

Internal Audit

at Russian Enterprises

Summary of internal audit survey
of boards of directors, top executives
and internal audit directors

Institute of Internal Auditors - Moscow
Russian Institute of Directors
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Opening Comments and Key Results

The Institute of Internal Auditors - Moscow (IIA-Moscow) and Russian Institute of Directors (RID) are pleased to present the survey and analysis of internal audit at Russian enterprises. IIA-Moscow and RID are grateful to all those who took time and responded to our survey. We hope its results will contribute to the development of internal auditing in Russia.

The growth of the national economy in recent years, rapid development of Russian enterprises, increasing competition and difficult external environment put to the forefront the problem of enhancing the efficiency of company management. Building a world-class internal audit function can be one of the powerful tools in these efforts. Quite recently, owners and management of Russian enterprises did not even recognize the role internal audit can play and its importance to the business. A new-born internal audit departments of Russian companies have been courageously overcoming numerous “growing pains”, severe lack of knowledge and continuous shortage of qualified staff and are striving to prove their value, “bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes” [1].

How far has internal audit in Russia advanced over the past several years and how much is it called for by businesses today? To get answers to the posed questions was the objective of the survey conducted jointly by the Institute of Internal Auditors - Moscow and Russian Institute of Directors in July-August, 2003.

The questionnaires were sent to 100 Russian enterprises with securities traded at two major stock exchanges - Moscow Inter-bank Currency Exchange (MICEX) and Russian Trading System (RTS). The survey is based on responses received from 32 respondents broken down into three groups: chairmen of the board of directors, top executives (presidents, chief executive officers) and internal audit directors. Participating companies represented the following sectors:

- Energy and utilities
- Oil and gas
- Primary metal
- Transportation
- Communications

The survey questions are broken down into the following topics:

- (1) Building internal audit function;
- (2) Internal audit reporting lines and organizational independence;
- (3) Internal audit current role and objectives, emerging trends and expected shifts - vision of the boards, executives and internal audit heads;
- (4) Internal audit key customers and their perception of internal audit value.

Following are key results of the survey.

- boards of directors exercise oversight responsibilities over controls at 9 out of each 10 responding enterprises. At the same time, audit committee is established only at every fifth enterprise.
- Internal audit function exists at all responding enterprises, though in some cases this role is assigned to department of control and revision.
- Internal audit departments at two thirds of enterprises are established within the last five years, each fourth department established within the last year.
- Internal audit department at 6 out of each 10 enterprises consists of over 10 persons.
- Half of enterprises plan to increase internal audit department headcount, no one plans to cut off the headcount.
- Two thirds of respondents indicated that their internal audit function reports to the executive management, and one third – to the board of directors (audit committee).
- Overall, the majority (83%) of respondents view their internal audit function as fully or considerably independent; noteworthy, this opinion expressed by 45% of chairmen of the board of directors and by 95% of internal audit directors.
- For those internal audit functions reporting to the executive management, half of boards plan to change reporting relationships passing the authority to the board.
- Internal audit functions currently perform the following main activities:
 - Conducting traditional internal audits;
 - Control over safeguarding of the company's assets;
 - Assisting management in setting up/maintaining internal controls.
- Main types of audits are operational and financial audits; IT audits are conducted only at 25% of enterprises.
- Respondents indicated that they plan to shift internal audit focus toward the areas of risk-management and corporate governance.
- Top executive management and line management were named the primary customers of internal audit function; board of directors (audit committee) was mentioned among main customers by less than half of respondents.
- Time constraints and difficulties in getting source data were indicated by internal audit directors as major drawbacks encountered in the course of internal audit engagements.
- Overall, almost 75% of respondents are satisfied with their internal audit functions. Interestingly, this view is shared by 40% of chairmen of the board, by 60% of top executives and by 84% of internal audit directors.
- Half of internal audit directors named professionalism as the most important attribute of an internal auditor; noteworthy, only 19% of respondents mentioned integrity and objectivity among the most important attributes.
- Lack of knowledge and skills were most often mentioned as the weakest points of internal auditors.

1. Building Internal Audit Function

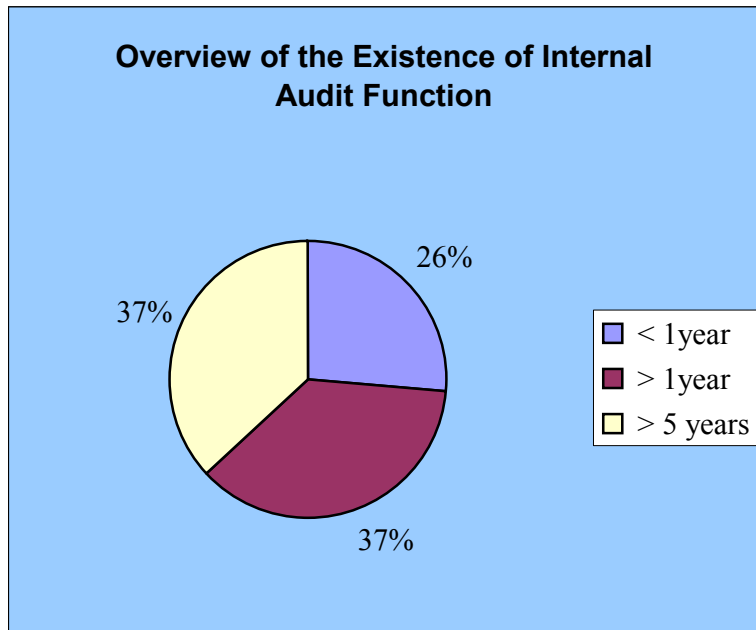


Fig. 1.1

During the past several years Russian companies have been demonstrating an increasing interest to internal auditing. Thus, at almost two thirds of survey respondents internal audit functions were established within the past 5 years, and at each fourth enterprise – within the last year (Fig. 1.1). Internal audit function at 6 out of each 10 enterprises consists of more than 10 persons.

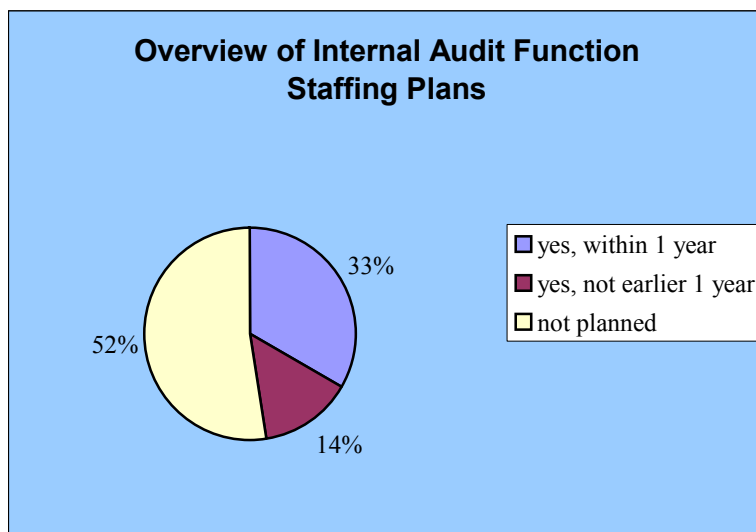


Fig. 1.2

Half of respondents plan to increase the internal audit headcount and none plan cut-offs (Fig.1.2).

The majority of internal audit directors (63%) would prefer to hire internal audit staff from employees of their own enterprises, 50% of respondents are ready to hire certified bookkeepers and public accountants, 25% - internal auditors from other companies (Fig. 1.3).

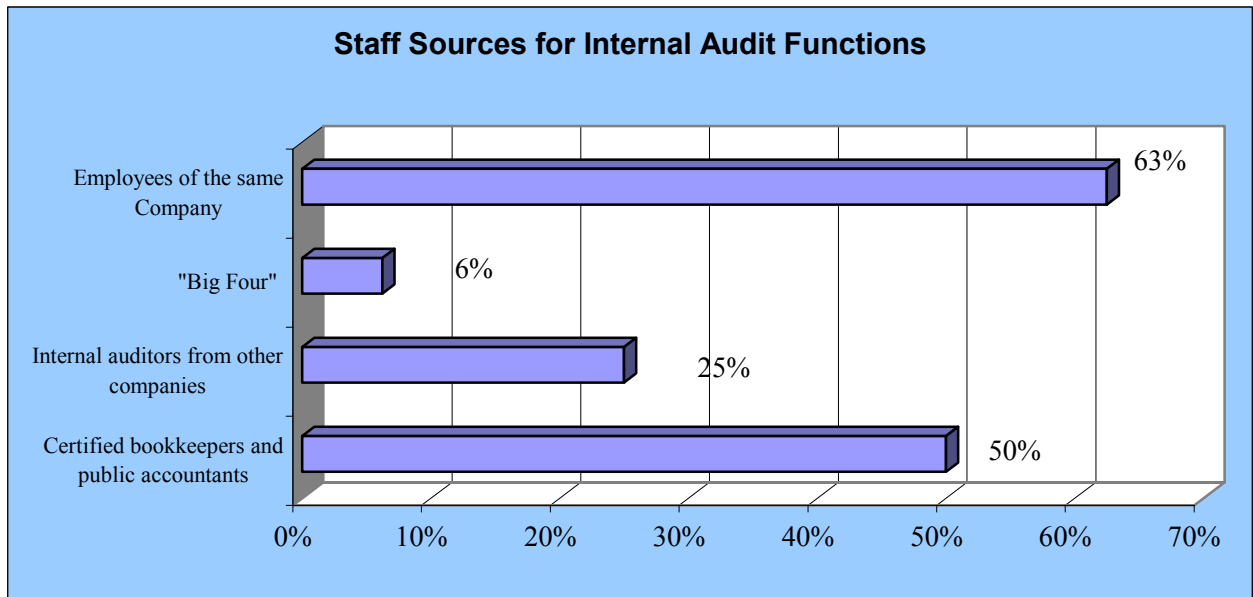


Fig.1.3

Internal audit directors pointed that professionalism is the most important quality for internal auditor (Fig. 1.4) and, at the same time, the weakest point of Russian internal auditors (Fig. 1.5). Integrity and objectivity were mentioned among the most important attributes only by one of each five internal audit directors.

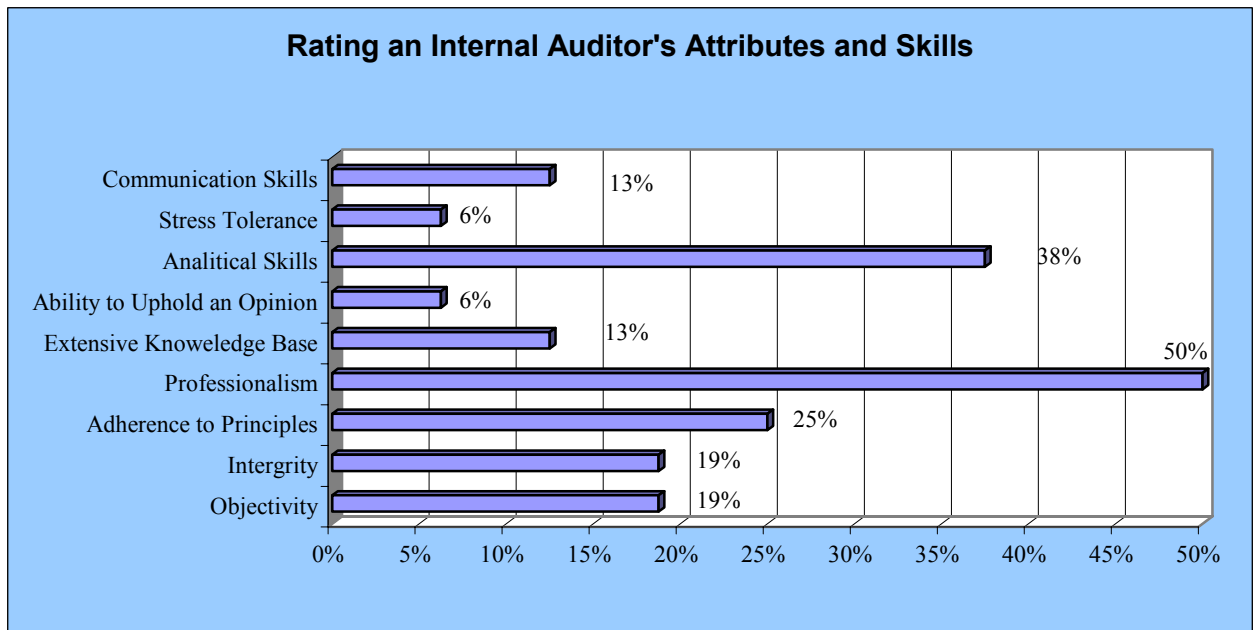


Fig.1.4

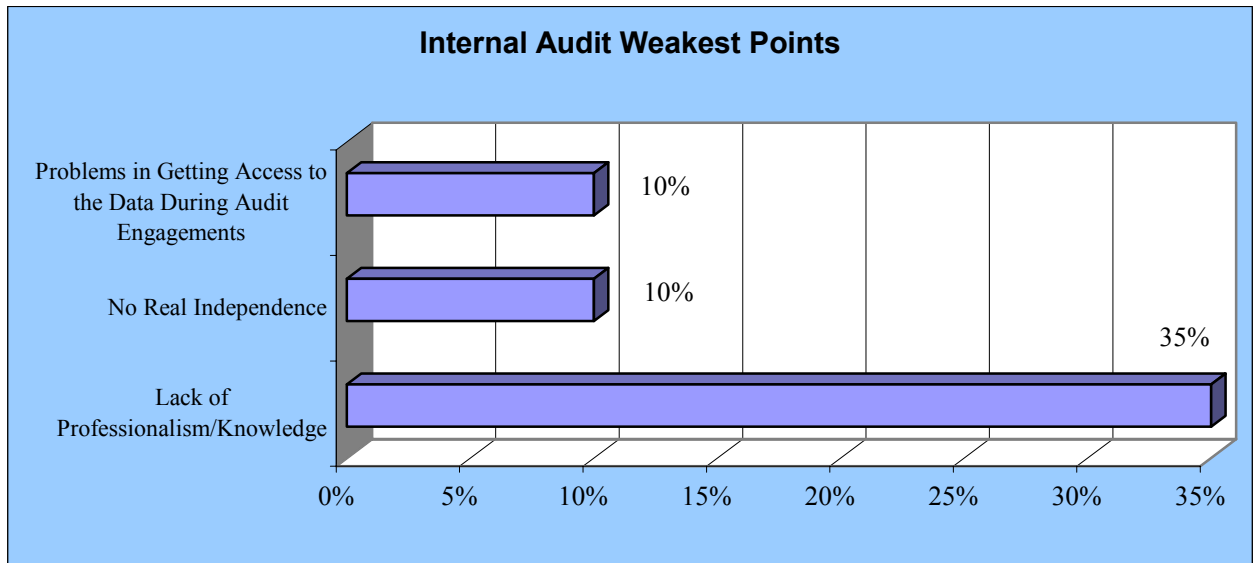


Fig.1.5

One third of internal audit directors pointed that internal auditors are lacking professionalism and knowledge (Fig. 1.5). Respondents also mentioned that seminars and group trainings are the most demanded types of training for internal audit staff (Fig. 1.6).

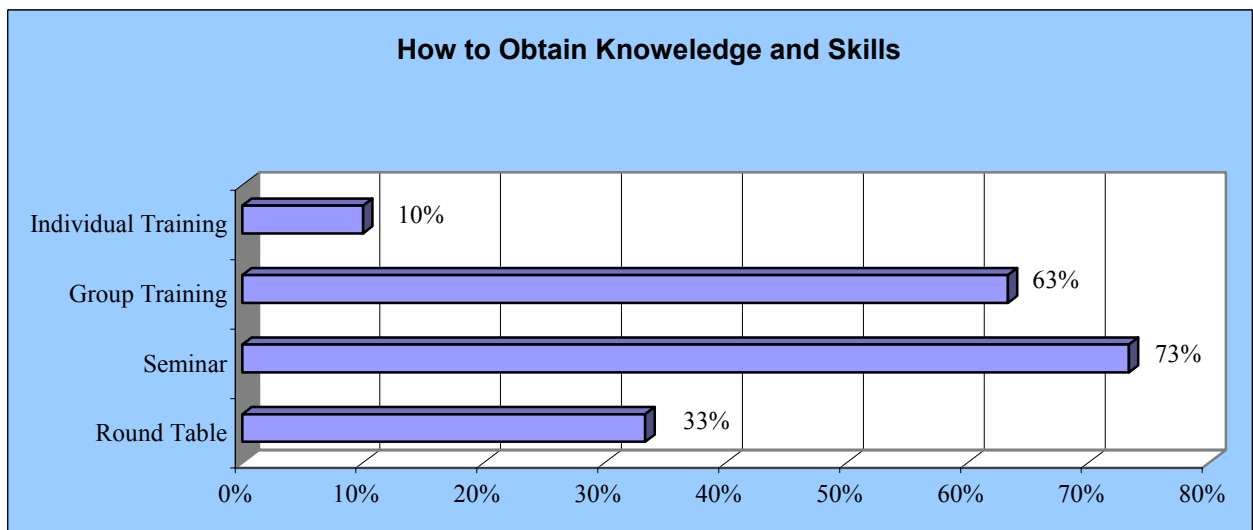


Fig.1.6

Thus, internal audit functions have proved they can bring value both to boards of directors and top management of the Russian companies. At the same time, internal auditors are lacking professionalism, while professionalism is recognized by internal audit directors to be the most important quality of an internal auditor. Most likely, that is why internal audit directors would prefer to hire internal audit staff among certified bookkeepers or public accountants, rather than

Building internal audit function

internal auditors from other companies. The fact, that only one out of each five internal audit directors mentioned integrity and objectivity among the most important attributes of an internal auditor, can indicate that internal auditing is still not perceived as independent and objective source of information for boards of directors and top management.

2. Internal Audit Organizational Independence

The question of internal audit reporting relationships and accountability in terms of internal audit independence and objectivity is one of the most disputable in both Russian and abroad internal audit practices. Just to mention that one of the recent researches on internal audit reporting relationships conducted by The Institute of Internal Auditors Research Foundation was named “Serving two masters” [2].

According to the survey conducted by The Institute of Internal Auditors Research Foundation, about 55% of the internal audit directors report directly to the audit committee, about 22% - to the executive management (chief executive officer), and almost one fourth – to senior financial people (finance director or controller) [2]. According to our survey (Fig. 2.1), about two thirds of internal audit directors of Russian companies report to the executive management (chief executive officer or finance director).

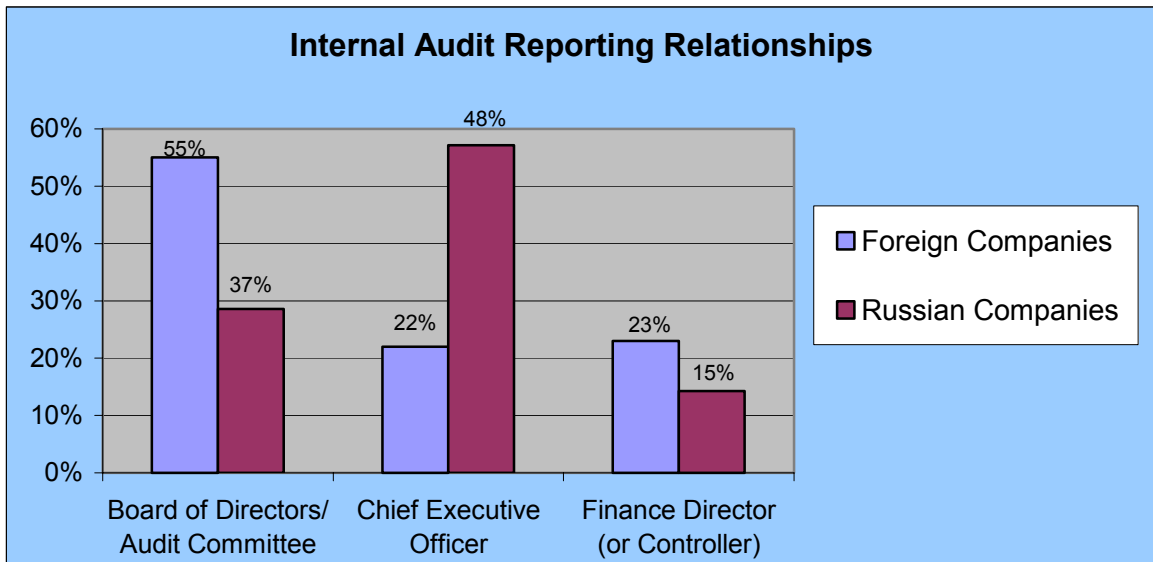


Fig. 2.1

Overall, 83% of respondents view their internal audit function as totally or considerably independent (Fig. 2.2).

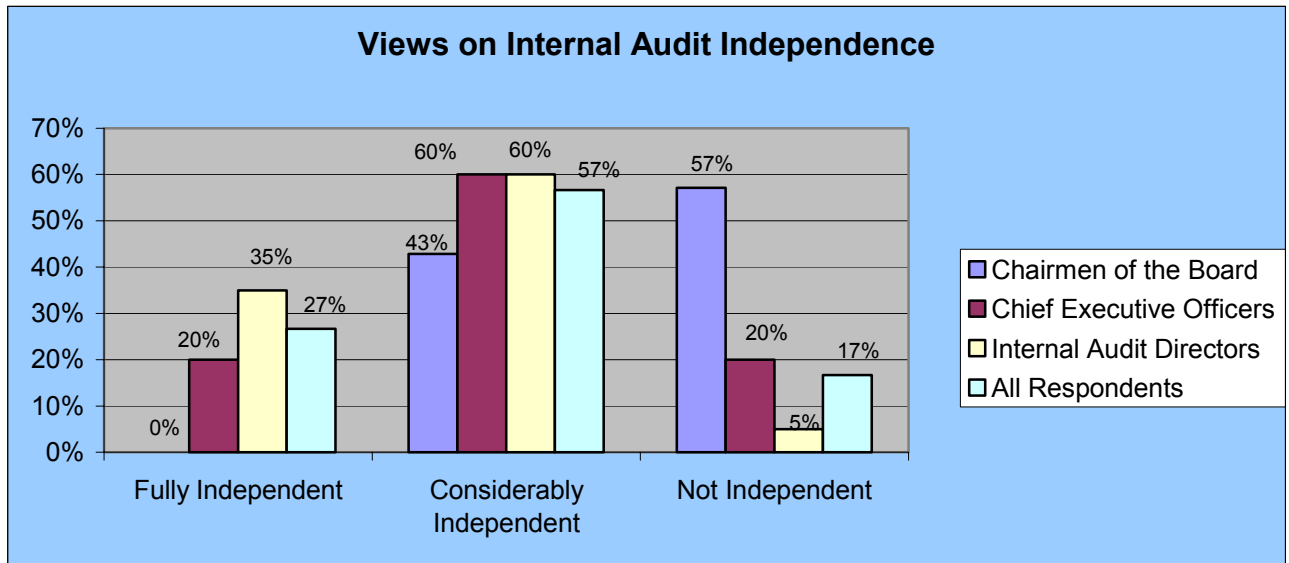


Fig.2.2

Chairmen of the board and internal audit directors are more optimistic about internal audit independence – correspondingly only 20% and 5% of respondents pointed to actual dependence from management. Quite differently, 57% of chairmen of the boards view their internal audit function as not independent. (in all these cases, internal audit director reports to chief executive officer or financial director). Interestingly, in cases internal audit director reports to the executive management, over half of chairmen of the boards plan to change internal audit reporting relationships as to internal audit director reporting to the board (audit committee).

Thus, internal audit functions have a long way to go to reach organizational independence which represents one of the most important prerequisites of internal audit objectivity. However, boards of directors seemingly have recognized the importance of internal auditing and plan to change internal audit reporting relationships, making it report to the board (audit committee). As to internal audit directors, they feel fairly comfortable as to internal audit independence. This can indicate either existing initial restrictions of internal audit scope or a kind of internal audit directors' subjective bias when assessing their own independence.

3. Internal Audit Objectives: Looking Into the Future

Internal audit functions are currently engaged in the following main activities (Fig. 3.1):

- 1) Conducting traditional internal audits (100%);
- 2) Helping safeguard the company's assets (100%);
- 3) Assisting management in setting up/maintaining internal controls (78%);
- 4) Consulting activities (67%);
- 5) Fraud investigations (61%).

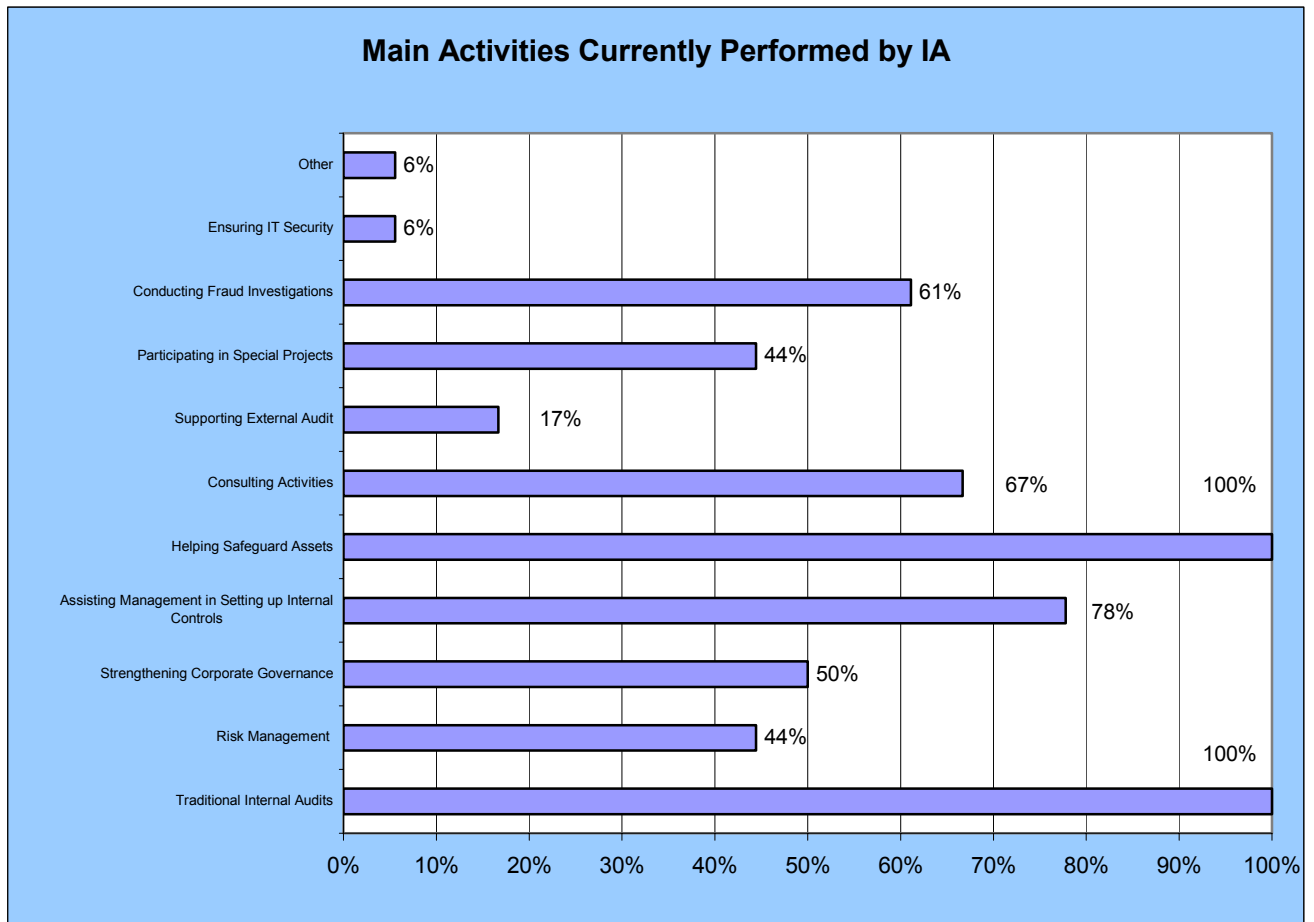


Fig. 3.1

In this relation, it is interesting to compare current responsibilities of internal audit functions with those identified in an internal audit survey of 100 companies in Russia and the CIS conducted by Ernst & Young in 2002. In order for the results to be comparable, the data in our survey was transformed in the way to harmonize two sets of results¹. Forecasts made in 2002 are represented as a line chart.

¹ When reviewing Fig. 3.2, one should keep in mind some differences in respondents profiles of the two surveys. In Ernst & Young survey each third company was a multinational.

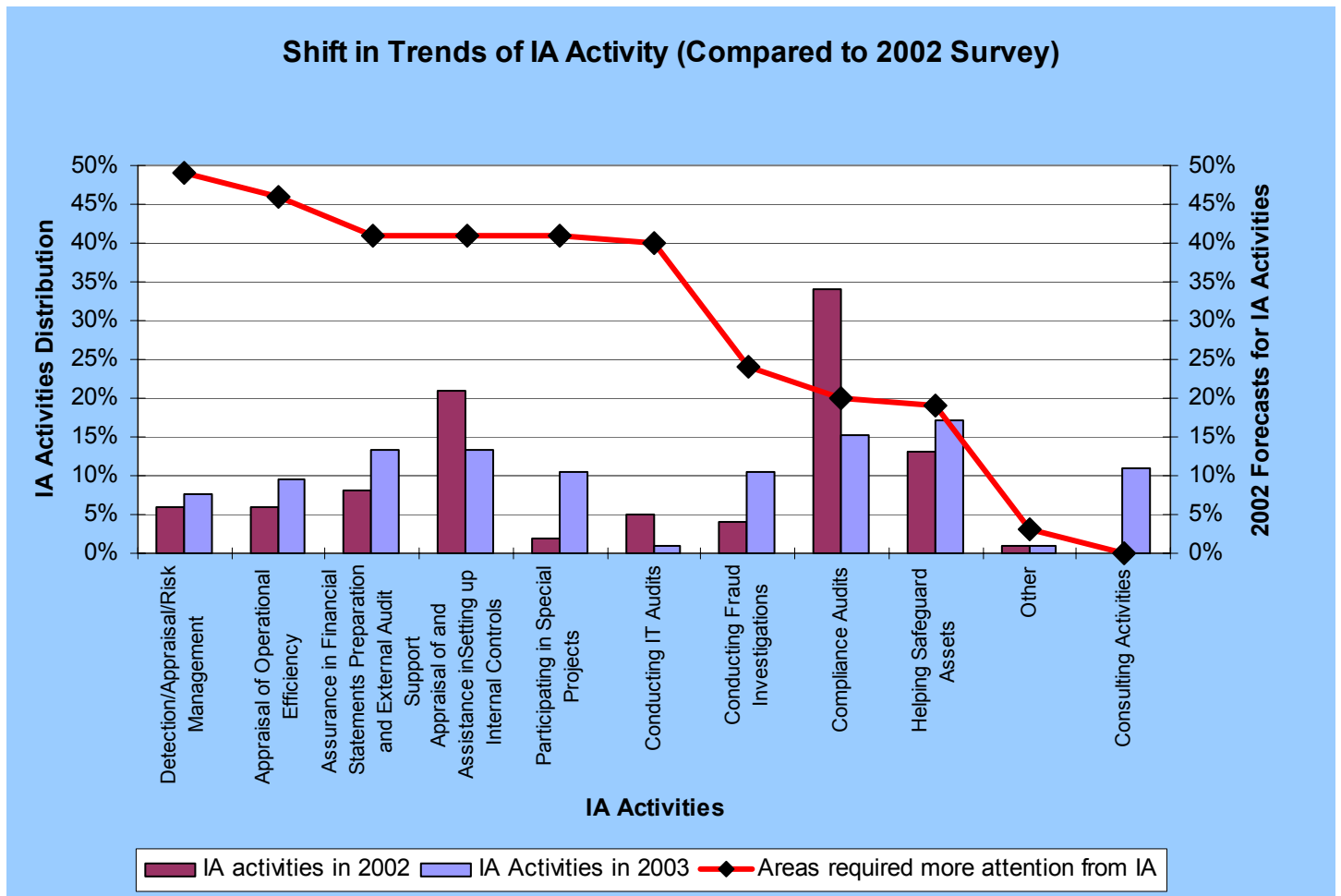


Fig. 3.2

Without going into too much details, forecasts of 2002 proved to be correct for reduction in time spent by internal audit functions on compliance engagements and increase in time spent on special projects. At the same time, internal audit functions have not shifted focus towards areas considered to require more internal audit involvement:

- Business risks identification/evaluation/management,
- Appraisal of operational efficiency,
- IT audits.

Survey respondents indicated the following main activities internal audit functions will be performing in the future (Fig. 3.3):

- 1) Conducting traditional internal audits (85%);
- 2) Helping safeguard the company's assets (81%);
- 3) Assisting management in setting up/maintaining internal controls (81%);
- 4) Strengthening corporate governance (63%);
- 5) Risk management (assessing the company's processes over the identification, evaluation and management of business risks) (59%);
- 6) Consulting activities (56%).

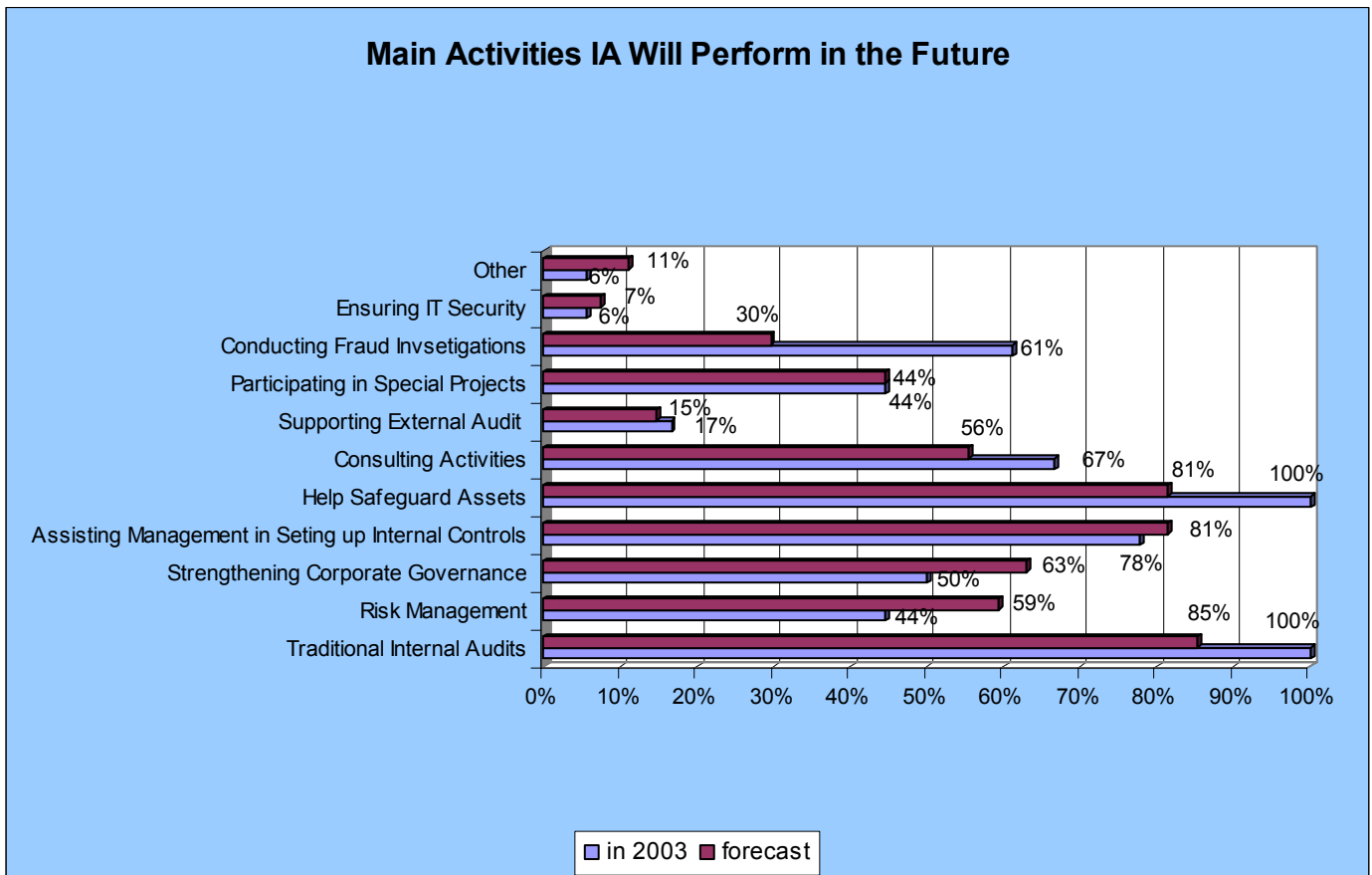


Fig 3.3

Analysis of responses shows relative shifts in focus of internal audit function from traditional internal audits, control over safeguarding of the company's assets and helping management in setting up internal controls towards more active involvement in the areas of risk-management and corporate governance.

It is interesting to note that while top executives view main responsibilities of internal audit function in the future to be assisting management in setting up/maintaining internal controls (100%), helping safeguarding the company's assets (80%) and involvement in special projects (60%), boards of directors consider helping safeguarding the company's assets (83%), involvement in risk-management process (67%) and strengthening corporate governance to be a priority for

Internal audit objectives: looking into the future

internal audit function. Internal audit directors set up priorities as follows: conducting traditional internal audits (75%), assisting management in setting up/maintaining internal controls (70%) and helping safeguarding the company's assets (65%).

It should be noted, however, that fairly often internal auditors and management view differently internal audit assistance to management in setting up/maintaining internal controls. Management is likely to perceive internal audit function as a management resource assigned with the responsibility of building internal controls. This obviously raises concerns as to internal audit objectivity since, in such cases, internal audit is put in the position of appraising the results of its own activity.

Thus, boards of directors would like their internal auditors to refocus activities from their traditional role of control watchdogs towards the role of consultants in the areas of risk management and corporate governance. However, with regard to the role internal audit function will play in the future, internal audit directors are likely to share the views of top executives rather than that of boards of directors. This, apparently, testifies to internal audit directors viewing top executives rather than boards of directors to be their main customers.

4. Internal Audit Key Customers

The survey identified that presently top executives and line management are the main customers of internal audit services, mentioned by 83% and 63% of respondents correspondingly (Fig.4.1). At the same time, board of directors/audit committee was named among the main customers by less than half of respondents.

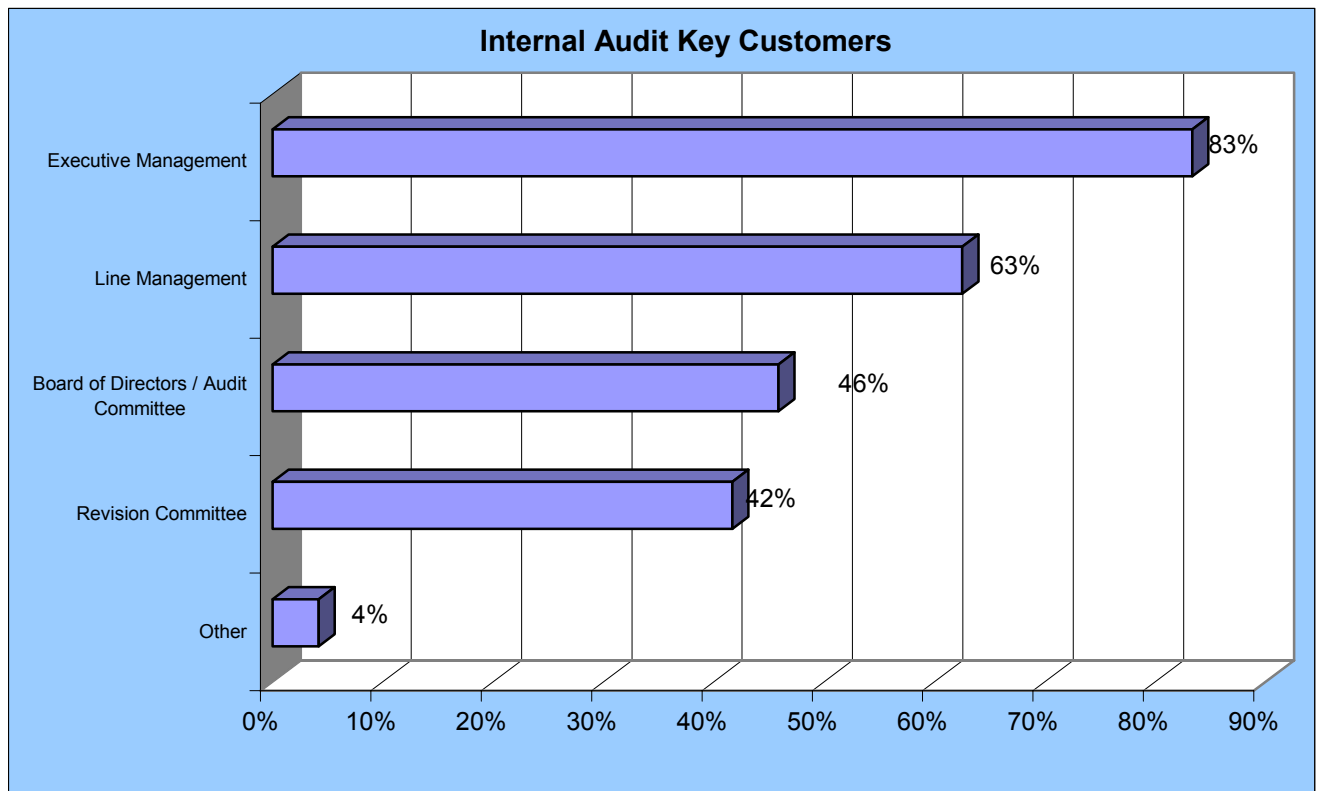


Fig.4.1

Importantly, the responses of top executives and internal audit directors are significantly different (Fig.4.2). Internal audit directors ranked top executives notably higher than any other users group as the main user of internal audit efforts. At the same time, top management leaves this role with line management, considering themselves as a “secondary” user along with the board of directors.

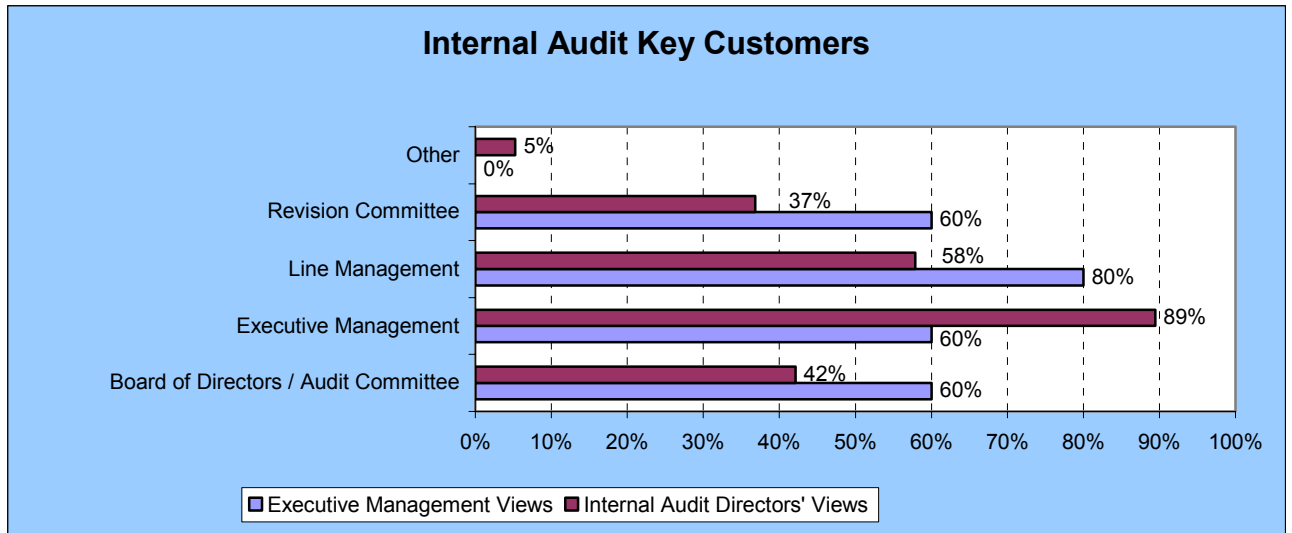


Fig.4.2

Three fourths of respondents are overall satisfied with their internal audit functions. However, the analysis by respondent groups (Fig.4.3) makes evident that internal audit directors are far more satisfied with the performance of their departments (satisfied 8 out of each 10 respondents), while chairmen of the boards are much more concerned with the quality of internal audit services (satisfied 4 out of each 10 respondents). Top executives are in the middle position, with the satisfaction rate of 60%.

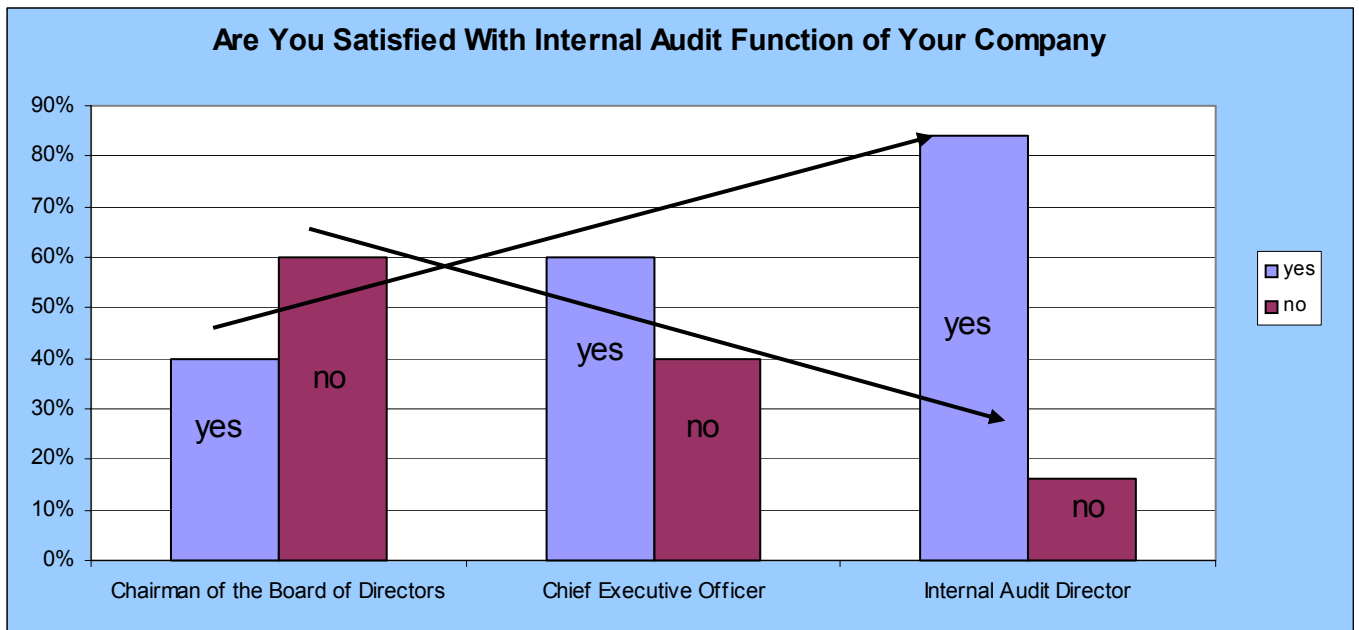


Fig.4.3

Internal audit key customers

Consequently, at present the internal audit departments of Russian enterprises are far more orientated towards the needs of the executive (top and line) management other than that of the owners. At the same time, half of top executives and most of chairmen of the boards of directors are not satisfied with their internal audit functions. This may be driven by the following factors:

- Lack of understanding on behalf of internal audit directors of customers'/clients' needs,
- Excessive or unjustified expectations on behalf of the boards of directors and management coupled with insufficient resources allocated to the internal audit,
- Overall poor control environment at the enterprises,
- The quality of communication between internal audit and key customers, including the failure to inform key customers about how internal audit is adding value to the organization.

On the positive side, four out of each ten internal audit directors pointed to the board of directors as internal audit's main customer which could be hardly imaginable just a couple of years ago.

List of Additional Sources

1. The Institute of Internal Auditors. Standards for the Professional Practice of Internal Auditing. 2001. www.theiia.org
2. The Institute of Internal Auditors Research Foundation. Internal Audit Reporting Relationships: Serving Two Masters. 2003. www.theiia.org
3. Ernst & Young Internal Audit Survey in Russia and CIS, 2002.

This analysis is prepared based on responses received from the 2003 Internal Audit Survey at Russian Enterprises. The above information may not be perceived as official position and (or) formal recommendations of the Institute of Internal Auditors – Moscow and Russian Institute of Directors. The Institute of Internal Auditors - Moscow and Russian Institute of Directors are not liable for any errors or losses of third parties resulting from use of this survey results.

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