, Rationale for using a particular sampling technique, Effect of the sample results, Projection of sample results.

Testing of Controls – CGI

Testing of Controls also involves understanding Computer generated information (CGI) or report:

Nature of CGI	Purpose which the CGI Serves
CGI that the entity uses	When performing relevant controls
CGI that the auditor uses as an audit Evidence	When performing tests of operating effectiveness of controls

CGI typically consists of three elements : (1) Source data , (2) Report logic , (3) Parameters. An illustration is given below:-



Sub-processes / Activities – for all Business Cycles

Business cycles – In a Manufacturing Concern

- Revenue
- Inventory (Purchases and Production)
- Property Plant & Equipment
- Expenditure
- Human Resources & Payroll
- Treasury
- Statutory compliance
- Financial Reporting

Business cycles and sub-processes

The key business cycles along with sub-processes identified by us are summarised below:-

Business Cycles	Sub-processes
Revenue	➢ Receipt of Purchase orders and updation of Sales order/Delivery order in ERP / Accounting Software / Spreadsheet. ➢ Creation of customer code, assignment of credit limit, credit period etc ➢ Controls over dispatch process – Weighment, truck movement, quality check ➢ Raising of Invoice and recording of Sales in ERP / Accounting Software ➢ Recognition of revenue considering principles of Ind AS 115. ➢ Levy of taxes such as GST and TCS at appropriate rates. ➢ Delivery of goods to customer, acknowledgement, rejections/short quantity, debit notes, freight recovery etc. ➢ Periodic review of over due debtors, short receipts from debtors, Budget Vs Actuals etc. ➢ Process of estimation for expected credit loss for receivables

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Revenue (Contd..)	➢ Reconciliation of sales register vs GL, periodic customer confirmations etc. ➢ Monitoring of credit period provided to customers and follow-up for collections.
Inventory (Purchases & Production)	➢ Raising and approval of Purchase Indent. ➢ Vendor identification and evaluation. ➢ Obtaining quotations , rate negotiation, PO finalisation and vendor code creation etc ➢ GRN related controls - Receipt, quality inspection and updation in ERP / Accounting Software. ➢ Accounting of Purchases, availment of GST credit. ➢ Purchase return, raising of debit note, dispatch of rejected materials etc. ➢ Monitoring of credit period provided by vendors and payments within due dates. ➢ Compliance with provisions of MSME Act, 2006.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Inventory (Purchases & Production) (Contd..)	➢ Controls over issue and accounting of consumption of stores and spares. ➢ Monitoring and recording of Daily production of Finished Goods. ➢ Control over safeguarding of inventories. ➢ Physical verification of inventory and posting of adjustments if any. ➢ Identification of processing cost (labour and overheads), absorption of the same to various products and ensuring consistency across divisions ➢ Valuation of inventory, work in progress, Non moving inventory/Net Realisable Value provision, and other adjustments to Inventory value.
Property Plant & Equipment	➢ Raising and approval of Purchase Indent, Budget approval etc. ➢ Obtaining quotations, rate negotiation and PO finalisation. ➢ GRN related controls - Receipt, quality inspection and updation in ERP / Accounting Software. ➢ Advance Bank Guarantee (ABG) for advance payment and Performance Bank Guarantee (PBG) for critical equipment's. ➢ Follow up with User/Operations teams for status of ongoing projects/commissioned-to be commissioned machines and the corresponding dates of capitalisation. ➢ Monitoring of Capital Work in progress and its movement.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Property Plant & Equipment (Contd..)	➢ Identification of capitalizable expenditure and compliance with Ind AS. ➢ Determination of useful life of Fixed Assets/depreciation rate and depreciation method. ➢ Preparation and maintenance of Fixed Assets register and Fixed Asset Schedule. ➢ Depreciation computation, ensuring compliance with Companies Act, 2013 / Ind AS w.r.t depreciation rates etc. ➢ Control over sale/scrapping of assets, determination of profit/loss on sale of asset ➢ Physical verification of fixed assets and accounting of discrepancies, if any ➢ Intangible Asset identification and capitalisation. ➢ Insurance of Fixed Assets etc. ➢ Accounting of Leases in accordance with Ind AS 116

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Expenditure	➢ Contract finalisation and awarding for routine expenditure such as Security/Canteen/Staff Bus/Goods dispatch (Transport) etc. ➢ Obtaining quotations and PO finalisation w.r.t other non-routine/one-time expenditure ➢ Receipt of Invoice, user certification, confirming the rates as per contract/PO ➢ Control over accounting of provisions and classification of expenditure under correct account head, cost centre, vendor payment etc. ➢ Availment of GST Input Credit where applicable, discharge of liability on reverse charge mechanism wherever applicable, application of withholding tax where applicable. ➢ Procedures for receiving, accounting and processing invoices for various expenses such as Info-tech expense, Legal & professional charges, Communication charges, electricity charges, etc. ➢ Payment Processing - determination of payment date, accounting and processing of payments including ageing reports, confirmations and reconciliations. ➢ Vendor creation and management process, including process of identification of Micro Small and Medium Enterprise (MSME) vendors

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Human Resources and Payroll	➢ Manpower approval plan based upon requirement ➢ Addition of employees – interview, medical & background verification, salary fixation, appointment letter, induction program etc. ➢ Creation of employee master and providing biometric access. ➢ Time recording and leave monitoring, leave procedure etc. ➢ Monthly Payroll processing including non-CTC components such as Overtime allowance, Production Incentive etc. ➢ Recording of payroll expense in GL and disbursement. ➢ Updation in employee masters w.r.t promotions/increments. ➢ Resignation – Notice period, no-due certificate, processing of Full and Final settlement. ➢ Statutory liabilities such as PF/ESI and Professional Tax – identification of eligible employees, application of correct rate on the appropriate base amount. ➢ Computation of TDS on salaries based on employee declaration, submission of investment/reimbursement proof. ➢ Granting, Exercise and Accounting of Employee Stock Option Scheme. ➢ Accrual of Retirement and other benefits such as Gratuity, leave encashment and superannuation etc.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Treasury – Borrowings & Investments	➢ Accounting of receipts and application of the same against outstanding invoices. ➢ Preparation of vouchers & accounting of payments and application of the same against outstanding invoices. ➢ Preparation and review of Bank Reconciliation Statement (BRS), reversal of entries for stale cheques etc. ➢ Monitoring the position of surplus funds and investing in Mutual funds/ Fixed deposits, obtaining balance confirmation. ➢ Accounting of bank charges, dividend income, interest income, month end accrual entries such as accrued interest etc. ➢ Determining the requirement of funds for the purpose of redemption. ➢ Monitoring the covenants of the loan agreement including due dates for repayment of principal/interest and compliance with RBI regulations, wherever applicable. ➢ Procedure for opening, monitoring & closure of LC's & BG's issued ➢ Obtaining Credit Rating of Company for submission to banks. ➢ Creation of charge for borrowings.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Statutory Compliance	➢ Appropriate accounting of all statutory liabilities such as PF, ESI, TDS, GST and Income tax ➢ Monitoring of various notifications/circulars/case laws including various extensions provided by regulators due to COVID-19 pandemic and assessing the applicability to the Company and making adequate changes to the processes / software / systems. ➢ Filing of statutory returns & remittance – monthly, quarterly, annual within due dates ➢ Controls over data collections and report generation for the purpose of reporting to statutory authorities and reconciliation of the aforesaid information – amount remitted and amounts disclosed in returns with books of account. ➢ Implementation of a Compliance software & monitoring of various compliances under various statutes. ➢ Availment of eligible GST Input Credit, discharge of liability on reverse charge mechanism, application of appropriate withholding taxes, reconciliation performed between GSTR 2A and books for claiming of ITC, GST TDS receivables as per books and as per electronic cash ledger. ➢ Review of compliances under Goods & Services Tax (GST) like E-way bill, E-invoicing etc.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Statutory Compliance (Contd..)	➢ Compliances arising out of SEBI (Listing Obligation and Disclosure Requirements), 2015, Company Law and other regulatory requirements. ➢ Compliance with FEMA guidelines w.r.t. maintenance of proper documentation for export sales, preparation and submission of forms / returns such as FLA, etc.
Financial Reporting	➢ Control over non-routine/non-standard journal entries. ➢ Reconciliation of sub-systems/sub-ledgers with General Ledger/Trial balance. ➢ Preparation and review of schedules. ➢ Management information system like daily reports, weekly reports, Monthly reports, quarterly Board meetings etc. ➢ Preparation of financial statements both standalone and consolidated – including review by senior management, auditors and the Audit Committee/Board of Directors. ➢ Controls over identification of related parties and transactions with related parties. ➢ Control over preparation and circulation of Board folder including relevant data for meaningful discussions & informed decision making by the Board.

Business cycles and sub-processes (Contd..)

Business Cycles	Sub-processes
Financial Reporting (Contd.)	➢ Variance and Ratio analysis. ➢ Compilation of workings for disclosures in notes to accounts. ➢ Controls over Contingent liabilities/legal disputes and monitoring of status of existing matters, inclusion of new matters etc. and assessment of the same as per Ind AS. ➢ Monitoring the requirements emanating from Ind AS and other applicable regulatory/professional pronouncements. ➢ Monitoring the requirements of SEBI Regulations w.r.t quarterly results. ➢ Assessment and discussion at level of Audit Committee and Board regarding estimates/ assumptions in financial statements.

Summary of Risks and Controls

Business Cycle	No. of Risks	No. of Controls	Operational		Financial		Compliance	
			Key	Non-Key	Key	Non-Key	Key	Non-Key
Revenue								
Inventory								
Purchases								
PPE								
Expenditure								
Human Resource								
Treasury								
Statutory Compliance								
Financial Reporting								
ITGC								
ELC								
Total								

Summary of Controls Testing (Basis Priority of Controls)

Cycle	No. of controls	Key Controls				Non-key controls			
		Effective	Partially effective	Ineffective	Total	Effective	Partially effective	Ineffective	Total
Revenue									
Inventory									
Purchases									
PPE									
Expenditure									
Human Resource									
Treasury									
Statutory Compliance									
Financial Reporting									
ITGC									
ELC									
Total									

Summary of Testing of Controls (Classification of Controls)

Cycle	Total no. of controls	Operational		Financial		Compliance	
		Effective	Partially effective	Effective	Partially effective	Effective	Partially effective
Revenue							
Inventory							
Purchases							
PPE							
Expenditure							
Human Resource							
Treasury							
Statutory Compliance							
Financial Reporting							
ITGC							
ELC							
Total							

Evaluation of Control Lapses

Evaluation of Control lapses

As per the Guidance Note issued by ICAI, any aberration noted in the control/process generally followed by the Company is required to be classified into Deficiency(D)/Significant deficiency (SD)/Material weakness (MW).

The following extract from the Guidance Note is given for ready reference: -

"A 'Deficiency (D)' in internal financial control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."

"A 'Significant Deficiency (SD)' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

"A 'Material Weakness (MW)' is a deficiency, or a combination of deficiencies, in internal financial control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

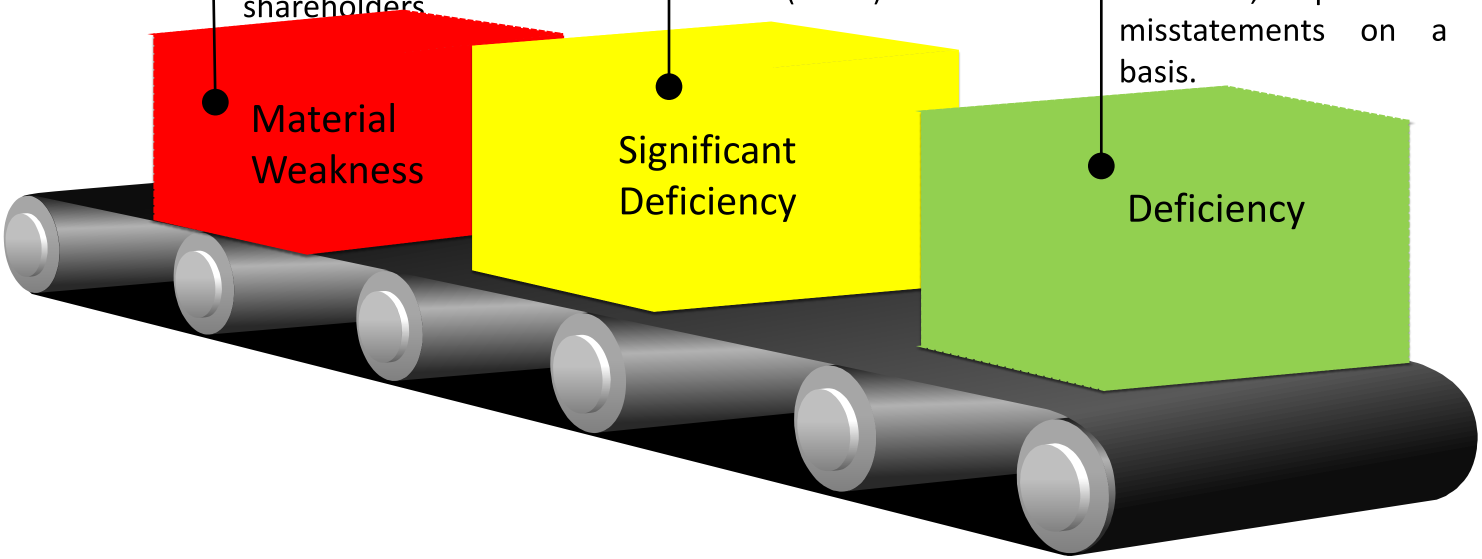
Evaluation of Control lapses (Contd.)

Observations are categorised as below:

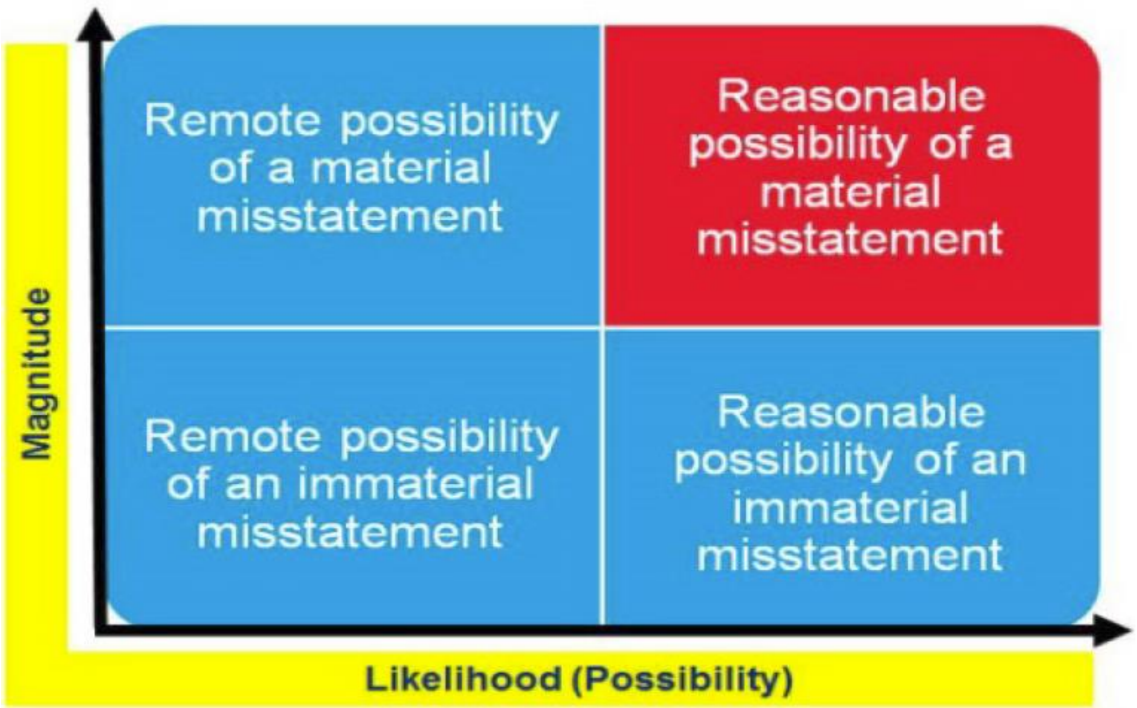
A possibility that a material misstatement of the company's annual or interim FS will not be prevented or detected on a timely basis which warrants attention of TCWG (Board) and shareholders.

A possibility that a misstatement of the company's annual or interim FS will not be prevented or detected on a timely basis which warrants attention of TCWG (Board)

The design or operation of a control does not allow anyone, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.



Evaluation of Control lapses – Magnitude vs Possibility



Evaluation of Control lapses – Design vs Operation

A deficiency in design exists when

(a) a control necessary to meet the control objective is missing or
(b) an existing control is not properly designed so that even if the control operates as designed, the control objective would not be met

A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Reporting on internal financial controls system is similar to reporting on operations of the company. Whilst the testing is carried out on the transactions recorded during the year, the reporting is as at the balance sheet date. For example, if the company's revenue recognition was erroneous through the year under audit but was corrected, including for matters relating to internal control that caused the error, as at the balance sheet date, the auditor is not required to report on the errors in revenue recognition during the year.

Basis of Conclusion

Based on the results of the sample testing, the conclusion on operating effectiveness of the control designed by the management is required to be assessed for which the following approach has been adopted by us: -

% of aberrations noted	Impact on financial reporting on account of aberrations	Classification of nature of observation	Conclusion on operating effectiveness in Risk Control Matrix	Indication of Priority of observation
No aberration noted	None	Not application	Effective	Not applicable
Upto 50% of the total sample size	Process deviation but no impact/negligible impact	Deficiency	Partially effective	Low
Upto 50% of the total sample size	Not having a material impact	Deficiency	Partially effective	Medium
Higher than 50% upto 100% of sample size	Process deviation but no impact/negligible impact	Deficiency	Ineffective	Medium
Higher than 50% upto 100% of sample size	Having a direct and material/significant impact	SD/MW	Ineffective	High

Reporting on ICFR – Audit Opinion

Sample Reporting formats – Clean Opinion

Clean report

In my / our opinion, the Company has, in all material respects, an adequate internal financial controls system over financial reporting and such internal financial controls over financial reporting were operating effectively as at March 31, 20X1, based on ______ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.

Sample Reporting formats – Qualified Opinion

Qualified opinion on adequacy and operating effectiveness

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:
a) The Company **<u>did not have an appropriate internal control system</u>** for customer acceptance, credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

In my / our opinion, **except for the effects/possible effects of the material weakness/es described above** on the achievement of the objectives of the control criteria, **the Company has maintained**, in all material respects, adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were operating effectively as of March 31, 20X1, based on ______ [for example "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.

I / We have considered the material weakness/es identified and reported above in determining the nature, timing, and extent of audit tests applied in my / our audit of the March 31, 20X1 standalone financial statements of the Company, and the / these material weakness/es does not / do not affect my / our opinion on the standalone financial statements of the Company.

Sample Reporting formats – Qualified Opinion (Contd.)

Qualified opinion on operating effectiveness

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

The Company's internal financial controls over customer acceptance, credit evaluation and establishing customer credit limits for sales, **were not operating effectively** which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

In my / our opinion, **the Company has**, in all material respects, **maintained adequate** internal financial controls over financial reporting as of March 31, 20X1, based on ______ [for example, "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India"], and **except for the effects/possible effects of the material weakness/es** described above on the achievement of the objectives of the control criteria, the Company's internal financial **controls** over financial reporting **were operating effectively** as of March 31, 20X1.

Sample Reporting formats – Adverse Opinion

Adverse opinion on adequacy and operating effectiveness

According to the information and explanations given to me / us and based on my / our audit, the following material weakness/es has / have been identified as at March 31, 20X1:

a) The Company did not have an appropriate internal control system for customer acceptance, credit evaluation and establishing customer credit limits for sales, which could potentially result in the Company recognising revenue without establishing reasonable certainty of ultimate collection.

b) The Company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification. Further, the internal control system for identification and allocation of overheads to inventory was also not adequate. These could potentially result in material misstatements in the Company's trade payables, consumption, inventory and expense account balances.

Adverse opinion on adequacy and operating effectiveness

In my / our opinion, because of the effects/possible effects of the material weakness/es described above on the achievement of the objectives of the control criteria, **the Company has not maintained** adequate internal financial controls over financial reporting and such internal financial controls over financial reporting were not operating effectively as of March 31, 20X1 based on ______ [for example "the internal control over financial reporting criteria established by the Company considering the essential components of internal control stated in Guidance Note on Audit of Internal Financial Controls Over Financial Reporting issued by the Institute of Chartered Accountants of India.

Mr. Manish P, Partner
Mukesh Manish & Kalpesh
Chartered Accountants
7th Floor, Briley One,
New No. 64, Old No. 30,
Ethiraj Salai
(Near Ethiraj College)
Chennai – 600 008, Tamil
Nadu, India

Ph No: +91-98406 75792
Email: manish@m2k.co.in

Thank You