

Chapter VI.

INTERNAL AUDIT: CURRENT STATUS AND DEVELOPMENT PROSPECTS

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Internal audit in Russian companies has made a great headway, scored notable success and won recognition in the business community over the last decade. As the internal auditor profession is relatively new and evolving, internal audit moves forward by the 'try-and-error method', by absorbing new ways and approaches and by discontinuing the practices not meeting the present-day requirements. Currently, internal audit faces challenges addressing of which would determine, to a great extent, its future. The need for changes has been felt long ago, and the crisis has just accelerated the renovation.

1. Internal Audit Trends and Development Prospects

Early in the 21st century, a series of corporate scandals involving falsified financial statements of major

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multi-national companies spurred interest in internal audit. As a consequence, owners started paying greater attention to the status of internal controls in their companies, and the appropriate amendments to the law were made in many countries (including adoption of the Sarbanes-Oxley Act in 2002). Therefore, the demand of the companies' boards of directors and the management for internal audit as for an independent function assessing the internal control system rose. It's on the one hand. On the other, internal audit operations in many companies were focused on testing and documenting internal controls, which was an extremely routine work. In those days, internal audit was shifting from conventional cyclic inspections of internal control systems to risk-oriented audits, and this process was slowing down, while participation of internal auditors in building the risk management system completely fell into the shade.

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As a result, several years later many companies were exposed to most severe risks, against the background of inefficient, if any, risk management systems/processes. Could internal auditors do more to help their companies avoid this trouble? It seems so. To this end, internal audit would have had to, firstly, focus on the most significant risks, in terms of their influence on a company, including strategic ones, and secondly, make the board of directors and senior executives understand the things that they were not always willing to take into consideration.

The future of internal audit largely depends on its ability to successfully live through the time of changes, to choose the right direction for its development and to learn to be more useful while using fewer resources. Now, internal audit has three tasks to fulfill.

Firstly, to have a deep knowledge of industry-specific features and to understand operations of a company, both in general and at the level of business processes in particular. It is important for the management and the board of directors that the internal auditor will not only have professional skills and knowledge, but also be aware of specific features of the company's business. Internal auditors are specialists in identifying risks and applying the appropriate controls. However, their knowledge and skills should be

used in the appropriate business environment; in the vacuum, they cannot be applied efficiently. By understanding the business and having an eye for operating details of a company, the internal auditors are able to give efficient risk mitigation recommendations. Moreover, ‘speaking the business language’ makes the internal auditor’s task of ‘being heard’ and convincing the management that his conclusions and advice are justified much easier.

Secondly. Internal auditors should be more proactive in risk management. Apart from risk-oriented planning of its operations and risk assessment as part of audit functions, internal audit should regularly provide the corporate management with its assessment of the most severe risks. Meanwhile, in the current situation, assessing risks once a year is not enough; continuous monitoring of changes and the resulting risks is a need already. Internal audit can and should initiate launching the risk management system. In addition to evident advantages for the company, this would also enable greater appreciation of internal audit by the management. However, internal audit playing an active role in risk management should certainly not substitute the management of the company.

Thirdly. Internal audit should level up to assessment of the strategic risk management quality. This does not mean it should develop the strategy and participate in managing these risks. Internal audit is tasked to assess the identification of the said risks. To review and discuss with the company’s top management the issues relating to strategic risks and strategic decision making is, undoubtedly, a highly responsible step for any internal audit service head. It is also necessary for internal audit services to carry out a more active ‘explanatory’ work as boards of directors and top management do not always see and realize the role internal audit could play in the above mentioned issues.

2. Specific Features of the Current Stage of Internal Audit Development in Russia

In recent years, Russian companies have demonstrated a steady growth of interest in internal audit. Companies’ boards of directors and senior executives start perceiving it as an independent component of the corporate

arrangements – the one making a material contribution to business development. Now internal audit is tasked, along with traditional internal control system assessment duties, with new goals, – first of all, to enhance efficiency of business processes and to build the risk management system.

Analysis of the Russian companies’ practice shows that, in most instances, one of the three approaches is used in establishing internal audit.

The first approach – the internal audit is considered as a revision, its main objectives being to review safety of the company’s assets, proper use of resources and fulfillment of the management bodies’ decisions. Notwithstanding the high importance of these issues, this approach greatly limits the internal audit’s role and reduces it, in many instances, to the function of corporate ‘policeman’ with the key task to identify errors and abuse. As a result, the internal audit focuses on identification of adverse events that occurred and persons at fault, rather than on risks and search for opportunities to improve the existing systems and processes.

The second approach – the internal audit is regarded as a financial audit that verifies financial statements of branches, subsidiaries and of a company in general. Such an approach narrows the internal audit’s influence on processes within the company and leads to under-utilization of its potential. One more adverse consequence is that the external auditor’s work and the internal auditor’s work overlap and, therefore, the company has to pay for the audit twice.

Lastly, the third approach – the internal audit function expands its scope from dealing with individual aspects of control (safety of assets, reliability of statements) to assessing the whole internal control system across different functional areas. In doing so, the internal audit focuses on risks, i. e. possible adverse events and their influence on achieving of the company’s goals.

It is rather often that the management of Russian companies tends to regard the internal audit as a resource to tackle managerial tasks involving the establishment the control system. Meanwhile, it is necessary to separate

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the control system establishment and improvement task from the system operating efficiency review task. Tackling both tasks by one unit entails a conflict of interests and cannot but impact on the internal control quality. Moreover, the internal control may be efficient when it is regarded not as a function of the controlling business unit, but as a part of the management process, the part built in everyday operations of the company's management and employees.

An important practical issue in many Russian companies is to select what to establish – the control and revision unit or the internal audit service. To this end, one should distinguish between the function and its corporate implementation: sometimes, a unit called the Control and Revision Service may deal with the conventional tasks for the internal audit, for example, to assess the purchasing process efficiency or the asset to be acquired (due-diligence). On the contrary, in some cases, the internal audit service operations may be fully centered on investigation into abuses and fraud.

In other words, separation between the control and revision service and the internal audit service by function is highly conditional, particularly with the view of the fact that the revision subfunction is one of the natural components of the internal audit function. Differences between the control and revision unit and the internal audit service are more likely related to the prioritization of operations and setting up operating tasks. As a rule, the control and revision unit operations are focused on revision and analysis of events that have already taken place and their consequences, namely: determination of the extent of losses and shortages, of improper use of funds, identification of guilty persons, etc. Meanwhile, less attention is paid to analysis of the risks these events are associated with.

The analysis of publications and practice of the internal audit in Russian companies suggests that, in recent years, its target function has been gradually switching from control and revision to control and assessment. Presently, the internal audit is not so much the internal control function as such, but is rather tasked with securing an unbiased assessment of reliability and efficiency of different systems

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in a company (first of all, the internal control and the risk management) and optimization of management decisions.

The 2008–2010 crisis required the internal audit services (IAS) to update their working practices in order to provide timely assistance in addressing the objectives the companies faced in the downturn period. In the crisis, the internal audit services, like other business units of the companies, went through the stage of reduction in staff and financing. Approaches to the work process arrangement, principles of daily performance record and the system of performance efficiency indicators for IAS employees were reviewed.

Notwithstanding the reduced financing, much was still expected from the internal audit in recent years. It was more essential for IAS than ever to demonstrate their utility for the companies. Identification of business process improvement openings, cost saving opportunities and countering fraud became the principle areas of work for them during the crisis. The IAS role in internal investigations strengthened, which made internal auditors expand their professional knowledge and improve their respective skills.

While the internal audit services slightly shifted the focus of their operations in the time of crisis, they continued to perform their functions of assessment of internal control systems within different business processes and of monitoring the implementation by the management of the corrective action plans based on audit results.

The crisis revealed the vital need in efficient risk management arrangements and the essential role of the internal audit services in this process. A new line of IAS operations, to introduce the process for control self-assessment by the companies' management, has emerged. Implementation of the internal audit quality enhancement programs and holding of external quality assessments by the internal audit services of Russian companies have been another trend of the last years. Development of the internal audit services' staff potential and upgrading their qualifications are still the principal objective for IASs in Russian companies.

The internal audit developmental prospects in Russia are generally in line with the global trends as the Russian

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internal audit practice shows, to a great extent, the same phenomena and processes that existed or exist in companies of the economically developed countries. The future of internal audit in Russian companies largely depends on whether auditors will have a detailed view of the specific features of the corporate operations, play an active part in risk management, and level up to assessment of strategic risk management quality. The current developmental level of Russian internal audit enables to cope with these tasks successfully.

Chapter VII.

REGULATORS' AND INVESTORS' REQUIREMENTS IMPROVE INFORMATION TRANSPARENCY OF RUSSIAN COMPANIES

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Regulatory changes, such as tightening control over legal compliance on the part of regulatory authorities, became the prevailing factor that influences Russian companies' information transparency in the post-crisis period.

1. Subjects of Disclosure Requirements in Russia

Formal, binding disclosure requirements in Russia apply to some 40,000 companies with the legal form of incorporation of an open joint-stock company. The OJSC status enables general public to deal with shares in these companies. However, securities of just 692 companies are admitted to trading at MICEX that accounts for the bulk

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