Years of Demystifying Complexities

Internal Financial Controls (IFCs)

What is IFC?

- As per the Companies Act, 2013, IFCs are policies and procedures adopted by a company to ensure orderly and efficient conduct of its business, including

  ✓ Adherence to company's policies,
  ✓ Safeguarding of assets,
  ✓ Prevention and detection of frauds and errors,
  ✓ Accuracy and completeness of accounting records, and
  ✓ Timely preparation of reliable financial information

- IFCs in India are similar to 'SOX', i.e., the 'Sarbanes–Oxley Act' of 2002 which is a United States federal law that mandates certain practices in financial record keeping and reporting for corporations. The passing of the SOX Act in 2002 established rules to protect the public from fraudulent or predatory practices by corporations and other business entities. The Act increased transparency in financial reporting by corporations and established a system of internal corporate checks and balances.

What are the components of IFCs?

- IFCs are a combination of:

  ✓ (A) Internal Controls on Financial Reporting (ICFR), (i.e., controls designed to provide reasonable assurance that the company's financial statements are reliable and prepared in accordance with key accounting principles),

  ✓ (B) Operational Controls (i.e. controls designed to provide reasonable assurance on business operations, process efficiency and effectiveness, other than those covered for financial reporting), and

  ✓ (C) Fraud Controls, aimed at prevention and detection of frauds and errors

Internal Controls on Financial Reporting (ICFR)

- ICFR is 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

- The objective of having ICFR in place is not limited to being a legal requirement as per Companies Act 2013, but also that the company is proactively informed before compliances become due and the stakeholders are able to check the health of company's compliances at any given point of time

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Legal requirement for IFCs as per Companies Act, 2013

- **Directors** of all listed companies have to report in the Directors Responsibility Statement that the laid down IFCs of the company have been followed and that such IFC are adequate and were operating effectively

- In the case of following companies, the **Audit Committee** of the company is required to evaluate IFCs and risk management systems.

  (a) Public companies with a paid-up share capital ≥ INR 100 million
  (b) Public companies having annual sales / turnover ≥ INR 1000 million
  (c) Public companies having aggregate outstanding loans or borrowings or debentures or deposits ≥ INR 500 million

  The Audit Committee may call for comments from auditor about internal control systems before their submission to the Board of directors.

  Further, for the above companies, the **Independent Directors** should satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust.

Legal requirement for ICFRs as per Companies Act, 2013

- The **Statutory Auditor** of a company is required to report in the annual audit report:
  - ✓ Whether the company has adequate ICFRs in place or not, and
  - ✓ The operating effectiveness of such controls

  In other words, simply having ICFRs in place is not sufficient. The ICFRs must be operating effectively for a clean report from the statutory auditor

- The **Board of Directors** of a company are required to comment on adequacy of ICFR and operating effectiveness of the same in the directors' report

- An **Exemption** is available to Private Companies from reporting on ICFRs in following cases:
  - ✓ One-Person company, or
  - ✓ Small company (i.e., company having paid up capital ≤ INR 40 million and annual sales / turnover ≤ INR 400 million), or
  - ✓ Company with annual sales / turnover < INR 500 million, or
  - ✓ Company with aggregate outstanding loan and borrowings from bank < INR 250 million at any point of time during the year

What is the required documentation to show that IFCs / ICFR are operating effectively
• Key policies and procedures • Identification of account balances, related business processes and controls environment • Adoption of a control network • Defined procedures for governance and monitoring • Identification and assessment of risks related to business processes • Identification of control objectives to address identified risks and related control activities to mitigate such risks • Identification and assessment of controls designed and implementation against each of the control objectives • Assessment and documentation of the operating effectiveness of the controls designed for the period under review • Analysis of deficiencies, if any, in the assessment of controls and remediation of gaps identified • Report on results of management's evaluation of controls to the board of directors

Methodology for Documentation, Testing and Implementation of IFC / ICFR	
Scoping for the company	• Identify significant account balances and disclosure Items. Understand significant flows of transactions. Identify risk of material misstatements by performing walkthroughs in the most effective way • Identify controls addressing risk of material misstatement. Testing Design, Implementation and Operating Effectiveness of such Controls
Designing IFC / ICFR framework and conducting: (a) <u>Entity Level Controls</u> (<u>ELC</u>) assessment, and (b) <u>Process Level Controls</u> (<u>PLC</u>) assessment	• Design of IFC / ICFR framework on behalf of the company considering leading practices and available guidance notes (including roles and responsibilities across various positions such as executive management, administration staff, auditor, vigilance team, etc) • Assessment of ELCs ✓ <u>ELCs are Organization level controls</u> impacting culture, ethical standards, oversight, responsibility and accountability ✓ The various components of ELCs are control environment, risk assessment, control activities, information system, communication and monitoring

	• Assessment of PLCs ✓ As the name suggests, PLCs are controls at a process-level ✓ It includes mapping of accounts and processes. PLCs relate to revenue, receivables, purchase, payable, fixed assets, etc. ✓ Certain tools for adherence to PLCs are standard operating procedures (SOPs), risk control matrix (RCM), delegation of authority mix, segregation of duty, information technology (IT) general controls, etc.
Design assessment of Internal Controls	• Consolidation of existing controls documentation (SOPs / RCMs, etc) • Review of the documentation to assess how much of the same can be leveraged • Preparation of flow-charts / narratives of associated processes
Identification and Remediation of Control Gaps	• Identification of design gaps. Prioritizing financial gaps into material / non-material. Review of these gaps with the auditor • Preparation of corrective action plan and timelines • Ensuring closure of control gaps
Test for Operating Effectiveness	• Identification and testing of key controls • Ensuring existence of adequate documentation evidencing effectiveness of controls • Reporting on operating effectiveness of such controls

Documentation for IFC / ICFR evaluation	Points to be kept in mind
• Risk management framework including Process RCM • Scoping documents for mapping of Significant Accounts and Processes • Process flow-charts / Narratives / SOPs / Compliance Calendar • Management Testing Documents and Summary Report on IFC / ICFR Evaluation	• IFC / ICFR evaluation is predominantly based on concept of Materiality, especially in case of large companies. While sincere efforts should be made to cover all the relevant matters, areas not important or critical may be dropped in consultation with management / auditors • It is advisable to take statutory auditor's views while undertaking IFC evaluation exercise • IFC evaluation exercise per-se may not include setting up new policies on behalf of the Company. Rather, the role is limited to mapping of the existing policies, which are in practice or custom within the Company

Benefits of IFCs / ICFR
• An accurate and fair reflection of transactions and dispositions of the assets of the company; • Provides 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 • Provides 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

How KrayMan can support:

We support our Clients in following manner:

- Establishing a robust Risk Management Framework
- Documenting IFC / ICFR for each Process and Mapping of Risks to Controls
- Documenting SOPs including policies and guidelines

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This publication contains information of general nature. The information is only for general guidance and is not meant to be a substitute for professional advice in any manner. In case the reader requires any specific advice from our end, please contact us separately.

For sake of brevity, this publication does not discuss the following aspects in details. If required, we shall be glad to discuss / guide on the same separately.

- *The detailed components of entity level controls such as control environment, risk assessment, monitoring, information, communication and control activities*
- *The detailed components of process level controls such as purchase, sales, fixed assets, payroll, IT, admin, etc.*
- *Format for reporting on IFCs / ICFRs in audit report / directors' report*
- *Audit of ICFRs considering the principles laid by The Institute of Chartered Accountants of India (ICAI) and best industry practices*

About KrayMan

KrayMan Consultants LLP (KrayMan) is an accounting and consulting firm headquartered in the National Capital Region of India & serving Clients across India. We specialize in India-entry, Accounting, Tax, Regulatory, Transaction Advisory, M&A, HR & Payroll services. We are a team of Chartered Accountants, Company Secretaries, Advocates & MBAs. For details, please visit our website www.krayman.com.