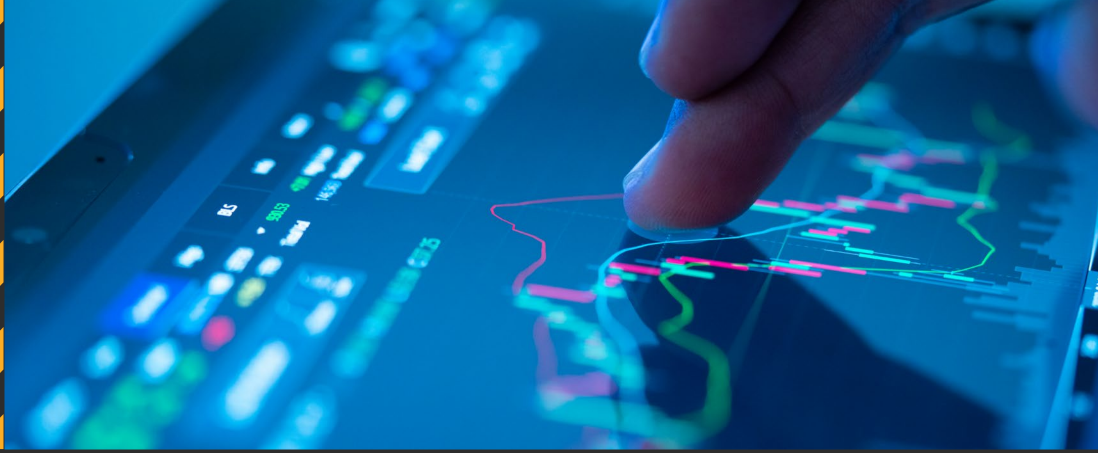

A decade of internal financial controls (IFCs)

Perspectives on implementation, benefits, usage, evolution and the future of IFC programmes in the Indian corporate world

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The de facto regulation for internal controls in India

How India's regulatory landscape has kept pace with global regulatory changes on internal controls

Over the years, regulators have increasingly shifted their focus towards internal controls to enhance the accuracy and reliability of financial reporting, business management and, in general, enhance corporate governance and accountability from businesses. While this wave largely started as a result of major accounting scandals in the US, various countries have issued their own regulations on internal controls with a focus on controls over financial reporting.

Global regulatory landscape on internal controls, corporate governance or internal controls over financial reporting

Geography	Regulation	Year
US	Sarbanes-Oxley (SOX) Act	2002
UK	Financial Reporting Council	2024*
Canada	Bill 198	2002
Japan	Japan Financial Instruments and Exchange Law	2006
France	Loi de Sécurité Financière	2003
Australia	Corporate Law Economic Reform Program (CLERP 9)	2004
China	Basic Standard for Enterprise Internal Control	2008

* Updated from 2018

While some of the above laws are applied specifically to listed organisations, certain countries have enacted laws that also apply to large unlisted organisations.

India's regulatory regime on internal controls

The foremost regulation in India that deals specifically with internal financial controls (IFCs) is the Companies Act, which was introduced in 2013. Section 134 of the Companies Act required a report from the board of directors that in the case of listed companies, the directors had laid down IFCs to be followed by the company and such internal controls were adequate and operating effectively. It went on to further define IFCs to mean policies and procedures adopted by the company for ensuring orderly and efficient conduct of its business, including adherence to its 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.

India's regulatory focus on internal controls started with the enactment of the Companies Act, 2013, which in many ways aligns with global regulatory changes.

Further, Section 143 laid responsibilities on statutory auditors to comment on the adequacy and effectiveness of IFCs in reference to financial statements.

While in many ways this regulation appears to adopt an SOX-like requirement, there are key differences with respect to the scope of its applicability, especially as regards controls that do not relate to internal controls over financial reporting. The onus of the design and operating effectiveness is placed on the board of directors, specifically in the case of listed companies.

This led to a spate of compliance activities in the years following the enactment of the law where companies had to set up specific frameworks to establish and monitor internal controls. A decade after its implementation we look at the impact that this law has had on the overall internal controls environment in businesses and on corporate governance at large.

A decade of experience summarised

Implementation challenges, benefit realisation and some common pitfalls

Given that implementation of IFCs was a new requirement, Indian companies had to get their act together in a fairly short time to drive compliance with the regulations. To a certain extent, since this mirrored global regulations, specifically the SOX Act, a template for creating an IFC programme already existed. Most SOX programmes across the globe had been modelled on the Committee of Sponsoring Organizations (COSO) Framework for Internal Controls, and this became a de facto framework that was adopted by large Indian corporates as well.

When the law was enacted there was confusion with respect to applicability to consolidated financial statements, coverage of non internal control over financial reporting (ICFR) controls, assurance frameworks, etc. Over time, updated laws and generally accepted practices steadied these concerns and we are now at the stage where most companies consider this as business as usual. The key implementation challenges that are still seen when organisations implement such programmes afresh or extend their applicability to their subsidiaries include:

Awareness: Actual implementation teams, i.e. the front-line staff who are responsible for implementing controls on the ground have a limited understanding of the broader requirements of the objectives of the programmes, their regulatory implications as well as business prerogatives. This lack of awareness at the execution layers can challenge the benefits to be realised from an effective control environment.

Scoping and coverage: In the absence of clearly defined guidelines on scoping of IFCs, there is ambiguity around coverage. This can vary from company to company with perspectives being different even between the management, external auditors and internal auditors.

Participation from leadership and boards: Leadership and board members are not necessarily active participants in setting up the IFC agenda and look at this more as a reporting responsibility. The intensity of discussions on IFC programmes is not necessarily the same as that for other governance areas.

Roles and responsibilities: In most organisations, the responsibility for the overall programme lies with the CFO group or the internal audit function. While these personnel are more exposed to the requirements of internal controls and therefore may be more qualified to manage the programme, the fact that IFCs go beyond of just finance-related processes is not fully appreciated.

We have seen some real progress in how IFCs have managed to effectively transform the internal controls environment across several organisations.

Notwithstanding these challenges, we have seen some real progress in how IFCs have managed to effectively transform the internal controls environment across several organisations. Some of the key benefits that IFC programmes have delivered include:

A structured approach for controls management: Over the last few decades, internal control evaluations have always happened through the route of internal audits. Frameworks like COSO, largely popularised through the SOX implementation, added structure to the way controls are documented and evaluated. IFCs largely follow this route and have brought about greater visibility with regard to the actual controls within an organisation. One can now find at a glance the list of controls and understand which of those are critical, which are automated, how many are preventive, etc.

Clarification of roles: A key benefit of documenting internal controls and associated risks is clarity on the custodianship of controls. This also helps an organisation to hold people accountable for control execution and the risks arising from deficiencies in the control's operating effectiveness. User trainings can be more targeted to create more awareness around controls and their implications for the wider organisation.

Reducing compliance overheads: A formal, structured view of controls has helped organisations to look at internal controls from a transformation lens: How can I rationalise my controls? How can I automate some of my manual controls and make them more efficient? How can I structure roles differently if I find a heavy concentration of controls in a particular individual, etc.?

Regardless of these benefits, we have also seen IFC programmes fail to deliver adequate value to organisations. These challenges have stemmed from a range of shortcomings in the way these programmes were perceived, designed and implemented. It is important for organisations to understand the potential pitfalls and plan for these in order to realise the true benefits of IFC programmes.

Taking a compliance-led approach: While compliance with Indian regulations is core to IFC implementations, the programme takes a back-seat when it is viewed as just another compliance activity to be done towards the end of the year. Internal controls are meant to help businesses run their functions and processes efficiently and effectively and to help them achieve their business goals – revenue maximisation, profitable growth, etc. Linking IFCs to business objectives is therefore key. Business stakeholders should be as much a part of this exercise as finance or compliance teams.

Over-engineering controls: A lot of programmes do not realise adequate value because they are over-complicated in terms of the number and extent of controls covered. Adopting a balanced approach that is rooted in the materiality of the business helps focus organisational efforts towards controls that are key to the business.

Leadership participation: IFC programmes that have a strong leadership backing are more successful. Leadership buy-ins are possible if such programmes are able to articulate the real business value to having an effectively run control environment.

Standalone programme: IFC programmes that are run on a standalone basis, without an overall perspective on where they fit in in the overall assurance landscape of the organisation run the risk of becoming redundant over time. Instead, when they are effectively integrated with other risk assurance activities such as internal audit, compliance, enterprise risk management, control self-assessments, legal risk evaluations, quality and business excellence, they have a higher probability of sustaining themselves and thereby elevating their importance. In fact, significant synergies can be brought in by de-duplicating activities of other risk assurance functions when such functions can rely on work performed through the IFC programme itself.

Static programme: IFC programmes run the risk of being static. In many cases, risks and controls articulated in IFCs remain the same over a decade. Businesses change, processes change, technologies change. It is therefore important to re-evaluate IFCs on a periodic basis such that they remain current and are aligned to the changing landscape of people, process and technology in organisations.

Focus on financial reporting: IFCs are, in a large number of cases, looked at primarily from a financial reporting lens. Inclusion of business controls and organisation-level controls is important to derive comprehensive value from such programmes.

IFC programmes have evolved over time. Since the reporting on such programmes, in many cases, is provided to the audit committee and board (especially as Boards have an obligation to report on IFCs), there has been due focus given to make sure that these programmes are meticulously run and managed. However, it is also true that today IFCs are primarily a concern of the finance, compliance and internal audit teams. Elevating their value proposition to businesses and making them an integral part of business operations is crucial to realise the overall benefits that a well-run IFC programme can offer.

Driving an optimised IFC programme

Evolution of methods and practices to optimise compliance overheads of IFC implementation

As indicated in the earlier section, it is important to maintain a lean IFC programme, one that focuses on real business value and one that drives the right control behaviour within the organisation. Our experience has shown that, in the early 2000s, when SOX was first implemented, organisations were overburdened by the need to document and test a significant number of internal controls. This added significant compliance costs to organisations. IFCs have taken a similar route, and organisations are taking a more pragmatic approach today towards operationalising and sustaining IFC implementations.

Organisations have taken a pragmatic approach towards operationalising and sustaining IFC implementations to make them business relevant and manage the cost of compliance.

Some of the practices that we have seen adding immense value in terms of optimising the cost of an IFC programme are:

Connected governance: IFC programmes have significant overlap with areas such as internal audit, compliance, IT compliance, privacy assessments and legal assessments. Over and above this, some organisations within India also have global controls programmes running in the nature of SOX, J-SOX or other regulatorily mandated programmes. This not only duplicates the activities of the controls and audit teams but also results in significant audit fatigue of control owners who need to respond to and answer multiple entities carrying out such assessment activities. It augurs well if an organisation can clearly articulate these redundancies and implement a strategy for reliance on these controls by other functions. This can significantly reduce overheads associated with running such large programmes.

Training and control self-assessments: Controls are embedded within processes. A clear definition, awareness and training on expectations of the control owner on such controls – for example, the extent of documentation needed, how to retain evidence of controls performed and how controls are embedded into the natural flow of the process – can seamlessly incorporate controls management rather than making it an 'add-on' activity done on a post-facto basis. Further, programmes such as control self-assessments, if run well, can act as a further point of reliance for external and internal auditors, which can reduce further the burden on testing activities.

Rationalising controls: Defining key controls and focusing efforts on documenting and testing of such key controls have also significantly reduced the testing burden while not compromising on the quality of such programmes. In addition, a comprehensive view of all controls across the organisation in a single repository provides the ability to look for redundant controls or to reshape the processes and optimise controls.

Automating controls: A distinctive feature of any control documentation is the mapping of critical attributes. One such attribute is whether these controls are automated or performed manually. Manual controls, by their very nature, are time-consuming and organisations have run specific programmes to focus on reducing manual controls in their processes. As a result, they achieve the twin objectives of having a more efficient process and enhancing the quality and reliability of the control. Further developments in GenAI can also help in increasing the effectiveness of critical controls such as management reviews.

Automating control testing: With the development of technology tools such as simple automated scripting solutions, robotic process automation or even simple and easy macros, the testing of standard controls, including activities of data extraction and workpaper documentation, can be easily automated. These can, over time, reduce control evaluation overheads on the IFC programmes.

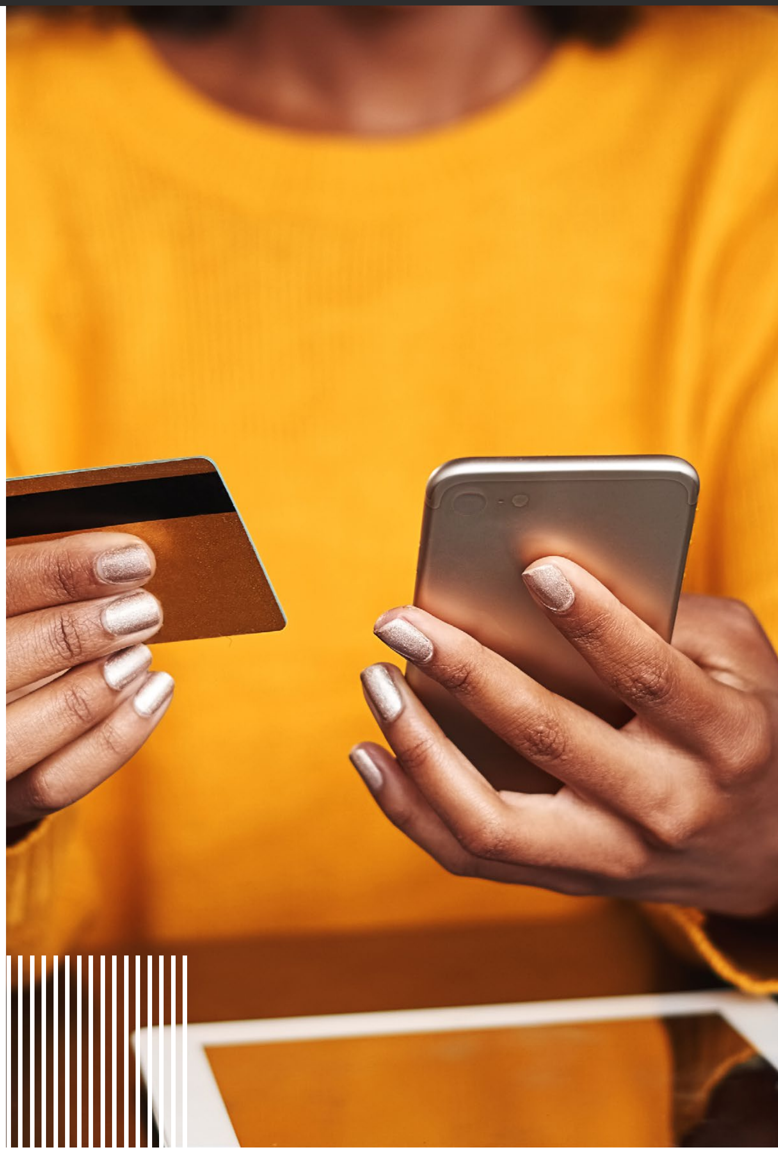
Using continuous control monitoring solutions: Moving away from testing limited sample transactions to embedding continuous control monitoring solutions can also help in enhancing the overall quality of controls in IFCs while also significantly reducing the testing burdens. In fact, organisations can choose to reframe some of their transaction-level controls to have a continuous monitoring layer, with automated alerts and notifications for control failures.

Audit reliance: A well-executed IFC programme can be leveraged by both external as well as internal auditors to reduce re-performance of their own planned testing activities. They can focus their efforts on complex business or accounting matters instead. This can also add value to organisations from both a commercial as well as a quality perspective.

Transforming perceptions of IFCs

Making IFCs a business enabler rather than a compliance driver

Based on our experience, we have found that business leaders who run businesses efficiently are naturally attuned to the importance and relevance of controls, even though they may not be formally documented. As organisations achieve scale, there is merit in developing a formalised structure such as IFCs to help create a sustainable process. Organisations would do well to look at IFCs and other such control programmes beyond the lens of just compliance. There are various means through which this is being done:



Articulating operational controls: While IFCs largely focus on financial and financial reporting controls, giving due attention to upstream business-specific operational controls not only enhances the depth of the controls frameworks but also helps in making such controls a part of the day-to-day execution of control owners. Failures in such controls can activate business leaders to drive process rigour, enhancing their efficiency and effectiveness.

Driving control consciousness: Effective implementation of IFCs, along with specific nuances such as code of conduct mechanisms, management reviews, accountability for governance and measuring people performance, can help drive a risk culture that can over time simplify management overheads on ensuring that processes are run smoothly. Instead, business leaders can refocus their efforts on market growth, business model reinvention and other transformations.

Standardising processes and identifying weak links: A deep view of internal controls across business processes, business units and geographies can help in identifying inconsistencies in business processes. Such inconsistencies can lead to sub-optimal resource allocations, inability to leverage technology at scale to automate processes, and make processes error prone. Management can reap benefits from standardising underlying processes and controls by getting an overarching view of the nature and extent of variations that exist in processes. IFC programmes can help lay the foundation for several process transformation initiatives.

Seeing the other side of documentation: Many business leaders look at any controls framework as a 'documentation' exercise. Given the standards laid down for demonstrating the presence of controls through an evidence-based mechanism, there is naturally a lot of emphasis on documentation. Though this can be labour intensive, at times, such documentation requirements create the necessary level of clarity that is required for operating teams to run in an unambiguous environment rather than rely on word-of-mouth or unwritten practices.

Converging governance: Top-level executives can appreciate and understand the status of their business process and organisational governance health by looking at the results of a strong controls programme. The assurance that they gain from knowing that controls have been designed adequately (even for operational processes), that they have operated effectively (evidenced by self-assessments or periodic testing results) and that there is a mechanism to remediate issues identified, if any, is invaluable in cases when they need to approach the board or audit committee and apprise them of the status of their business and business performance.

What's next for IFCs?

As we look forward to a new decade of IFC programmes, there are several ways in which they can be transformed to add significant value to businesses. IFC programmes can seem complex and, at times, daunting. A few things that we look forward to in the ways and means that such programmes will be implemented, enhanced and governed in the future are discussed below.

Firstly, we see a focus on reducing administrative burdens on managing a range of compliance initiatives across the organisation. Carrying out an assurance mapping exercise to cross-leverage control-monitoring activities will reduce overheads. We see a more integrated governance, risk and compliance (GRC) replacing point-specific control activities covering aspects of controls, audits, SOX, cyber assessments, control self-assessments, third-party assessments, etc. Another area of significant benefit realisation would be the use of technology – particularly end-to-end GRC management solutions, data analytics and potentially GenAI – for easing out the administrative burdens on such programmes.

Secondly, as new regulations and external reporting requirements come up – for example, Business Responsibility and Sustainability Reporting (BRSR) requirements for listed companies – we see these being incorporated into existing IFC frameworks. Organisations should be prepared to incorporate such control requirements into their IFC processes.

Thirdly, we see that there will be a deeper focus from external auditors on the quality, depth and extent of activities within the IFC programmes. Learnings from developments in the SOX processes indicate that greater emphasis will be placed on aspects such as quality of management review controls, extent of focus of controls on information produced by entities or key reports (IPEs), covering new-age risks such as cybersecurity controls especially over financial reporting, quality of control performance and the control performers themselves.

These aspects are just taking root in IFC programmes as we speak.

Overall, the IFC framework has laid down good guidelines for enhancing the focus on controls and overall corporate governance. While India Inc. has made great strides here, we believe that there are opportunities to further strengthen and optimise such initiatives.

India Inc. has, no doubt, achieved considerable progress in the implementation of IFCs. However, there is scope for making these initiatives more robust, which will help in reducing the administrative burden, bring in a greater focus on new reporting requirements, and enhance the quality of internal controls.

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