ASSURANCE INSIGHTS

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Dear Associate,

We are pleased to present the June issue of SKP Assurance Insights – our newsletter that aims at providing insights into company law, accounting and assurance related developments in India.

Internal audit helps executive management and boards to demonstrate that they are managing the organisation effectively on behalf of their stakeholders. Internal audit function ensures constant improvement of internal controls of an organisation by focusing on process oriented controls rather than person. Executive management can thus rely on Internal Audit for insight on the effectiveness and efficiency of governance, risk management and internal control processes.

From the sphere of internal audit, we move onto the premise of compliances. The Ministry of Corporate Affairs (MCA) had announced an exemption notification on 5 June 2015 which granted exemptions to certain classes of private companies. In its recent notification, the Department of Industrial Policy and Promotion (DIPP) of the Ministry of Trade and Commerce has defined 'Start-ups' and has laid down the criteria for start-ups to avail benefits in taxation related matters. On 13 June 2017, the MCA announced a notification in extension to the notification announced on 5 June 2015. This notification grants exemptions and holidays in compliance to specified private companies which include start-ups. These relaxations, although available only to private companies compliant with specified filing requirements, are a welcomed step. Smaller private companies will benefit a great deal from reduction in compliance. Notifications of this nature, are helping the government to strengthen its stand in bringing about a conducive environment for doing business in India.

We hope you find our newsletter useful and look forward to your feedback. You can write to us at skpgrp.info@skpgroup.com.

Warm regards,
The SKP Team

In this issue

How internal audit can help in IFC/ICFR compliance

Introduction

As our society has increasingly become more complex due to the booming economy and rapid industrial/commercial growth, the possibility of unreliable information being delivered to the management, decision makers or the shareholders has increased. There are several reasons for this, with lack of information, enormity of data and existence of complex transactions being a few of those.

As a means of overcoming the challenges faced due to unreliable information being conveyed, the management must develop a process of assuring that the information provided is trustworthy, so as to legitimise and strengthen the internal controls of the organisation. A common way to obtain authentic information is to have some form of verification i.e. audit performed by independent persons. Information provided by the management can be used in the decision-making process on the assumption that it is reasonably complete, accurate and unbiased.

Meaning of internal audit and IFC/ICFR

Internal audit: Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operational functionality. It helps an organisation accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the operational effectiveness of management, control and governance processes. Also, an internal audit makes the management aware about the possibilities of fraudulent and other risk prone activities being carried out in the organisation and helps to set-up processes which minimises such risks.

IFC/ICFR Audit: The concept of Internal Financial Control (IFC) and Internal Control over Financial Reporting (ICFR) emerges from the Sarbanes-Oxley Act, 2002, in which an auditor is required to attest specific class of companies for internal control over financial reporting in addition to attestation of their financial statements. In India, the government has defined the concept under Section 143(3) (i) of the Companies Act, 2013 whereby an auditor needs to obtain reasonable assurance from the management of companies to confirm the existence, adequacy and operating effectiveness of internal controls in the company to the stakeholders. It is the primary responsibility of the management to identify and lay down the IFC that are operating in the organisation. Directors are required to state in the Director’s responsibility statement under Section 134(5) (e) of the Companies Act, 2013 whether the defined IFC are working effectively or not. Under Section 143(3)(i) of the Companies Act, 2013, it is the responsibility of the statutory auditor to verify and confirm the same in the Auditor’s Report. The requirement of reporting the IFC is also included in Companies Auditor's Report Order (CARO).

Applicability of internal audit and IFC/ICFR

Applicability of internal audit

Internal audits are applicable to the following class of companies as per Section 138 of the Companies Act, 2013:

1. Every listed company.
2. Every unlisted company that has:
   a) A paid up capital of **INR 500 million** or more during the preceding financial Year; or
   b) A turnover of **INR 2000 million** or more during the preceding financial year; or
   c) Outstanding loans/borrowings from a bank or public financial institutions of **INR 1000**

million or more at any point of time during the preceding financial year; or

d) Outstanding deposits of **INR 250 million** or more at any point of time during the preceding financial year.

3. Every private company that has:

a) A turnover of **INR 2000 million** or more during the preceding financial year; or

b) Outstanding loans/borrowing from the banks or public financial institutions of **INR 1000 million** or more at any point of time during the preceding financial year.

Applicability of IFC audit:

Section 134 (5)(e) of the Companies Act, 2013 has prescribed the Director's Statement of Responsibility over establishing adequate IFC and asserting operating effectiveness of such controls only in the case of 'listed companies'.

However, it should be noted that Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the Board of Director's report of **all companies** to state the details in respect of adequacy of ICFR. MCA has provided exemptions to private limited companies vide notification G.S.R. 583(E) dated 13 June 2017.

Basic differences between internal audit and IFC/ICFR

Difference between internal audit and IFC/ICFR
Internal audit is performed as per the scope defined by the management and the report is presented to the audit committee/management. The data collected by the internal auditor is not shared with the management because the auditor is the sole custodian of that data, and only his findings and recommendations are shared with the audit comittee/management. Internal audit includes governance, risk management, efficiency and effectiveness of operation, compliance testing, etc. which denotes that there is no specific limit for the scope of internal audit. Internal audit can be conducted as an in-depth process or as a mere transaction depending on the scope agreed upon by the auditor with the management. The main objective of an internal audit is to provide assurance to the management about the controls defined by them to mitigate identified risks.

IFC/ICFR control testing is the primary responsibility of the management, aimed at providing assurance to the statutory auditor that all the controls identified and laid down by the management are working effectively. The management shall test these controls internally or can hire an expert to test the same. The management needs to maintain documents as to how the testing of the controls was conducted and the same needs to be shared with the statutory auditor for their opinion.

- Internal audit is a function whereas internal controls (IFC/ICFR) are a system. Internal audit evaluates if the process of risk identification is robust in an organisation and is working as intended. It evaluates the organisation's governance, compliance systems and processes. Internal control on the other hand, is made up of procedures, policies and measures designed to make sure that an **organisation meets its objectives** and the **risks that can prevent an organisation from meeting its objectives are mitigated.**
- An internal audit's scope is mutually defined by the auditor and management based on risk assessment, whereas in IFC/ICFR, there is no pre-defined scope, as it is based on the internal control environment designed by the management for which operating effectiveness tests are carried out.
- An internal audit is the responsibility of the internal auditor, to submit the report to the management. Whereas internal control testing is purely the management's responsibility.
- Internal auditors are the sole custodians of documents/ evidences collected during an internal audit, whereas for internal controls testing, the management needs to document the testing evidence conducted to provide the same to the statutory auditors.
- Another point of contrast is the frequency. Internal audit is carried out as per the approved audit plan at specific intervals, while internal control testing is an ongoing activity to make sure **operational efficiency and effectiveness are achieved through the control of risks**.

Relationship between internal audit and IFC/ICFR

Having discussed the difference between an internal audit as a function and internal control as a system, it is also important to understand certain similarities in the evaluation process. Typically, in an internal audit, the auditor carries out following steps:

- Assessing the risk associated with an organisation, prioritise/select functions to be audited and draw the audit plan accordingly.
- Conduct process walkthroughs and document the same for better understanding.
- Identify the gaps where controls are not properly defined.
- Perform tests on the controls to understand and document their operating effectiveness.
- Provide a report to the management along with the findings and recommendations.

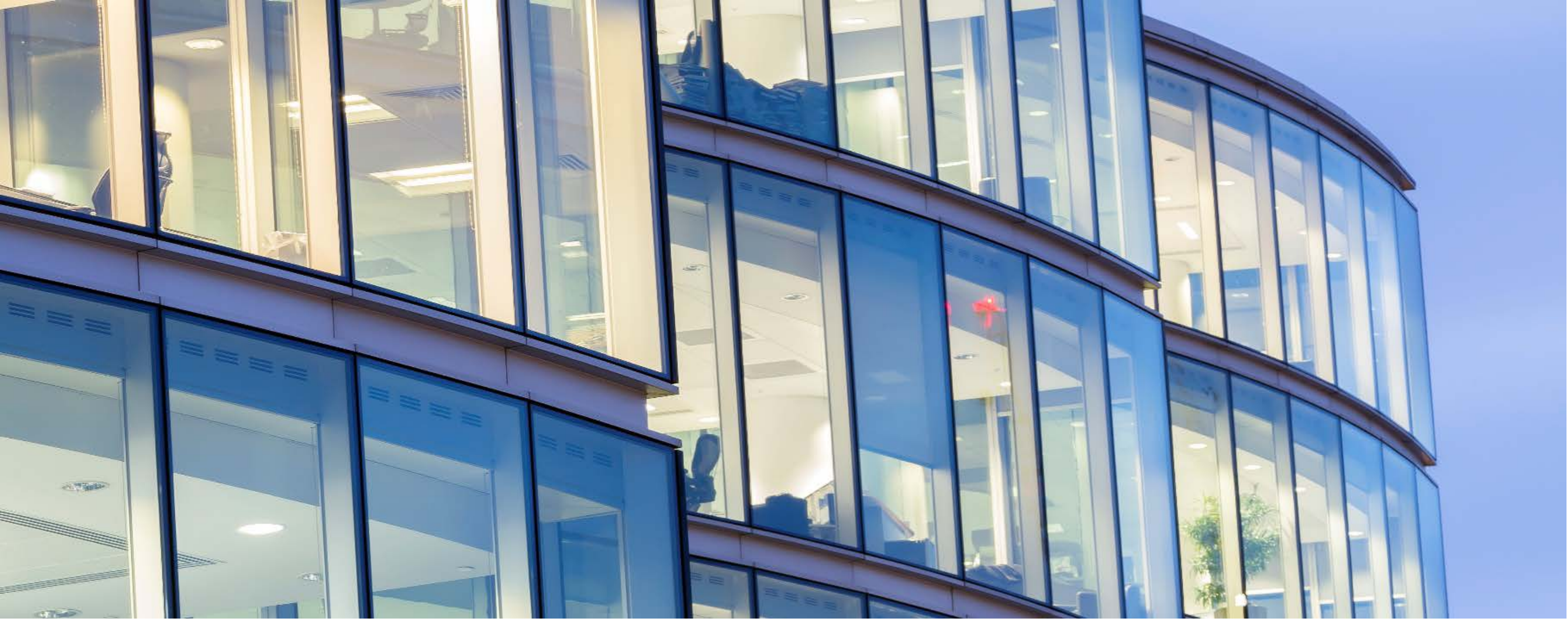
The process followed in internal control testing is also similar. While in internal audit, the audit program and risk identification is performed by the auditor, in internal controls, the controls are defined by management. Hence, for processes/functions audited by the internal auditor as a part of his audit plan, there could be common risks and controls that are evaluated. Hence, integrating internal audit with IFC/ICFR testing may help the management in testing operating effectiveness and documenting the same for the period of review.

Furthermore, internal audit also helps the management in identification of certain controls not forming a part of the defined Risk Control Matrix used for IFC/ICFR testing. Internal audit can thus be used as a good source of qualitative assessment of the design controls laid down by the management and continuous improvement of the same. Recommendations given by internal auditors for control gaps identified by them during the course of internal audit can be used by the management to implement alternate controls or to strengthen the existing controls. Internal audit can also support the management by providing insights on the various parameters of internal control like materiality, valuation, cost, weightage and assertions making IFC/ICFR testing more accurate and efficient.

Conclusion

In the end, it may be mentioned that internal audit is a broader concept concerned with evaluating and improving the effectiveness of risk management, control and governance processes in an organisation, whereas internal control testing is limited to testing of operating effectiveness of operational, financial and fraud related controls identified by the management of an organisation.

However, internal audit and internal control testing complement each other in several aspects. By effectively integrating internal audit with control testing, the management of an organisation can save time and cost.



Exemptions to Private Companies

The Government of India (GOI) has announced 'Startup India' initiative for creating a conducive environment for start-ups in India. Various ministries of the government have initiated a number of activities for facilitating initiatives like Startup India. Make in India, Digital India, e-BIZ Portal, etc. are some other programs similar to Startup India introduced with the objective of bringing about ease of doing business in India. A universally accepted way to bring about ease of doing business is to reduce the burden of compliance and reporting, especially with respect to novice entrepreneurs. This said reduction in burden, coupled with the provision of facilitative support to business and industry is considered a surefire way to create an environment for entrepreneurs to thrive in. However, reduction in compliance should not be viewed as a complete exemption from compliance. Such cushions are provided merely to ensure that the primary focus of the entrepreneur or promoter lies in building a robust business.

The Department of Industrial Policy and Promotion (DIPP) of the Ministry of Trade and Commerce has announced notifications to provide a supportive platform for start-ups. These notifications by the DIPP provide guidance and clarity on compliance framework to be followed and tax holidays to be enjoyed by start-ups. Most recently, on 13 June 2017, the Ministry of Corporate Affairs (MCA) has announced various exemptions, modifications and adaptations for private companies via a notification vide number G.S.R 583(E) (henceforth referred to as 'the notification') that has been published in the Official Gazette of India. The notification comes as an extension to exemption notification vide number G.S.R 464(E) dated 5 June 2015 (henceforth referred to as 'the principle notification').

This issue shall cover:

a. A chronology of notifications
b. The definition of start-ups as per DIPP and an overview of the same
c. An overview of notification number G.S.R 583(E).

Chronology of Notifications

5 June 2015: MCA issues notification number 464(E) which lays down exemptions for private companies.

17 February 2016: DIPP issues notification G.S.R 180(E) which defines and lays down recognition criteria for start-ups

23 May 2017: DIPP issues notification G.S.R 501(E) which supersedes earlier G.S.R 180(E). This notification provides comprehensive guidance on criteria such as definition, recognition of tax benefits and revocation of start-ups

13 June 2017: MCA issues notification number 583(E) which lays down exemption criteria for private companies with special focus on one person companies, small companies, start-ups and other prescribed private companies.

Definition of Start-ups

Start-ups were defined in the superseded notification 180(E) of the DIPP. The notification 501(E) issued on 17 February 2017 elaborates upon the definition of start-ups and makes it more comprehensive than the earlier given definition. As per G.S.R 501(E), an entity shall be considered as a start-up if:

1. It is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under Section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India; and
2. Has been in existence for up to seven years from the date of its incorporation/registration; however, in the case of start-ups in the biotechnology sector, the period shall be up to 10 years from the date of its incorporation/registration; and
3. Its turnover for any of the financial years since its incorporation/registration has not exceeded INR 250 million; and
4. If it is working towards innovation, development or improvement of products, processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

It has been provided that any entity formed by splitting up or reconstruction of a business already in existence shall not be considered as a start-up.

The following points need to be considered in context of the above definition:

a) Companies falling under the definition of start-ups shall make an online application through the mobile app/portal set up by DIPP in order to be granted start-up status.

b) The superseded G.S.R 180(E) identified enterprises as start-ups only for a period of up to five years from the date of incorporation/registration.

c) There was no special cushion of an additional period for biotechnology companies as is provided by G.S.R 501(E). It must be noted that:

   i. The biotech industry has witnessed a year on year growth of 57.14% in the financial year 2016.

   ii. The total size of the biotech industry in India stood at USD 11 billion in the financial year 2016 and estimated to reach USD 11.6 billion in the financial year 2017.

d) More comprehensive guidance is provided under G.S.R 501(E) compared to its superseded predecessor with respect to:
   - Process of recognition for start-ups
   - Tax benefits for start-ups
   - Revocation of status as a start-up.

An overview of the notification number G.S.R 583(E)

The current notification has announced exemptions, modifications and adaptations in the following areas for prescribed classes of private companies:

1. Exemption from cash flow statement in the financial statements Section 2(40) of the Act.
2. Certain compliances with respect to monies borrowed as Deposits Section 73(2)(a) – Section 73(2)(e) of the Act.
3. Provisions related to annual return of the company Section 92 of the Act.
4. Reporting on internal financial controls and the operating effectiveness of those control Section 143(3)(i) of the Act.
5. Meetings of the board of directors Section 173(5) of the Act.
6. Exemptions in quorum prescriptions Section 174(3) of the Act.

Cash flow statement

Earlier, One Person Companies (OPC), small companies and dormant companies were not mandated to include cash flow statements in their financial statements. Now private companies (if such private companies are start-ups) too shall enjoy the same holiday i.e. they will not be mandated to include cash flow statements in their financial statements.

Deposits

Currently, as per the principal notification, if monies borrowed in the form of deposits do not exceed 100% of paid up share capital and free reserves, private companies are not required to comply with clause (a) to clause (e) of sub-section (2) of Section 73. The notification raises the existing limit for exemption from compliance under sub-section (2) of Section 73. Effective from 13 June 2017, if the monies borrowed in the form of deposits do not exceed 100% of the paid up share capital, free reserves and security premium, private companies are not required to comply with clauses (a) to (e) of sub-section (2) of Section 73. This change allows private companies to raise additional monies in the form of deposits to the extent that security premium exists in their books of accounts albeit without additive compliances.

Start-ups, for the first five years from their date of incorporation do not have to comply with clauses (a) to (e) of sub-section (2) of Section 73. Start-ups by definition are private companies. The limit imposed by the MCA on private companies for raising monies on the form of deposits from its members is 100% of the paid-up share capital, free reserves and security premium. Hence, in spirit this exemption notification provides no additional concession to start-ups. As a matter of fact, private companies are not allowed to raise monies beyond 100% of their paid up share capital, free reserves and security premium as per the Companies (Acceptance of Deposits) Rules, 2014. Hence the question of complying with clauses (a) to (e) of sub-section (2) of Section 73 of the Act does not inherently arise for private companies.

The following other classes, private companies that will no longer have to comply with clauses (a) to (e) of sub-section(2) of Section 73 are:

1. Companies which are not associates or subsidiary companies of any other company;
2. Companies whose borrowings from any bank, financial institution or any corporate body is lower of:
    - An amount less than twice its paid up share capital; or
    - INR 500 million.

Exemption, modifications and adaptations pertaining to annual return

Part A

OPC, small companies and private companies (if such private company is a start-up) can have their annual return signed by the director of the company where such companies do not have a company secretary.

Section 203(1) read with Rule 8 of the Companies (Appointment and Remuneration) Rules, 2014 requires that listed companies and public companies with a paid up share capital of INR 100 million or more shall be required to appoint a full-time key managerial person. Here, it must be noted that the definition of key managerial person as per Section 2(51) includes the company secretary.

Rule 8A of the Companies (Appointment and Remuneration) Rules, 2014 requires that companies other than those covered in Rule 8 who have a paid up share capital of INR 50 million or more shall have a whole time company secretary.

Private companies, so long as they enjoy the status of start-ups, are not required to appoint a whole time company secretary even if their paid up share capital exceeds INR 50 million. However once the holiday period of seven years (10 years in the case of biotechnology companies) expires, such private companies shall have to comply with Rule 8A mentioned above by appointing a whole time company secretary if their paid up share capital is INR 50 million or more.

Part B

Companies are required to prepare and submit to the Registrar of Companies (ROC) an annual return at the end of the financial year. The said return discloses the remuneration of directors and key managerial personnel. The notification now requires small companies to disclose the aggregate amount of remuneration drawn by directors.

The disclosure of director's remuneration was already prescribed by Section 92 of the Act. The presentation of aggregate remuneration of the director is mere tabulation of information already presented. The qualitative impact of this addition made by the MCA appears unclear.

Internal financial controls and their operating effectiveness

Section 143(3)(i) of the Act read with Rule 10 A of the Companies (Audit and Auditors) Rules, 2014 states that for financial years commencing on or after 1 April 2015, the report of the auditor shall state about the existence of adequate internal financial control system and its operating effectiveness.

The notification provides an exemption from Section 143(3)(i) and the corresponding Rule 10 A to the following companies:

- OPCs; or
- Small companies; or
- Private companies with a turnover less than INR 500 million; or
- Private companies with aggregate borrowings from banks or financial institutions or any corporate body less than INR 250 million at any point of time during the financial year.

Hence with effect from 13 June 2017 i.e. the date of publication of the notification in the Official Gazette, the above classes of companies are exempted from Section 143(3)(i) and Rule 10A. Here, it must be noted that even if notifications of the MCA exempt the audit reports of such classes of companies from stating the adequacy of internal financial controls and their operating effectiveness, the Standards on Auditing issued by the Institute of Chartered Accountants of India (ICAI) provide no exemption in audit procedures to be carried out by the auditor.

Section 134(3)(q) of the Act read with Rule 8 (5)(viii) of the Companies (Accounts) Rules, 2014 requires the board of directors to include in their report, to be placed before the company in a general meeting, the details in respect of adequacy of internal financial controls with reference to the financial statements. Since the directors will still be required to comment and disclose in their report matters pertaining to internal financial controls, there seems to be a minimal holiday granted by the MCA to the prescribed private companies in this regard.

Meetings of the board

Earlier OPCs, small companies and dormant companies were required to hold at least one meeting of the board of directors in each half of a calendar year and the gap between two meetings should not be less than 90 days.

The notification, along with the existing classes of companies, now prescribes that private companies (if such private company is a start-up) to hold a meeting of the board at least once in each half of a calendar year and the gap between the two meetings should not be less 90 days. However, nothing contained in Section 173 of the Act shall apply to OPCs in which there is only one director on its board of directors.

Private companies not covered in these specified classes shall continue to adhere to Section 173 as earlier.

Quorum requirements

Earlier, as per Section 174(3) of the Act, interested directors were not considered for the purposes of quorum of a board meeting. The quorum of meetings where interested directors were present comprised of at least two non-interested directors, if present at such meeting. For private companies, the notification now allows interested directors to be present for the board meeting to be counted towards quorum. It must be noted that the interested directors in question shall be required to disclose their interest as laid down in Section 184 to be counted towards quorum under this notification.

Conditions for availing the exemptions, modifications and adaptations laid out in the notification

The exemptions, modifications and adaptations provided in the principle notification and the current notification are available to a private company which has not committed a default in:

1. Filing financial statements with the Registrar of Companies under Section 137 of the Act; or
2. Filing annual return with the Registrar of Companies under Section 92 of the Act.

Both Sections 137 and 92 have been enforced with effect from 1 April 2014. Hence, the exemptions, modifications and adaptations in the notification shall be available only to private companies who have not committed defaults in the above mentioned compliances since 1 April 2014.

Here it must be highlighted that Section 403 of the Act provides a cushion of 270 additional days to comply with the submission/filing of any documents specified under the above mentioned provisions.

This can be summarised as under:

Section	Total Period available to ensure compliance
137	30 days after (Annual General Meeting) AGM + 270 days = 300 days
92	60 days after AGM + 270 days = 330 days

Note: In case private companies seek an extension in conducting the AGM, the period mentioned above shall be calculated with respect to such date of extension sought by the private companies under discussion.

Only a delay beyond 300 and 330 days respectively would amount to a default which would lead to cancellation of availing the exemptions/holidays made available by the principle notification and the notification.

It must be highlighted with utmost importance that in case a private company defaults with respect to the above mentioned compliances, it shall not be able to avail any of the announced exemptions or holidays from both the principal notification and the current notification. Furthermore, it shall have to comply with all the provisions of the Act as if both notifications in question do not apply to it.

In retrospect

The notification issued by the MCA on 13 June 2017 comes as a welcomed change for private companies. Such relaxations in compliance and reporting echoes the intention of the government to bring about an ease of doing business in India. Start-ups and smaller private companies will breathe a sigh of relief with reductions in compliances, that allows them increase their core focus on the development and growth of their respective businesses. However with clarity required on some covenants of the notification, industry will keenly await to hear further on this subject form the MCA.

About SKP

SKP is a long established and rapidly growing professional services group located in seven major cities across India. We specialise in providing sound business and tax guidance and accounting services to international companies that are currently conducting or initiating business in India as well as those expanding overseas. We serve over 1,200 clients including multinational companies, companies listed on exchanges, privately held firms and family-owned businesses from more than 45 countries.

From consulting on entry strategies to implementing business set-up and M&A transactional support, the SKP team assists clients with assurance, domestic and international tax, transfer pricing, corporate services, and finance and accounting outsourcing matters, all under one roof. Our team is dedicated to ensuring clients receive continuity of support, right across the business lifecycle.

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