INTERNAL AUDITING PRACTICES IN INDIA

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A Survey of Internal Auditing Practices in leading Companies of India

THE INSTITUTE OF COST ACCOUNTANTS OF INDIA

Head Office: CMA Bhawan, 12, Sudder Street, Kolkata- 700016 | New Delhi Office: CMA Bhawan, 3, Institutional Area, Lodhi Road, New Delhi- 110003

Executive Summary

Evolution of Internal Audit

It has been long since 'Internal Audit' was introduced in India by some enlightened companies. Recognizing its worth in achieving independent review of financial data and controls within the organizations, *internal audit* was first made mandatory for a particular set of companies vide the Manufacturing and Other Companies (Auditor Report) Order, (MAOCARO, 1975). MAOCARO, 1975 required the auditor to certify *whether the company has an internal audit system commensurate with its size and nature of its business. And also, whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials including components, plant and machinery, equipment and other assets, and for the sale of goods.*

At that time, internal audit was thought to be subservient to statutory auditors having prime focus on the audit and finance function and internal controls. The focus of internal audit was to continuously audit financial records to provide an assurance to the statutory auditors and the management that the financial controls are adequate and operating effectively. The statutory auditor, who is external to the company, used to rely on the assertions of the internal auditor.

Time and again, with the MAOCARO, 1988 and CARO 2003 the need for internal audit was emphasized and focused. Section 581ZF of the Companies (Amendment)Act, 2002 also stipulated that *'Every Producer Company shall have internal audit of its accounts carried out, at such interval and in such manner as may be specified in articles, by a chartered accountant'*. We conjecture that certification by the statutory financial auditor has led to the belief that internal audit is a separate vertical within the finance and accounting function. Even today, in around 23 percent of companies, the Chief Internal Auditor (CIA) administratively reports to the CFO or the senior most authority in the finance department.

Internal Audit- Current Status

However, post CARO, 2003 and with the evolution of the internal audit in other advanced economies of the world, the scope of internal audit in India too evolved. The scope of the Internal Audit enhanced on the premise that 'Internal Audit is a management tool that can help the organizations and its top management to evaluate and improve upon the operational, procedural, managerial and governance aspects of the organization; that also provides consultancy and advisory on areas of strategic importance to the business'. The worth of internal audit in improving the overall performance of a company was being acknowledged.

In India, the government acknowledged internal audit as an independent function that has the potential to support good governance. Section 138 of the Companies Act 2013 requires certain classes of companies to appoint an internal auditor to conduct internal audit of the functions and activities of the company. Section 134 (5) (e) of the Act gives the definition of the term *internal financial controls,* reporting on which is a part of the Director's Responsibility Statement. As per the Clause, the term *'internal financial controls' means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.* Safeguarding of assets is not limited to safeguarding assets from fraud or pilferage. Board of directors is responsible for safeguarding the assets from use other than for creating shareholder value.

The directors without the support of an independent review cannot certify the adequacy of financial controls. Therefore, they depend on the report of the internal auditor. Similarly, the Companies Act requires independent directors to bring independent judgement to bear on the Board's deliberations especially on issues of strategy, performance, risk management, key appointments and standards of conduct. Independent directors have to depend upon the independent review by internal audit to discharge those responsibilities.

And thus, in a way, the Companies Act 2013 has broadened the scope of internal audit to include all important areas of a company's operations.

However, the scope of internal audit is still not well-defined. Companies at different internal audit maturity levels define audit scope differently. In countries that are at an advanced stage of adoption of the concept, have moved their focus on the *risk-based internal audit* moving from the era where the focus was on financial audit and then to operational audit and then to management audit.

This study is an attempt to identify the current state of the internal audit function, particularly in leading companies of India and to highlight its evolution (over the past years) and its need for further development in the coming years.

Some of the key findings from this study are enlisted below. The survey results are based upon the responses of 94 companies to the Questionnaire developed for the survey. Out of the 94 companies, only 14 are public sector enterprise (PSE) and 1 is a large co-operative society (Gujarat Co-operative Milk Marketing Federation Ltd., having an annual turnover of Rs. 18,143 crores for the year 2013-14).

Survey Findings

Section A: The Descriptives

1. 79 percent of the respondent companies had an annual turnover of more than 1000 crores. Thus, the survey has primarily captured internal audit practices in large companies.

2. There is almost an equal divide between the number of companies that have partly/ completely outsourced their Internal Audit functions and the ones that have an internal audit department.

   Chartered Accountant firms are the most preferred outside agency for those that have outsourced the function. This may be primarily due to the fact that the Companies Act, 1956 mentioned that the internal audit should be carried out by the specified companies by chartered accountants only. Section 138 (1) of the new Companies Act 2013, however, specifies that *an internal auditor may be a chartered accountant, or a cost accountant or such other professional as may be decided by the Board of the company.* Presumably, law makers appreciate that the scope of internal audit has shifted from audit of finance records to broad spectrum of corporate governance.

3. Although the Internal Audit literature suggests that the internal audit team should have appropriate mix of knowledge skills and other competencies needed to perform the audit plan, the survey results show that Internal Audit teams are significantly dominated by professional accountants and finance professionals. This might lead to the conclusion that in India internal audit is yet to come out from the image of a younger cousin of financial audit. It cannot be overemphasized that in a complex business environment, audit of functions and processes requires deep understanding of the business model and the business environment.

4. An average team composition for the internal audit function, drawn from the survey results, would include:
    - 65 percent professional accountants,
    - 17 percent 'Other Finance Professionals',
    - 8 percent 'Non- Finance Professionals'
    - 8 percent 'Graduate Engineers', and
    - 2 percent (Negligible) 'Other Technical Staff'

5. It is worth noting that although organizations appreciate internal audit has to play roles beyond supporting statutory financial audit, they are yet to reconstitute their audit team. It is still predominantly a team of accounting and finance professionals.

6. Another interesting finding from the survey is that although the companies at present did not have multi-disciplinary teams in their Internal Audit function, but, they lay emphasis on building capabilities amongst the team members by rotating them across other line functions. Companies also provide them adequate training. On average companies spend 31.45 hours (approximately, 5-6 days) per person during a year for training of audit team members. However, companies should debate whether engagement of specialists as audit team members would be more productive than rotating accounting and finance professionals to non-finance functional areas. Rotation has some significant benefits, but it might be too much

to expect that through rotation and training expert knowledge and skills are developed.

Section B: Audit Independence

7. 86 percent of the companies have Audit Committee in place. 50% of the private companies that are not statutorily mandated to form Audit Committee have formed the same. This is favourable for the internal auditing profession since this would definitely encourage the relatively smaller companies to follow the trend. Forming Audit Committee by companies is a step towards good corporate governance in ensuring audit independence, for both the statutory as well as the internal auditors.

8. Other positive findings on audit independence are:

    a. The level of Chief Internal Auditor (CIA) in most of the companies is either equivalent to or higher than the level of departmental heads. It is in congruence to the principle that the level of CIA should be equivalent to or higher than the level of auditees to bring audit objectivity.

    b. In a majority of the companies, the CIA reports (administratively and functionally) either to the Chairman, Audit Committee or to the CEO or to the CFO. This protects the independence of auditor from auditees, particularly in the area of operational audit. However, reporting to the CFO might impair the audit objectivity and independence in the audit of finance function. Reporting to the Audit Committee has to be the recommended practice atleast in the companies that have one in place.

9. On the alternate plane, in many companies the Audit Committee does not involve itself in the selection of the CIA. It is advisable that the Audit Committee should approve the appointment of CIA or the outsourced agency in order to ensure that a robust selection process has been followed and the selection is unbiased. The

Audit Committee not getting involved in the appointment of the CIA is presumably because it is considered as an executive function.

10. In relief to the above observation, in most of the companies CIA has a reasonable access to the Audit Committee. The practice of allowing the CIA to have access to the Audit Committee protects the company from frauds perpetrated by senior management.

11. While studying the perceived independence of the Internal Auditors, it was noted that around 64.5% of the CIAs perceived that their internal audit function is 'Highly Independent', around 31.2% perceived it as 'Moderately Independent', 2.2% perceived it as 'Not Independent' and 2.2% of the respondents marked their responses as 'can't say'. Number of companies in which the CIA does not perceive high audit independence is non-trivial. High perceived independence is most important to make the CIA motivated to offer creative solutions. Companies should take initiatives to improve the level of perceived independence by allowing the CIA to draw the audit plan independently in consultation with the Audit Committee.

12. While ranking for 'Who values the internal audit function the most', the companies gave the following order of preference (on an average):

    a) Audit Committee of the Board
    b) CEO
    c) Board of Directors
    d) CFO
    e) Auditees

    The finding shows that the auditees do not attach much value to internal audit, which is a matter of concern. It is possible that they may view internal audit as a 'policing function'. It is also possible that auditees are aware of weaknesses in the process/systems and therefore, do not see audit as a value-added service. The feedback of the auditees could not be recorded for the above possibility, which is a limitation of the study. In absence of insightful reporting internal audit will be viewed as a necessary evil by auditees.

13. The authority that evaluates the performance of the internal audit function is also identified as a factor having influence on the 'audit independence'. In most of the companies, the Audit Committee involves itself in the evaluation process, independently or jointly with other authorities. This is a good indicator that audit independence is valued in those companies.

    However, there are around 44.4% of the companies that do have Audit Committee but the Audit Committee does not involve itself in the evaluation process of the internal audit function. Section 177 (4) of the Companies Act 2013, amongst other things, has made Audit Committee responsible for:

    (i) reviewing and monitoring the auditor's independence and performance, and effectiveness of audit process
    (ii) evaluation of internal financial controls and risk management systems;

    In view of the above stipulations of the Act, the Audit Committees will now have to involve itself in the evaluation of the performance of the internal audit function

Section C: Capacity Building of Internal Audit Teams

14. Although companies do not have multi-disciplinary teams at present; a majority of the companies build capabilities by rotating the members of their internal audit teams to different line functions.

15. Another appreciable finding is that companies spend around 31.45 hours (approximately, 5-6 days) per person in a year (on an average) for the training of the internal audit team members.

16. Use of IT in internal audit is increasing and it was noted that around 60 percent of companies provide IT training to its internal audit staff.

Section D: What Internal Audit function means to different People

17. Out of the total number of Internal Audit hours, companies spend highest

percentage of their time in 'operations audit' followed by financial audit, compliance audit and management audit (in descending order).

18. 89.2% of the companies mentioned that they include 'operations audit' in their scope of Internal Audit while 10.8% didn't. On an average, 35.07 percent of audit hours are allocated to operations audit. This shows that internal audit has graduated from a function complimentary to financial audit to a management service.

19. While 73.1 percent of companies reported that 'management audit' is within the scope of audit, only:

    - Around 50 percent reported that they evaluate the alignment of organizational structure with that that of organization's objectives/strategies
    - Around 57 percent reported that they evaluate the alignment of objectives of various departments/SBUs/functions/ processes with the organization's objectives
    - Around 65 percent reported that they evaluate whether ethical standards have been understood and implemented across the organization
    - Around 55 percent reported that they review strategy implementation in the organization
    - Around 20 percent reported that they evaluate employee satisfaction levels
    - Around 32.6 percent reported that they review the movement in the customer satisfaction levels
    - Around 26 percent reported that they evaluate skill gaps within the organization

    From the above, it can be inferred that management audit is being included in the scope of their internal audit plan, particularly those higher-level decisions, which are outside the domain of a particular functional area.

20. Companies ranked their priorities for different functions within the Internal Audit function in the following order of their preferences:

A: Providing assurance on internal controls

B: Providing assurance on compliance to legal, regulatory, and internal policies and procedures of the organization

C: Achieving excellence in operations by providing assurance as well as value addition to operations of the organization

D: Risk-based internal audit

E: Identifying and managing strategic risks

F: Value-added advisory role for the betterment of the organization

G: Fraud Risk Management

H: Overall risk management

This is indicative of two pertinent facts:- first, that risk management and risk based internal audit have assumed importance in Indian companies, and secondly, management do not recognize internal auditor as an internal consultant and an advisor.

Section E: Internal Audit Programme

21. While ranking the consideration for stakeholder's priority while drafting the Internal Audit Programme, the respondent companies gave the following order of preference (on an average):
    a) Audit Committee of the Board
    b) CEO
    c) Board of Directors
    d) CFO
    e) Auditees

    This corroborates the finding that the auditees see least value in internal audit. This is so because auditees' priorities do not get importance in formulating the audit plan

22. A majority of the companies mentioned that the CIA does not meet with the Audit Committee while drafting the Internal Audit Programme. Also, a sizeable number

of companies reported that they do not modify their internal audit programme during a year. This is a matter of concern, since the involvement of the Audit Committee while drafting the internal audit programme is pertinent in ensuring a well defined scope for the functioning of the internal audit team. Also, companies have to appreciate that drafting of the internal audit programme as an ongoing process and the same cannot be treated as static, one time document, in a dynamic and complex business environment.

Section F: Risk Management in Organizations

23. A majority of the companies reported that they have risk management frameworks embedded in their systems. Although a sizeable number of companies mentioned that they don't think that the current risk management framework is adequate; but this can be thought of as the initial steps of the Indian companies to move towards the regime of risk-based internal audit.

Section G: Fraud Management

24. 85 percent of the companies reported that the internal audit function in their organization is assigned the task of investigating special issues (such as reported fraud, violation of policies, etc.). This is indicative of the fact that the companies are readily understanding the role of internal audit in *fraud management* as the same has been stressed upon in the Companies Act 2013. The analysis even indicate that the companies that do not have Audit Committee at present also have broadened the scope of their internal audit function to include fraud risk management in its scope.

Section H: Pre-Audit and Post-Audit

25. The companies are moving towards the regime of post-audit over the earlier practice of pre-audit. This is a good practice. It is generally felt that pre-audit is manager's responsibility and if the internal audit is assigned that responsibility, it

might obscure objectivity while auditing those transactions.

Section I: Use of IT in Internal Audit

26. The use of data analytical tools and IT tools and softwares for conducting internal audit assignments is increasingly being adopted by the Indian companies.

Section J: Internal Audit: Comparing the Trend

27. While comparing the survey results with the findings of the survey of the Institute of Internal Auditors' Global Pulse of the Profession Survey- 2014, it was observed that:

IIA's Global Pulse of the Profession Survey- 2014	Survey Results of Indian Companies
'Strategic business risk' is the top priority of stakeholders for the internal audit function in North America. *'Operational Audit'* is a also a focus area on the priority list of the stakeholders.	*'Assurance and compliance'* is the top priority for the internal audit function in India. *'Operational Audit'* is increasingly topping up the chart of priorities for the internal
Boards in North America are highly concerned about *'information security and audit'* as a part of their internal audit plans	*'Information security and audit'* is not a popular component of the internal audit plans in India. A probable reason , however, is that at present it is being handled by independent function heads.
The internal audit teams draw professionals with different skill-sets with focus on different technical as well as soft skills	Internal audit teams are dominated by professional accountants and finance professionals. However, rotation of audit staff across other line functions and training of the staff is highly focussed
'Risk management' is another pertinent area for the internal auditors. Board relies on the internal audit to educate them on the changing nature of risk and the actions being taken to mitigate the same.	The Indian companies are at stage where they are increasingly adopting risk management framework. Risk based internal audit is at the stage of gaining popularity amongst the leading companies. The risk maturity levels of Indian companies are gradually improving but not comparable with other developed economies of the world.