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Internal Financial Controls Perspectives 2016

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Foreword

The Companies Act, 2013 (the Act) has raised the bar on corporate governance with the introduction of Internal Financial Controls (IFC). Section 134 of the Act, requires directors to lay down the IFCs to be followed by the company and ensure they are adequate as well as operate effectively. As per the Act, all companies in India need to comply with the new provisions/requirements for financial periods commencing 1 April 2014. The audit committee (under Section 177of the Act) and statutory auditors (under Section 143 of the Act) need to review the adequacy and operational effectiveness of the IFCs.

As per the Act, the term IFC means "policies and procedures adopted by companies for ensuring the orderly and efficient conduct of its business, including adherence to company policies, safeguarding of its assets, prevention and detection of frauds and errors, accuracy and completeness of accounting records and timely preparation of reliable financial information."

Initially, there were concerns over the IFC's applicability, coverage of business operations, coverage of controls and subsidiaries and managing stakeholder expectations. Responses to these concerns have evolved over time and there is significant interest seen in the industry towards the approach and strategies adopted in meeting the requirements. Thus, we believe it is an opportune time to share perspectives and insights on how Indian companies are addressing these concerns.

Through this survey, we have attempted to understand the approach adopted by various companies to meet the provisions/requirements with respect to IFC. The report also provides insights into the challenges faced by companies while implementing IFC as well as its potential benefits.

We sincerely thank all our survey respondents for sharing their thoughts and perspectives. We hope that you find this survey helpful and are able to derive valuable insights to drive the IFC initiative within your companies.

Mritunjay Kapur
Partner and Head
Risk Consulting
KPMG in India

Executive summary

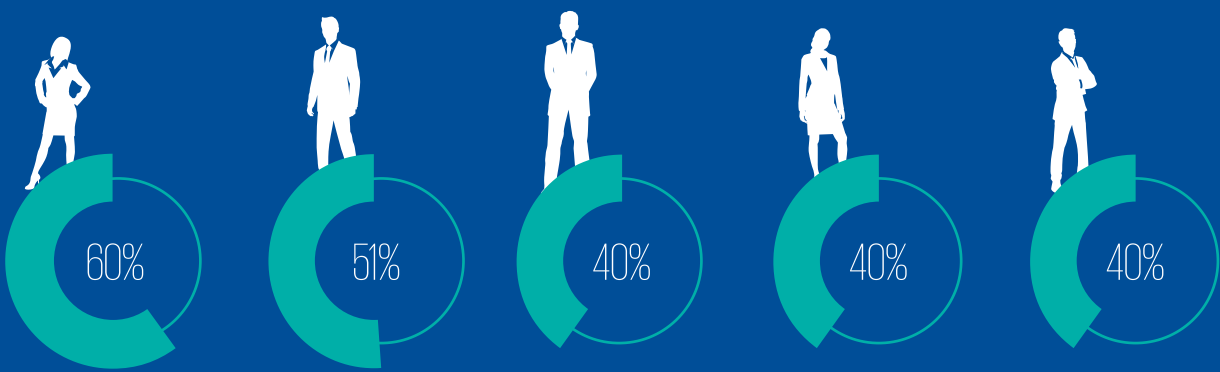
It has been more than a year since the new provisions have been made effective and companies have had sufficient time to implement and enhance their IFC frameworks in line with the Act's requirements. A 'Guidance note on Audit of Internal Financial Controls Over Financial Reporting' (herein referred as 'Guidance Note') issued by the Institute of Chartered Accountants of India (ICAI) in September 2015 has provided additional clarity on the subject. Further concepts and standards have been discussed with statutory auditors, thus resulting in companies taking a more proactive and thorough approach towards IFC implementation.

With an objective to understand industry expectations and the current state of IFC across industries, KPMG in India conducted a survey. Some of the notable outcomes of the survey include:

- Internal Controls Over Financial Reporting (ICOFR) has been covered by all the survey respondents, with **92 per cent** of them having included entity level controls as a part of their assessment.

- 73 per cent have defined the materiality on basis of stand alone financials, while the remaining **27 per cent** have considered consolidated financials.

- The initial stages of IFC implementation also see their own set of challenges, such as:



60% of the respondents believe that they do not have the required resource bandwidth within their company to support the initiative.

51% believe that determining control effectiveness during business transactions would be a challenge on account of the increased documentation requirements.

40% believe that ensuring adequate stakeholder involvement and obtaining a buy-in from functions other than the finance department would be a challenge.

40% believe that managing compliance costs and determining stakeholder involvement and buy-in beyond the finance department may be difficult.

40% also believe that change management will be a key area of focus for the ongoing effectiveness of the IFC frameworks defined by them.

- **28 per cent** respondents foresee no significant impact on the overall compliance costs, with **53 per cent** expecting a moderate increase and **19 per cent** expecting a substantial one. Challenges with respect to costs are likely to be addressed through a combination of internal and external teams for implementing and evaluating IFCs.

- 'Sales turnover' as a materiality threshold to exclude certain business processes has been considered by **58 per cent** respondents; whereas **29 per cent** consider 'profit' and **13 per cent** consider 'asset base' respectively as the materiality thresholds.

- As the process and implementation of IFC matures, we hope to see a standardisation in the approach for its implementation by having clear guidelines from regulators on the materiality levels to include/exclude any subsidiaries/systems/processes.

- Finance teams and senior management have been actively involved in leading the IFC initiative in more than **60 per cent** of the companies.

- **57 per cent** of the respondents agreed that statutory auditors are getting involved in various stages of the IFC roll-out process.

- **76 per cent** of the respondents believe that IFC will facilitate streamlining the control environment in companies. **67 per cent** of the respondents believe that successful IFC implementation can enhance the overall governance framework of their companies and **54 per cent** believe that IFC will benefit them by reducing leakages and potential frauds.

In the future, companies are expected to focus on rationalising the IFC framework and increasing its coverage with respect to business operations. We are optimistic that this framework can act as a robust mechanism and assist directors and Key Management Personnel (KMP) in discharging their governance responsibilities more efficiently.

Objective of the survey

The survey was conducted to understand the present state of IFC implementation, including identifying the trends and leading practices being adopted by Indian companies. Its objective was to understand:

01

Industry expectations from the IFC programme.

02

Extent and coverage of IFC implementation.

03

Challenges faced along with their potential impact on time and cost while implementing the IFC programme.

04

Role of statutory auditors in IFC.

Participant profile

Our survey participants included representatives from companies across various industries in India such as manufacturing, financial services, Information Technology and Information Technology enabled services, media, real estate, infrastructure, retail, healthcare and others. The survey has tried to capture the emerging themes fairly, across both listed and unlisted companies.

Respondents' industry profile

Manufacturing	Financial services	IT & ITes	Infrastructure	Others
36%	**17%**	**13%**	**8%**	**8%**

Media and entertainment	Healthcare	FMCG, retail	Real estate
6%	**5%**	**4%**	**3%**

Theme 1

Industry Expectations from the IFC compliance initiative

Figure 1: Industry expectations from the IFC compliance initiative

76%	Streamlining/ standardising controls
67%	Enhancing the governance framework
54%	Reduce leakages/ potential frauds
48%	Enhanced oversight over business operations by the management and the board
43%	Defines clear accountability and transparency
37%	Controls automation
20%	No major benefits perceived other than meeting compliance requirements

Source: KPMG in India's IFC survey results analysis, 2016 | Note: For the question above, the responses are inclusive in nature and multiple options could have been selected as a response

Highlights from our survey:

Companies are using IFC as a tool to derive various benefits, besides it simply being a compliance activity. Though this initiative may not provide an immediate benefit, however in the long-term, companies can derive several potential benefits. Our survey indicated that 85 per cent of the respondents perceive more than one benefit from IFC.

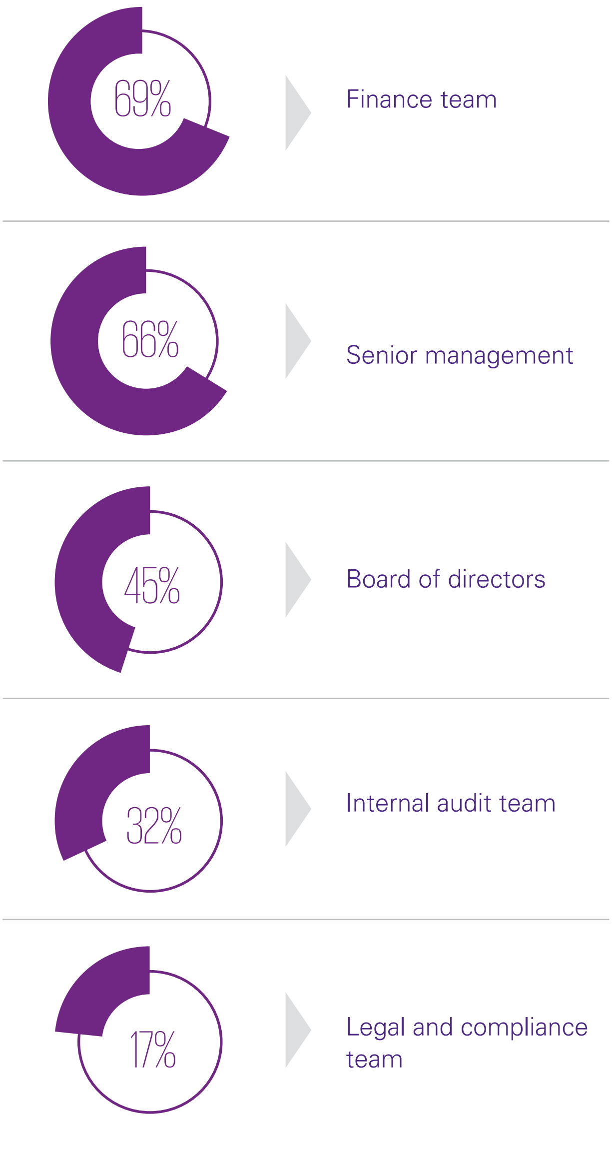
- IFC implementation is being viewed positively by stakeholders. 76 per cent of the respondents believe that IFC will facilitate the streamlining/ standardising of the control environment while 67 per cent of the respondents believe that successful IFC implementation can enhance the overall governance framework in their companies.
- Similarly, 54 per cent of the respondents agreed that IFC shall reduce the possibility of revenue leakages and fraud occurrence due to an enhanced control environment.
- A small 20 per cent believe that no benefits will accrue through the IFC compliance programme.

Traditionally, companies may not have laid enough emphasis on formalising or documenting their control environment. Adoption of IFC shall require companies to document and demonstrate the level of control effectiveness to the Board and statutory auditors. Going forward, companies may also use this as an opportunity to benchmark internal controls against industry leading practices for effective risk and control management.

Theme 2

Stakeholders' involvement across IFC

Figure 2: Who is driving the IFC programme?



Source: KPMG in India's IFC survey results analysis, 2016 | For the question above, responses are inclusive in nature and multiple options could have been selected as a response

The primary responsibility for defining IFCs and evaluating their effectiveness lies with the Board of Directors. As a result it is apparent that Board members are driving the IFC programme at many companies. Our survey indicates that in the case of 45 per cent of the respondents, the boards are active towards driving this programme.

For Boards to assess the adequacy and effectiveness of IFCs, the senior management will have to effectively operationalise the IFC programme within their companies. Consequently 66 per cent of the respondent companies have substantial involvement of the senior management members.

However, a large part of the survey respondents (69 per cent) feel that it is the finance teams who are driving the IFC programme on a day to day basis.

Internal audit teams have been involved in the IFC programme by 32 per cent of the respondent companies . Involvement of internal audit teams in the IFC exercise allows companies to leverage on their internal control knowledge and experience to cut down on the implementation timelines. In addition, internal audit teams are able to build effective controls in the IFC documentation based on the exceptions noted during internal audits.

The success of an effective IFC programme depends on the extent of the involvement of key stakeholders and business functions across all phases of the programme, not only during implementation but also for its ongoing maintenance.

Theme 3

Extent and thoroughness of IFC coverage

a. Key elements of the IFC programme

Figure 3: Key elements of the IFC programme

Source: KPMG in India's IFC survey results analysis, 2016 | Note: For the question above, the responses are inclusive in nature and multiple options could have been selected as a response

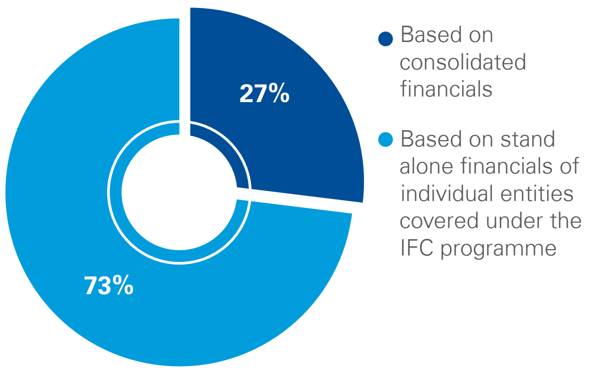
The earlier mentioned 'Guidance Note' issued by the Institute of Chartered Accountants of India (ICAI) released on (14 September 2015) emphasises on the coverage of IT and fraud related risks in the framework. Hence it is suggested that companies cover key financial reporting controls, entity level controls, IT controls and fraud related controls as part of their management documentation.

Highlights from our survey:

- 100 per cent of the respondents have covered ICOFR (also known as controls pertaining to financial statements)
- 92 per cent of the respondents have included entity level controls as a part of their assessment
- 75 per cent of the respondents have included IT controls as a part of their IFC programme. Companies that have not covered IT general controls, may rely substantially on manual controls since they may not have implemented integrated Enterprise Resource Planning (ERP) systems. Some companies could also be covering the IT controls review as a part of their internal audit and Sarbannes Oxley (SOX) programmes. Subsequently, companies may not separately cover Information Technology General Controls (ITGC) as a part of their IFC documentation.
- 73 per cent of the respondents have covered fraud/risk-related controls as a part of their IFC programme. Others may have included fraud risk controls in their existing process level documentation.

b. Materiality coverage

Figure 4: How has materiality been defined?



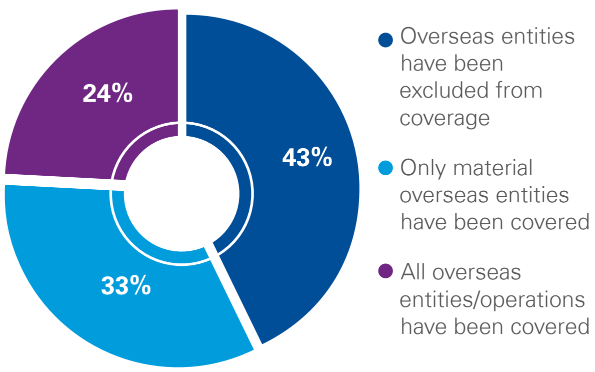
Source: KPMG in India's IFC survey results analysis, 2016

As indicated in the graph above, 73 per cent of respondents have considered stand alone financials as the basis for determining the materiality for IFC implementation while 27 per cent have considered consolidated financials. Determining materiality on the basis of stand alone financials for IFC coverage is likely to result in a larger coverage of their business operations as a part of the IFC programme. It may be noted that companies might need to use stand alone financials for determining the materiality levels for coverage of account captions at an individual company level.

The final materiality level and account balance coverage would need to be discussed and agreed upon jointly by the Board/management and statutory auditor.

c. Extent of Coverage of overseas operations

Figure 5: Extent of Coverage of overseas operations

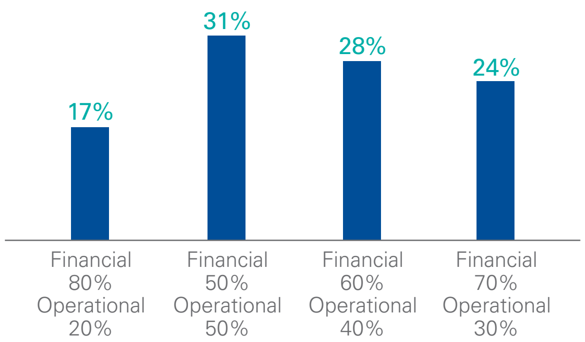


Source: KPMG in India's IFC survey results analysis, 2016

We believe that covering overseas entities to a reasonable extent is a good approach for companies to follow, since investment decisions of shareholders could be based on the consolidated financials of the group. For companies which have significant revenues/profitability being driven by overseas subsidiaries, it may be appropriate to encourage the coverage of oversight responsibilities for the financials of such companies. As per the earlier mentioned 'Guidance Note', overseas entities/ companies are to be excluded from the overall IFC coverage.

d. Coverage of financial and operational controls

Figure 6: Listed Entities : Controls Coverage



Source: KPMG in India's IFC survey results analysis, 2016

Highlights from our survey

A significant number of listed companies are covering operational controls as a part of their IFC programme. Inclusion of these controls could be a decision driven by the board for these companies to review and monitor process level efficiencies in the business.

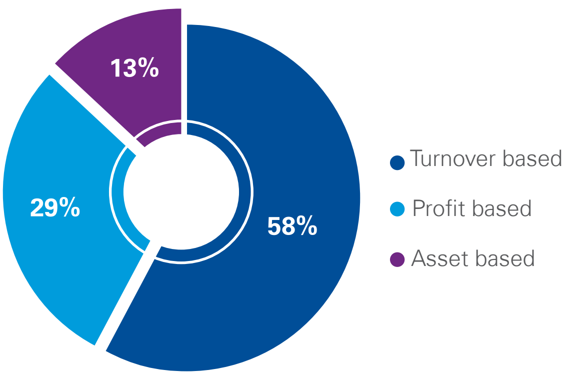
Unlisted companies are focussing more on financial controls. However, certain Boards have also suggested that the company management cover operational controls as a part of the compliance programme.

e. Criteria for coverage of business processes

With reference to the earlier mentioned 'Guidance Note' issued by the ICAI, currently, there is no specific mention on the parameters which could be considered for defining materiality thresholds with respect to including/excluding business processes from IFC. As a safeguard, it is advised that companies hold discussions with their statutory auditors before finalising the scope and coverage as part of the IFC programme. We believe that additional guidance and clarity from regulatory bodies on the coverage of entities, processes and systems for reference to companies could assist in avoiding subjectivity while implementing IFC.

Our survey indicated that sales turnover and profit are the two key criteria for determining the materiality levels for IFC coverage.

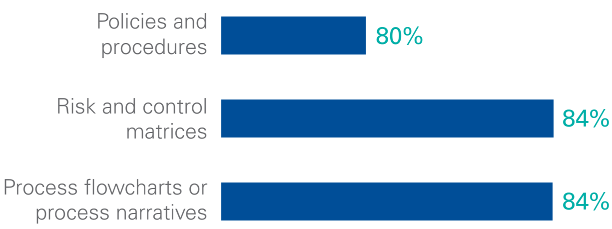
Figure 7: Criteria for coverage of business processes



Source: KPMG in India's IFC survey results analysis, 2016

f. Documentation for key business processes across companies

Figure 8: Documentation for key business processes across companies



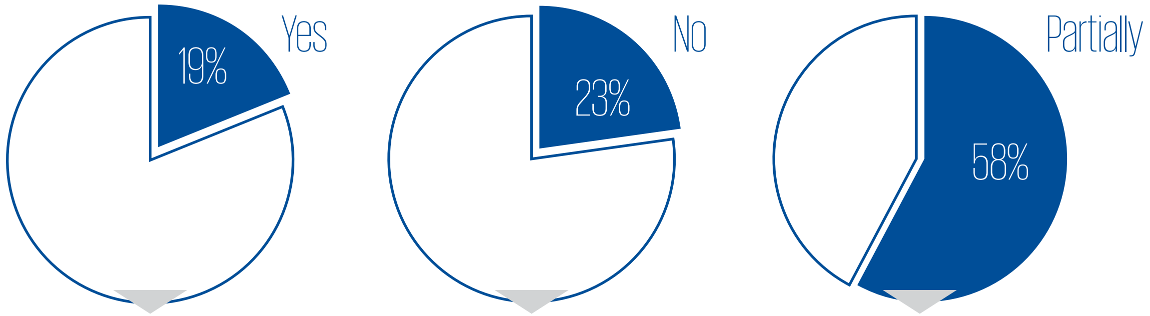
Source: KPMG in India's IFC survey results analysis, 2016 | Note: For the question above, responses are inclusive in nature and multiple options could have been selected as a response

As a part of the documentation exercise, it is advisable for companies to document their policies and procedures, risk and controls matrices and process narratives/process flowcharts for key business processes.

Theme 4

Role of statutory auditors in IFC

Figure 9: Involvement of the STATUTORY Audit Team



External auditors are involved in documenting the IFC framework.

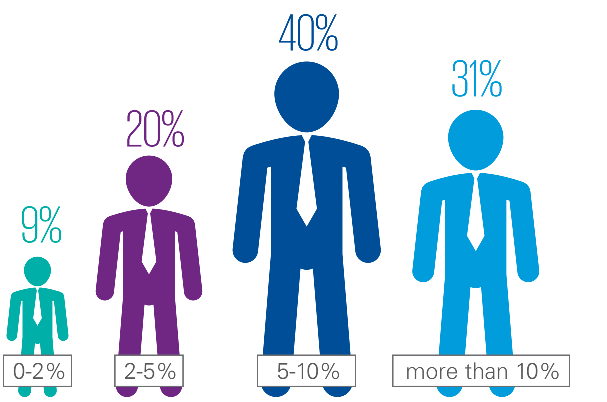
There is no involvement from the external auditors, except at the year-end.

IFC programme is being implemented by a separate team. However, inputs are obtained from the external auditors at key stages of implementation.

Source: KPMG in India's IFC survey results analysis, 2016

- Due to the stringent requirements of certifications on the design and effectiveness of internal controls, the role of statutory auditors has become crucial. It is advisable that auditors are involved in the critical phases namely planning and scoping, reporting/ reviewing control deficiencies and assessing entity level controls. It is also important to seek the auditor's buy-in on all IFC elements such as materiality thresholds, entity, process coverage and adequacy of internal financial controls at critical stages of the engagement.
- Our survey reveals that 77 per cent of the respondents agreed that the statutory auditors are getting involved in various stages of the IFC roll-out process, while 23 per cent have commented on no involvement, except at the year end. Inputs from statutory auditors, especially on coverage and control deficiencies noted are critical to avoid any last minute surprises at the year end.

Figure 10: Percentage of time involved by statutory auditors in the IFC programme



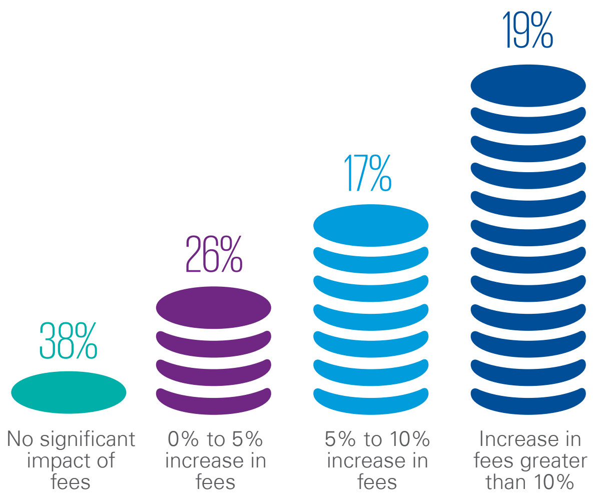
Source: KPMG in India's IFC survey results analysis, 2016

- The survey has highlighted a positive clue as 71 per cent of the respondents commented that the statutory auditor involvement is in excess of 5 per cent in the roll-out process.
- Though the auditor's involvement is considered in IFC implementation, some finer details with respect to deficiency classification might need to be discussed by companies in greater detail to avoid any expectation gaps. For companies who are currently in the documentation phase, it could be a good approach to involve the auditors at all crucial phases during implementation.

Theme 5

Cost of compliance

Figure 11: Impact of the IFC programme on statutory audit fees

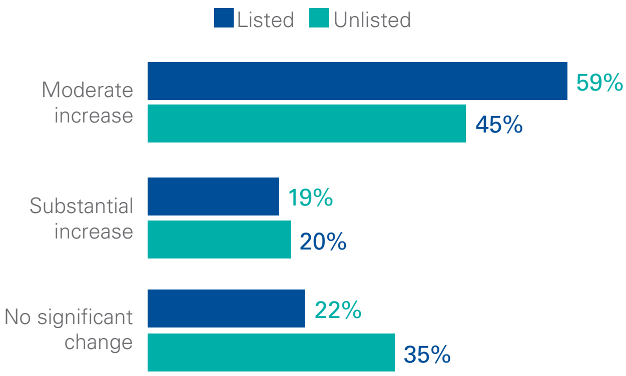


Source: KPMG in India's IFC survey results analysis, 2016

19 per cent respondents have reported an increase in statutory audit fees of greater than 10 per cent, thus increasing the cost of compliance. This may be due to the additional time and efforts incurred by the auditors to meet the Board's and external stakeholder expectations.

The survey also indicates that 38 per cent of the respondents don't see any significant impact on fees.

Figure 12: Impact on overall costs



Source: KPMG in India's IFC survey results analysis, 2016

On an average, 53 per cent of the respondents have witnessed a moderate increase and 19 per cent have seen a substantial increase in the overall costs. The potential costs for IFC implementation could include the cost of documentation, expert advice, increase in audit fees, additional resources, cost of remediating controls and future documentation maintenance costs, including annual testing costs.

Based on historical SOX implications, the costs of compliance are higher in the initial years for any new compliance implementation and the same get evened out over the years. Since the survey indicates costs going upwards, it is essential for companies to leverage on the existing control frameworks, such as policies and procedures, control self-assessment frameworks, SOX, Clause-49, etc.. This is expected to help in the reduction of compliance costs and also bring in potential benefits with respect to the timely completion of the project. Another area that companies could focus on is planning the effort and resource requirement at the start of the exercise. This can facilitate a regular monitoring of costs vis-à-vis the budgets.

There are various strategies such as an in-house approach, an outsourced approach or a co-sourced approach that companies could adopt for various stages of the IFC implementation to manage compliance costs. While the in-house approach could be cost-effective, it requires a significant amount of time and effort from the management. A completely out-sourced approach could help companies meet timelines as well as stakeholder expectations. In a co-sourced model, they could seek assistance from external consultants for the first year of implementation and subsequently move the transition in-house with proper training and knowledge sharing mechanisms.

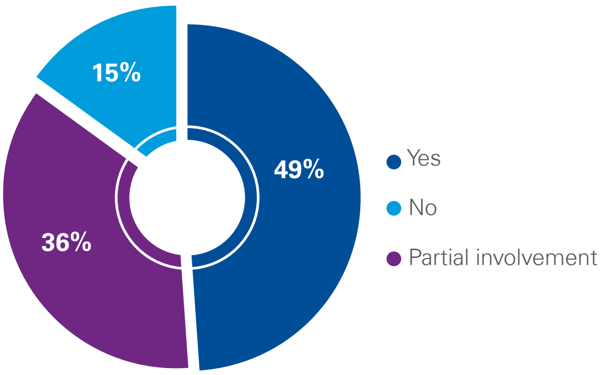
Some of the focus areas for companies keen on transition to an in-house approach could be establishing the right team with the appropriate authority, along with upgrading and retaining the skill sets and knowledge to execute the transition.

Companies could also focus on creating process/ control champions and rationalising the number of controls to reduce the testing efforts. They may also need to deliberate on the alternatives available such as control self-assessment with the senior management to assign more ownership on business.

Theme 6

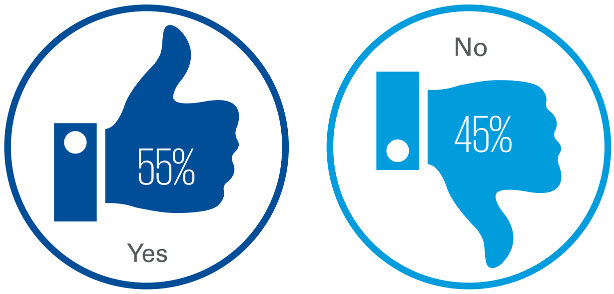
Integrating internal audit with IFC

Figure 13: Involvement of the internal audit team in implementing the IFC programme



Source: KPMG in India's IFC survey results analysis, 2016

Figure 14: Internal Audit Plan integrated with IFC



Source: KPMG in India's IFC survey results analysis, 2016

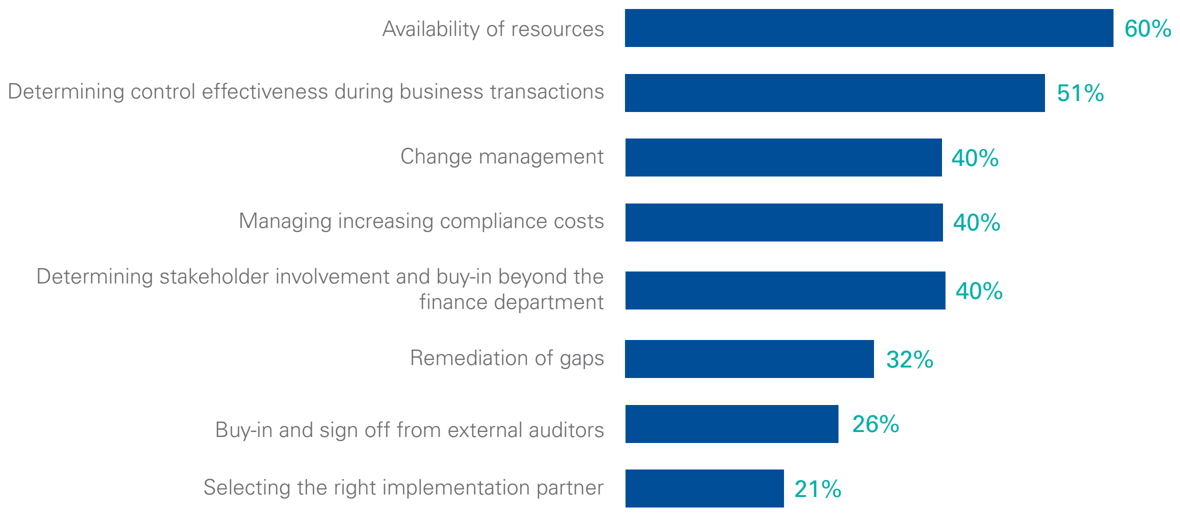
- The survey disclosed that a majority of the companies have started involving the internal audit function in the IFC programme.
- Of the total respondents, in 49 per cent of the companies, internal audit was extensively involved in the implementation of the IFC framework while in 36 per cent there was partial involvement.
- 55 per cent of the respondents mentioned that the 'Test of Operative Effectiveness' (TOE) of IFCs was integrated with the internal audit plan.

To leverage on the existing control framework, one of the best approaches for companies is to link their internal audit plan with the IFC programme. However, such an integration may also require adequate skill sets and time commitment from the internal audit team for the ongoing documentation and control automation, timing of internal audits and IFC testing procedures.

Theme 7

Challenges faced while implementing IFC

Figure 15: Key challenges faced across companies



Source: KPMG in India's IFC survey results analysis, 2016 | Note: For the question above, responses are inclusive in nature and multiple options could have been selected as a response

Indian companies listed on the U.S. stock exchanges are subject to compliance with regards to Section 404 of the Sarbanes Oxley Act, 2002 and therefore they are likely to be aware of the processes to be adopted for IFC compliance. However, for Indian listed and unlisted entities, this could be their first experience with regards to defining and implementing IFC frameworks. They could face several issues in terms of planning, execution and reporting as well as obtaining buy-ins from various stakeholders in the process. Our survey indicates some of the concern areas impacting companies:

- 60 per cent of the respondents believe resource availability will be a constraint to ensure the process and rigour is sustained on a long-term basis.
- 51 per cent of respondents also believe that determining control effectiveness during a business transaction may be an area of concern.
- 40 per cent of the respondents believe IFC is the responsibility of the finance department and therefore acceptability and accountability amongst other stakeholders becomes a challenge.
- 83 per cent of the respondents have faced multiple (more than one) challenges.
- Companies are also faced with the challenge of ownership of the entire process of ensuring the effectiveness of controls.

It is imperative for companies to thus prepare an in-depth test plan at the beginning of the year for IFC along with assessing the skill sets and resource requirement for these activities. Obtaining appropriate buy-ins from stakeholders and statutory auditors at every stage can also help in effective IFC implementation. Companies could also create process champions across teams to share responsibilities with respect to IFC. This may also facilitate responsibilities across functions to help adhere to controls on a day-to-day basis.

Conclusion

Focus areas

The introduction of IFC has helped companies enhance their internal control environment. For the IFC framework to be sustainable, each stakeholder is expected to play an important role during its implementation. Some of the key focus areas in the coming years for companies and internal auditors are mentioned below:

Companies

- The first year of IFC implementation might witness documentation and testing of policies, procedures and controls. However, business operations are likely to evolve continuously and there may be changes in the policies and processes, with the management having to ensure that the same are reflected in the IFC documentation. An effective change management process needs to be defined and implemented. Further, adequate training is required to be imparted to process owners on documentation and change management.

Internal auditors

- The Test of Operating Effectiveness requires the audit of transactions with respect to the internal controls defined in the IFC framework. The internal audit plan may be defined considering the TOE requirements and processes may be taken up for review accordingly. While the responsibility of maintaining internal controls is that of the management, efficiencies can be built by testing one out of the two cycles by the internal auditors and the other by the management.
- Since there is a certain level of difference with respect to the nature and extent of coverage strategies adopted by various players, the industry may be keen to seek more guidance on these aspects, especially in the case of unlisted and small entities. Further, having clear directions on how the deficiencies highlighted could be treated as a part of the IFC programme, might only help stimulate this exercise across India and help companies sustain their IFC compliance initiative.

IFC implementation is a journey and Indian companies over the next few years should focus on adopting the right approach to reap the potential benefits for their stakeholders as well as for themselves.

About KPMG in India

KPMG in India, a professional services firm, is the Indian member firm of KPMG International and was established in September 1993. Our professionals leverage the global network of firms, providing detailed knowledge of local laws, regulations, markets and competition. KPMG has offices across India in Delhi, Chandigarh, Ahmedabad, Mumbai, Pune, Chennai, Bengaluru, Kochi, Hyderabad and Kolkata. KPMG in India is currently offering services to over 3,000 national and international clients in India across sectors. We strive to provide rapid, performance-based, industry-focussed and technology-enabled services, which reflect a shared knowledge of global and local industries and our experience of the Indian business environment.

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