INTER AUDIT AND INTERNAL FINANCIAL CONTROLS FOR SMALL COMPANIES

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SMALL COMPANY

- **Meaning of Small Company**

Under Sec 2(85) of the Companies Act, 2013, ‘‘small company’’ means a company, other than a public company,

(i)paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees;

AND

(ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees:

Provided that nothing in this Section shall apply to—

(A) a holding company or a subsidiary company;

(B) a company registered under Section 8; or

(C) a company or body corporate governed by any special Act;

- **Benefits Available to a Small Company under the Companies Act, 2013**

As given by the definition, only a private company can be a small company. The following are the benefits available to a Small Private Company, as compared to a private company which is not classified as a small company:

1) **Filing Annual Return – can be signed by Company Secretary or Director, both need not sign**
2) **Cash Flow Statement – not required to be prepared**
3) **Rotation of Auditors - exempted**

4) **<u>Board Meetings – can hold only 2 meetings as against 4</u>**

These exemptions are available on yearly basis. A small company may in its subsequent years move to a non-small company. In case a particular company does not meet the requirement as mentioned above, for one year, the benefits and exemptions will be withdrawn from the subsequent year.

INTERNAL AUDIT

- **What is Internal Audit?**

"Internal audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system."

- **Objectives of Internal Audit**

➢ To strengthen Governance
➢ To enhance internal control system
➢ To assist strategic risk management
➢ To assure transparency in reporting – both for internal MIS purposes and statutory purposes.

- **Applicability Of Internal Audit**

➢ **Internal Audit provisions in Companies Act 2013 – Section 138:**

As per Section 138 of the 2013 Act, such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

- **Internal Audit provisions in Companies (Accounts) Rules 2014 – Rule 13:**

<u>**Applicability (Rule 13(1)):**</u>

The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) **every listed company**;

(b) **every unlisted public company having-**

> (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
>
> (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
>
> (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
>
> (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) **every private company having-**

> (i) turnover of two hundred crore rupees or more during the preceding financial year; or
>
> (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

For an existing company covered under any of the above criteria shall, it shall then comply with the requirements of section 138 and this rule within six months of 1st April, 2014.

Thus to conclude :

IA was not mandatory according to the Companies Act 1956. However, according to Companies Auditors Report Order, the external auditors are required to comment upon the effectiveness of the Internal Audit system for applicable companies

According to the Companies Act 2013:

- Such class or classes of companies as may be prescribed will be required to appoint an internal auditor
- Internal auditor should either be a chartered accountant or a cost accountant, or such other professional as may be decided by the board to conduct Internal Audit of functions and activities of the company
- Internal Auditor may or may not be an employee of the Company.
- The Central Government may, by rules, prescribe the manner and the intervals in which Internal Audit shall be conducted and reported to the board

- **Why Internal Audit?**

The expertise and knowledge of internal auditors can help in the following areas:

- Assess the effectiveness of the design and execution of the system of internal control and risk management.
- Assist management in the effective discharge of their duties.
- Internal audit reduces the exposure to unpleasant surprises.
- Evaluate compliance with laws and regulations.
- Evaluate the reliability and integrity of financial and operational information.
- Provide recommendation for the improvement of operations.
- Help in safeguarding company assets and utilization of its resources.

And let's always remember that the cost of preventive actions is much less than those of corrective actions.

- **<u>How Internal Audit is different from External Audit?</u>**

1) Meaning

> ➢ Internal Audit is a constant activity performed by the internal audit department of the organization. External Audit is an examination & evaluation by an independent body, of the annual accounts of an entity to give an opinion thereon.

2) Time period covered

> ➢ Internal Audit is a continuous process, while External Audit is conducted on periodical basis (many a times yearly).

3) Purpose

> ➢ The purpose of Internal Audit is reviewing the routine activities of the business & give suggestions for improvement. Conversely, External Audit aims at verifying the accuracy and reliability of Financial Statement.

4) Opinion

> ➢ Internal Audit assesses the controls for risk determination and provides an opinion on the effectiveness of the Operational Activities. On the other hand, External Audit expresses an opinion on the true and fair presentation of the Financial Statements.

5) Scope

> ➢ The scope of Internal Audit is decided by Those Charged By Governance, as opposed to the scope of External Audit, which is decided by the Law.

<u>To Conclude,</u>

Internal Audit and External Audit are not opposed to each other, instead they complement each other. External Auditor may use the work of internal auditor, if he thinks fit, but it does not reduce the responsibility of the external auditor. Internal Audit acts as a check on the activities of the business and assists by advising on various matters to gain operational efficiency.

On the other hand, external audit is completely independent in which a third party is brought to the organization to carry out the procedure. It checks the accuracy and validity of the annual accounts of the organization.

Internal Auditor is like an extended arms eyes and ears of the Management while External Auditor is like an Inspector.

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.

- **Auditor’s Responsibility**

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,

“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.”

SA 200 further states, “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 FR statements 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.

- **<u>Criteria for Internal Financial Controls Over Financial Reporting</u>**

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>Inherent limitations in an audit of internal financial controls over financial Reporting</u>**

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.

- **<u>Conclusion</u>**

  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. **Flow chart illustrating Typical Flow of Audit of Internal Financial Controls over Financial Reporting.**
II. **Draft Engagement Letter**
III. **Draft MRL**
IV. **Draft Auditors Report on IFCFR**
V. **Top 100 controls**