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Beyond regulatory compliance

Insights on Resolution No. (1), 2017 of the Chairman of ADAA

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Foreword

In August 2017, the Abu Dhabi Accountability Authority (ADAA) issued Resolution No. (1) of 2017 pertaining to auditing the financial statements of subject entities. The resolution aims to strengthen internal controls over financial reporting.

There is significant interest in the market with respect to the approach and strategies adopted to meet the requirements, and how to derive additional benefits to the company whilst complying. We believe it is an opportune time to share insight on how ADAA subject entities are complying with the requirements, the challenges they are facing and how these concerns can be addressed.

In this publication, we seek to present an overview of organizations' implementation efforts in the first two to three years of regulation. In doing so, we leverage our extensive experience and data collated through KPMG's 2020 Internal Controls over Financial Reporting survey. This report is designed to help companies compare their ICFR program against their peers.

We look forward to delving deeper into the topics discussed within this publication and exploring how your organization can make the most of the opportunities that lie ahead.

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Executive summary

According to Resolution No. (1) of 2017, all ADAA subject entities including material subsidiaries, wherever located, need to comply with the resolution, effective for all audits of subject entities contracted after August 2017.

Setting the context

Multiple instances of questionable financial practices in large companies around the world precipitated the need for regulators to reassess and strengthen governance structures and internal control requirements for companies. This includes setting new standards for public accounting firms, corporate management and boards of directors.

Gulf Cooperation Council (GCC) regulations are constantly evaluated and re- assessed to reflect the latest trends and leading global practices. The introduction of **Resolution No. (1) by the Abu Dhabi Accountability Authority (ADAA) is an endeavor which aims to strengthen governance structures within its subject entities.**

In August 2017, ADAA issued Resolution No. (1) of 2017 pertaining to auditing the financial statements of subject entities. As per the resolution, all ADAA subject entities, including material subsidiaries, need to comply with Resolution No. (1). This is effective for all audits of subject entities contracted after August 2017, stating that the statutory auditor would be required to issue a separate report that includes an opinion on the effectiveness of the internal control systems. This involves assessing design and testing the application of the internal control system.

Leading the change

Most entities subject to ADAA's regulations initiated their internal controls over financial reporting implementation journey in 2018, in line with the requirements of the resolution. While the resolution covers both internal controls over financial reporting and compliance controls, there was increased focus placed by subject entities on financial reporting in the initial phases of implementation. A few entities have also included fraud controls in their scope of implementation, which is also a mandatory part of any internal control framework.

Owing to the initial perception that the resolution is applicable from an external reporting perspective, **finance teams played a major role** in driving the ICFR implementation and a co-sourced model with external service providers was the prevalent option for entities in the region. The internal audit or risk governance and compliance teams were also significantly involved in some entities. While this was foreseeable considering the nature of the project, **determining stakeholder involvement and buy-in beyond the finance department proved to be a key challenge faced in the initial years of implementation.**

Implementing the change

The resolution provides flexibility to subject entities for the adoption of an internal control framework that would suit the needs of the organization. As per our experience in the region, **entities have chosen to adopt the COSO (Committee of Sponsoring Organizations of the Treadway Commission) internal control framework** since it is commonly used by various leading organizations and government entities across the globe.

For most, the ICFR implementation journey was set in motion with an assessment to define materiality thresholds, after discussion and agreement with management and statutory auditors to identify key processes and controls to be included in the scope. A **wide range of quantitative and qualitative parameters were used to determine the materiality thresholds** and entities have implemented processes for reviewing the scope on a yearly basis. Nearly all organizations have documented process-level, entity-level and IT general controls. A **few have also commenced covering fraud and compliance controls** as part of their ICFR exercises. Key risks and controls were documented using various tools, such as **process maps, process flowcharts, and risk and control matrices.**

ICFR implementation goals have been dynamic and moving targets, and stakeholders' priorities continue to evolve. Nevertheless, over the last three years, organizations have derived great value beyond compliance. Benefits range from standardization of processes and mitigating revenue leakages, to hitherto unexplored changes in the revenue model.

Based on survey data and our experience in the region, we noted certain trends in the approach adopted by entities in response to ADAA Regulation No. (1) of 2017.

58%

initiated their ICFR implementation journey in 2018, while others started in 2019

91%

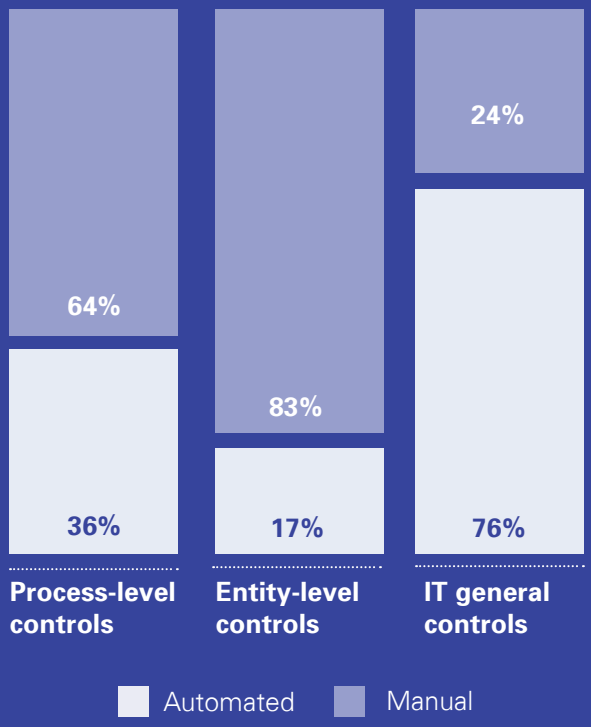
ICFR implementation was driven by the finance division in the initial year

95%

identified key, in-scope processes using quantitative materiality thresholds

Types of controls documented in entities

Process-level and entity-level controls are mainly being executed manually, while documented IT general are largely automated.



Material control weaknesses were identified by the statutory auditors in

1 in 5 entities

23% control failures were noted on average for in-scope processes

76% have sought external support in ICFR implementation

44% out of these intend to build these capabilities in-house

100% entities used COSO internal control framework for implementation

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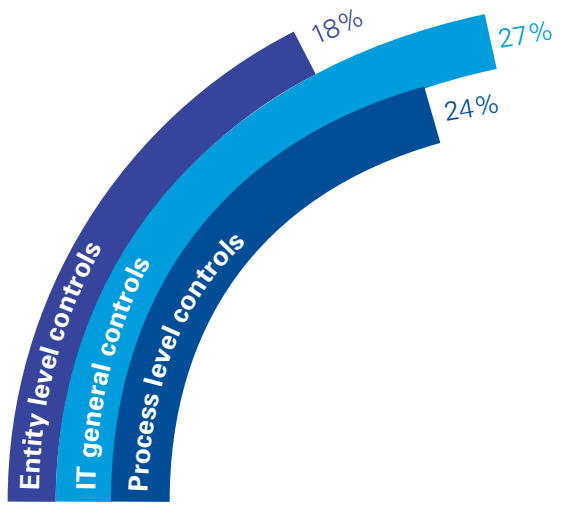
Year-over-year trends

The internal controls identified and documented against various risks recognized in the initial stages of the process would be assessed periodically by management to analyze if the design of the control is sufficient and appropriate. In addition, controls will be evaluated to determine if they have been operating effectively throughout the relevant period.

Ideally, the statutory auditors would review the testing performed by management in order to issue their opinion on the effectiveness of the internal control systems.



Percentage of control failure

Source: KPMG's Beyond regulatory compliance report

Over the last three years, the highest percentage of control failures were observed amongst IT general controls. These tended to be attributable to inadequate or no controls at the design level, or because the controls were not working effectively throughout the period.

Our experience in the region suggests required improvements in IT general controls were mostly design changes across the following domains:

- **User access management:** Absence of an access control matrix and periodic review of user access
- **Incident management:** Absence of an escalation matrix and non-compliance with the incident reporting process
- **Back up and restoration testing:** Absence of backup and restoration testing and assignment of a dedicated disaster recovery data center
- **Change management**: Segregation of duties for conducting changes not maintained and inadequate evidence to verify user acceptance testing

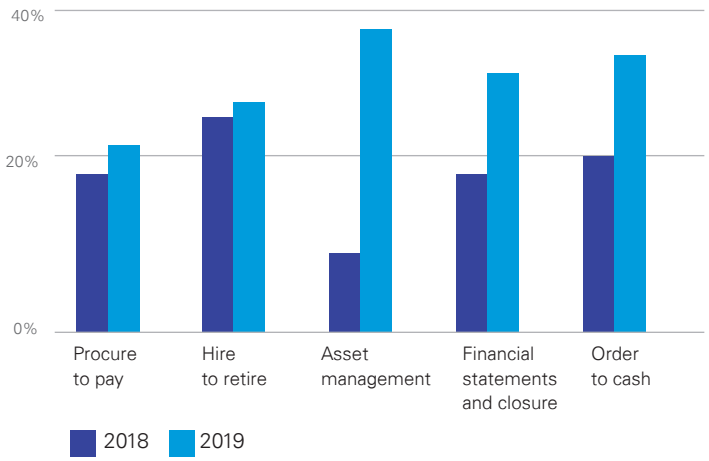
Entity-level objectives are defined at an organizational level, which include the tone at the top, operating style and ethical values. These are internal controls that help ensure management directives pertain to the entire entity. They have a pervasive influence throughout an organization.

Material entry level control (ELC) deficiencies were highlighted in a few unlisted entities while no material ELC deficiencies occurred in listed companies. It is evident that listed companies are more focused on building strong governance and setting the right tone at the top that defines the organization's culture.

Common deficiencies across entity level controls

Source: KPMG's Beyond regulatory compliance report

Process wise percentage of control failures

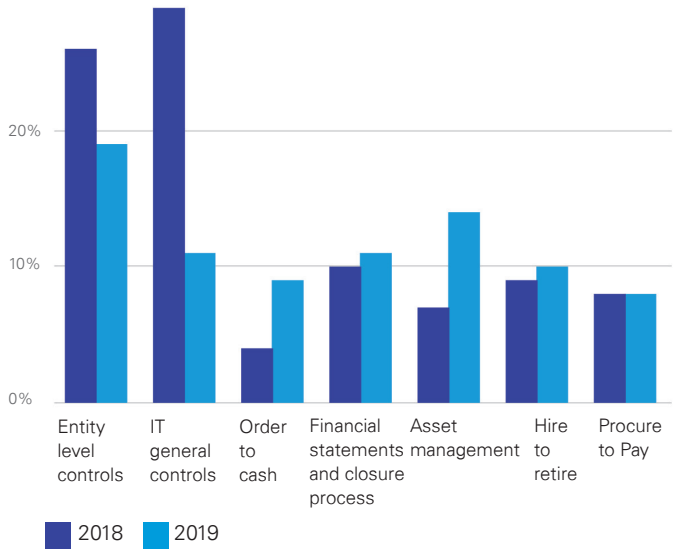


Source: KPMG's Beyond regulatory compliance report

Entities placed a greater focus on achieving compliance with the resolution in the first year of implementation. This shifted to identifying improvement opportunities and enhancing internal control systems in the second year. Consistent with this trend, there was a higher percentage of control failures documented across all processes in the second year of implementation. On average, the majority of control deficiencies were noted in the asset management process.

A material weakness is a deficiency, or a combination of deficiencies, in an internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Concentration of material and significant control deficiencies



Source: KPMG's Beyond regulatory compliance report

Entity-level controls had the highest concentration of material and significant control deficiencies in the initial years, which is expected considering their prominence within an organization's internal control environment.

Common themes across process-level controls in entities

Asset management

- Assets are capitalized without componentization or de-componentization
- Significant delays in moving from capital work-in-progress to asset cost account
- Assets are not tagged and referenced to an asset listing in the fixed asset register and there is an absence of a formal process for physical verification
- Useful life review of assets and impairment analyses are not conducted periodically

Financial statement and closure process

- Insufficiencies in calculation of provisions and accruals
- Balance confirmations are not obtained for significant customers and suppliers on periodic basis

Hire to retire

- Inadequate controls around attendance management and overtime calculation
- Super user access to employee master data
- Inadequate controls related to monthly reconciliation of headcount prior to payroll processing
- Unauthorized access or absence of maker-checker mechanisms for modifying employee master data

Inter-company reconciliations:

- Absence of clear and comprehensive policies and procedures for intercompany balance reconciliation
- Inadequate mechanisms to clear unreconciled balances on a timely basis

Order to cash

- Absence of controls over customer onboarding and master management
- Inadequate monitoring of aged receivable outstanding
- Inadequate provisioning for or write off of doubtful debts
- Inadequate controls over access to tariff master/price master

Evolving perception

Organizations in the region are increasingly exposed to broad shifts in the regulatory landscape and heightened scrutiny from regulators. Today's organizations need to significantly transform their business operating models to remain competitive amid a growing number of industry challenges. ICFR programs are, as of yet, an unfulfilled opportunity to deliver value to the bottom line of a company, impacting the cost of compliance.

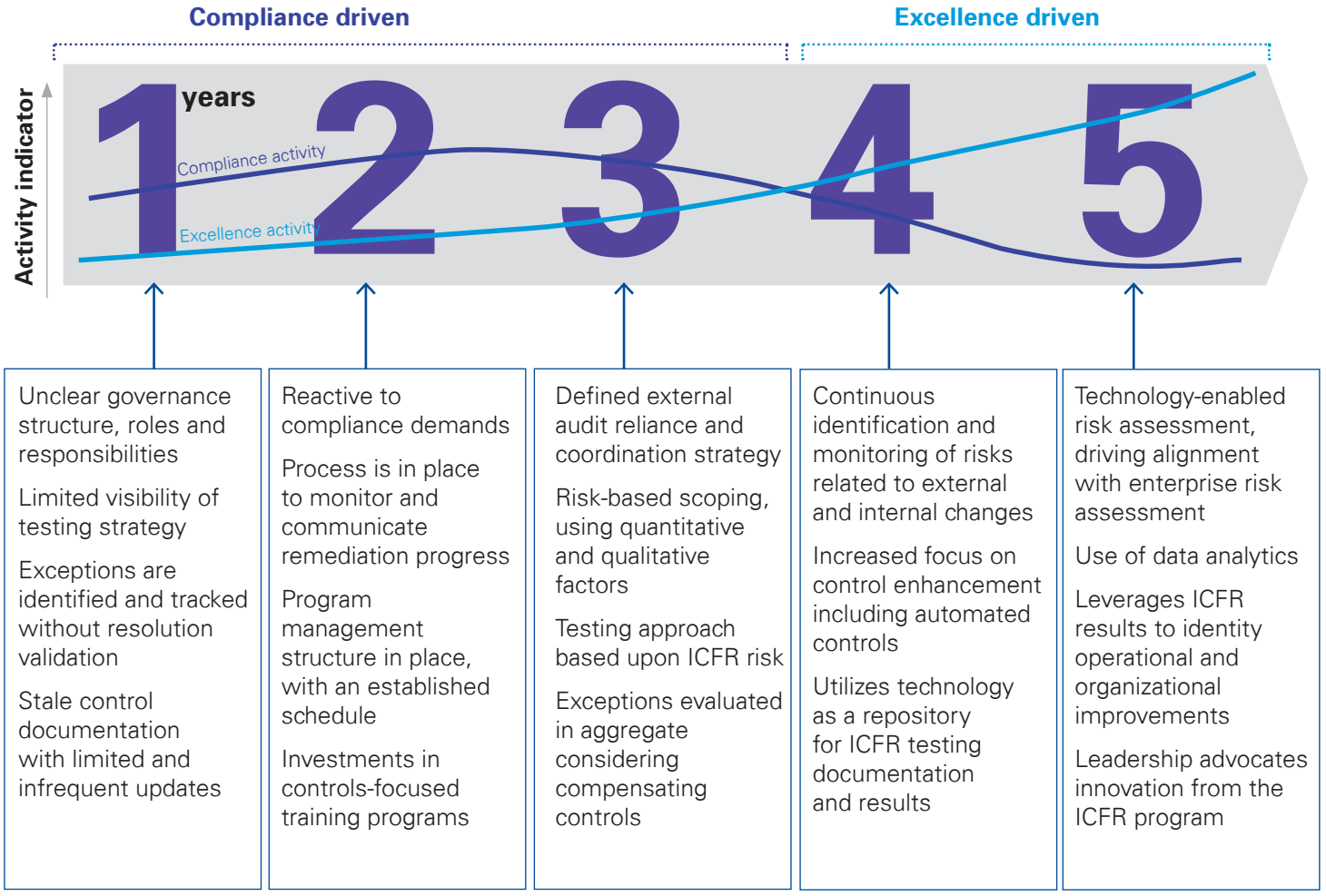
Investors are also willing to assign significantly higher PE multiples to entities with better governance. Implementing an ICFR program is an important step in this direction, as multiple entities seek to become transaction ready with several listings expected in the next two to three years.

Internal control teams need to take a close look at the fundamental business processes, understand core issues and financial reporting risks and subsequently identify opportunities for value creation.

In the initial phase of implementation, ICFR programs often focus on compliance, with less focus on identifying internal control efficiencies or value-add activities.

Globally, organizations are now focusing on structuring their ICFR programs to better align with their strategic direction, and to support growth, reduce risk, reduce costs or drive value. Management also includes key operational controls as part of their internal control assessment program and strives for process excellence, leveraging the ICFR program.While the requirements of ADAA Resolution No. (1) of 2017 emphasize the need to establish internal controls over financial reporting and compliance, organizations are thinking outside the box, using the regulation as an opportunity to improve business processes.

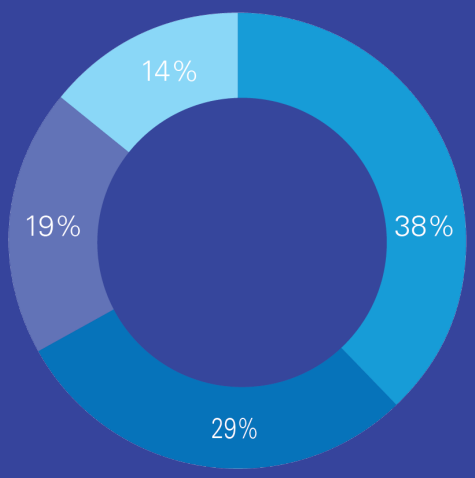
Organizations are increasingly looking at opportunities to derive value from mature and evolved ICFR programs, shifting their agenda from compliance requirements over financial controls to value enhancement.



Methodology

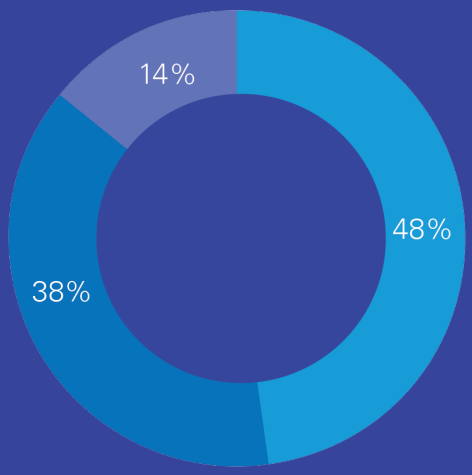
Research for KPMG's Beyond regulatory compliance report was conducted during H2 2020. Responses were gathered from 21 entities using an online survey. Respondent demographics are as follows:

Annual revenue



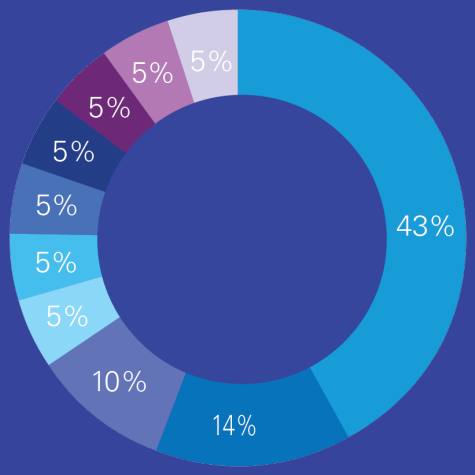
- Above AED 5,000 million
- Less than AED 500 million
- AED 500 to AED 1,000 million
- AED 1,000 to AED 5,000 million

Designations of participants



- Senior management team
- Mid-management team
- C-suite executive

Industry



- Energy
- Food & beverage manufacturing
- Transport
- IT
- Public investments
- Logistics/services
- Economic planning/ specialized zones
- MRO business
- Financial institute, capital markets
- Offshore and onshore oil & gas sector

About KPMG

For almost 50 years, KPMG Lower Gulf Limited has been providing audit, tax and advisory services to a broad range of domestic and international, public and private sector clients across all major aspects of business and the economy in the United Arab Emirates and in the Sultanate of Oman. We work alongside our clients by building trust, mitigating risks and identifying business opportunities.

KPMG Lower Gulf is part of KPMG International Cooperative's global network of professional member firms. The KPMG network includes approximately 227,000 professionals in over 146 countries. KPMG in the UAE and Oman is well connected with its global member network and combines its local knowledge with international expertise, providing the sector and specialist skills required by our clients.

KPMG is widely represented in the Middle East: along with offices in the UAE and Oman, the firm operates in Saudi Arabia, Bahrain, Kuwait, Qatar, Egypt, Jordan, the Lebanon, Palestine and Iraq. Established in 1973, KPMG in the UAE and Oman employs 1,485 people across four offices, including about 100 partners and directors.

Our latest initiative, KPMG IMPACT, aims to help clients future-proof their businesses amid times of increasing focus towards issues such as climate change and social inequality. The goal is to help them achieve success across 17 major Sustainable Development Goals (SDGs) and become more resilient and socially conscious. For FY21, the firm has earmarked a global budget of USD 1.43 million for the initiative.

As we continue to grow, we aim to evolve and progress, striving for the highest levels of public trust in our work.

Our values are:

Integrity: We do what is right.

Excellence: We never stop learning and improving.

Courage: We think and act boldly.

Together: We respect each other and draw strength from our differences.

For Better: We do what matters.

To meet the changing needs of our clients, we have adopted an approach aligned with our global purpose: Inspiring Confidence, Empowering Change. Our three pillars – exceptional quality of service, an unwavering commitment to the public interest, and building empowered teams – are the foundation of our firm.

Contact us

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