INTERDEPENDENCE OF INTERNAL AUDIT AND CORPORATE GOVERNANCE IN INDIAN PUBLIC SECTOR ENTERPRISES

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Abstract: India after independence in 1947 from the British has emerged as the world largest democracy and is predicted to be an emerging power by the sheer potential of it's markets and economy. India's economic approaches are a unique model of varied hybrid approaches of economic policies since independence. Post independence Indian economic thought was an attempt to insulate the country from economic shocks with state control, intervention & policies to that effect. Economy growth was based on features of centralized planning, complex industrial licensing requirements, public sectors for infrastructure growth, banks nationalization, substantial public ownership, high tariff barriers, import restriction, high bureaucratic control etc. After 1990's the economic approach changed to market oriented liberalization policies, which saw a spurt in economic growth, capital markets, foreign investments in varied sectors etc.

Public sector growth based economic approach since independence had led to formation of strong public sectors in different sectors of economy. But in the market economy based post liberalization scene of 1990's the need to revitalize and ensure profitability in Indian public sector enterprises has also led to resurgence in management paradigms, agency agent relationships, disclosures, regulations etc. of the public sector firms too. As the nascent experiment of new liberalization regime was being rooted in India, the world economic scenario was for shocks by the fiasco that featured in firms like Enron, Parmalat, WorldCom, etc. These corporate failures and accounting scandals have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets. In India from Satyam to 2G spectrums corporate scandals have raised public distrust in governance. The terms of corporate governance, audit, agent-agency relationships is for scrutiny the world over in all types of economies.

The scams of the corporate world have made lose the public trust in the auditing profession. There has also been public disquiet about the role auditors and audit firms have played in these corporate scandals. It was this nexus between the company management and auditors that forced business community and the accounting regulators to introspect and change the way things were working. For the audit profession, these developments have again highlighted the gap between public expectations and the reality of the role of the auditor. The response of governments worldwide to corporate scandals has been greater regulation. The internal audit helps to run a company more efficiently and effectively to increase shareholders' value .An efficient run company also epitomizes effective corporate governance.

But the public sector in which a colossal amount of national capital is held is also now more prone to scams and corrupt practices, going by the media corporate reports on public sector. This needs a look into the corporate governance and internal audit paradigm in the sector. This is a theoretical review on the interdependence of internal audit and corporate governance in Indian Public sector enterprises. Analyzing the scope, function, effectiveness and the limitations of internal audit of audit function within the matrix of corporate governance, ` is analyzed and recommendations to be more effective is suggested.

Keywords: corporate governance , internal audit,Indian Public sector.

Introduction: In the background of the many corporate scandals, scams and recent cases of public distrust in entities that are legally incorporated to carry out business in the market, owned by government and private sources of capital, the corporate governance paradigm has come under intense scrutiny. The effectiveness of management scrutiny tool of internal audit for probing & protecting the interests of various stakeholders in business is intensely reviewed. The interdependence between internal audit and corporate governance forms an important element of business in all sectors. This paper analyses the complexity nature of the relationships and effects of the relationships between audit and complex evolving systems of corporate governance.

In the public sector the corporate environment will be mostly quantified and is rule driven. The governance variable is intertwined in interdependence within the framework of internal audit in improving the governance parameter. Governance is an all-embracing process that incorporates the many components of a business entity to operate within and between these various departments as the central motive of business, to the manner in which the entity functions in overall, for improving value to the stakeholders. Out of the critical sectors that can make a difference in the governance function is the internal audit which is interconnected, interactive and interdependent in such a way that the governance of the business entity can only be fully understood if its inter-relationships with the internal audit are taken into account.

The media reports in the recent times on the Indian financial and corporate columns have been flooded about scams, cases of graft, endemic corruption, enforcement and whistle-blowers. In the year 2012, India ranked 94 out of 176 countries in the Corruption Perception Index of Transparency International. Many other surveys of recent times also reveal that globally also corruption has worsened in the last two years. The recent Grant Thornton India survey which surveyed 500 executives, found that public sector companies had seen a rise in fraud due to weaknesses in internal controls, scarcity of resources and senior manager overrides and that is a cause for concern.

Over the years of the Indian business environment the government has chosen a less interventionist stance, instead, providing managers with more autonomy—and of course correspondingly higher accountability. The emphasis now is less on the control and punitive aspects and more on the developmental benefits of the evaluative function. This articulates the trend for the development pattern for internal auditing which has increased the need for objective and early reporting of divergence from good practices. Corporate governance requires the need to generate effective demand for evaluation information in an entity.

The role of audit is to generating realistic expectations. Evaluations do not provide final answers; their findings are generally more persuasive than conclusive. There is the need to institutionalize evaluation process like audit. Audit should not degenerate into a routine, checklist evaluation but rather fit into the decision making cycle. Audit is traditionally under financial umbrella in enterprises. But with the importance of disclosures covering a vast area of corporate governance spheres, the debate on where to locate audit like evaluation function in administrative hierarchy is also important.

Overview of Indian Economic Model: Indian economic model since independence in 1947 was based on a socialistic economic approaches till 1990's after which, economic liberalization and market economy based approach was implemented. This resulted in extensive reforms in economic sector and corporate laws. The developments in opening up of India's economy triggered the resulting need for capital, which has led to a growth in India's capital markets. The Indian economy is the tenth largest in the world by nominal GDP and the fourth largest by purchasing power parity (PPP). The country's per capita GDP (PPP) was $3,339 (IMF, 129th) in 2010. Over the last two decades, GDP has shown significant growth averaging more than 8% in the last 5 years with contributions coming more or less from all the sectors.

Indian corporate law has shadows of British corporate law due to the historical colonial ties. After Independence till 1990's India adopted socialistic economic reforms for developing infrastructure and economy. India followed a path of mixed economy till 1991with a large role for public sector in infrastructure development. After forty years of socialist policies, in the 1990s Indian leaders strongly advocated economic liberalization with a move toward an Anglo-American model of corporate law.1990's was a period of extensive reform in India's economy and corporate legal regime. Not only were economic liberalization policies implemented, but also new legal institutions were established to implement new rules in India's corporate and securities laws. Economic reforms of 1991 liberalized licensing policy allowing the entry of private sector into areas hitherto reserved for public sector, removed import restrictions, brought in foreign competition. Industrial licensing was abolished except for a short list of industries related to security and strategic concerns, social reasons, hazardous chemicals and overriding environmental reasons, and items of elitist consumption; reservation for the small scale sector continued.

Today key sectors of the economy are dominated by mature public enterprises that have successfully expanded production, opened up new areas of technology and built up a reserve of technical competence in a number of areas. With economic liberalization post-1991, sectors that were exclusive preserve of the public sector enterprises were opened to the private sector too. The CPSEs, therefore, are faced with competition from both the domestic private sector companies (some of which have grown very fast) and the large multinational corporations (MNCs) too.

Role of Public Sector: Public sector is a dominant player in the Indian economy. Central Public Sector Enterprises are the lead players in companies of India with significant market-shares in niche sectors such as petroleum products, mining, power generation, power transmission, nuclear energy, heavy engineering, fertilizers, aviation industry, shipping and trading, and telecommunication. The Industrial Policy Resolution of 1956 gave the public sector a strategic role in the economy. Massive investments have been made to build a public sector, which has today a commanding role in the economy. A large number of CPSEs were set up as Greenfield projects consequent to the initiatives taken during the various

Five Year Plans.

There are 248 Central Public Sector enterprises (CPSE) under the administrative control of various ministries and departments as on 31.3.2011.Out of these 248 CPSE's, 220 were in operation and 28 CPSE's have yet to commence business.And out of the 220 CPSE's as many as 158 CPSE's showed profit during 2010-11 and 62 CPSE's incurred losses during the year. The cumulative investment (paid up capital plus long term loans) which was rs 29 crore in five enterprises as on 31.3.1951 has gone up to Rs 666,848 crore in 248 CPSE's as on 31.3.2011 .The capital employed (net fixed assets plus working capital) in 2010-11 stood at Rs 949,499 crore with total turnover at Rs. 1473,319 crore.The contribution of the CPSE's to the central exchequer in 2010-11 was to the tune of Rs 156,124 crore.

Public Sector has been granted substantial autonomy but continues to feel constrained in its competiveness due to its obligation to follow a plethora of rules and regulations. Despite the delegation of powers to CPSEs, the pace of new investments is not commensurate with the need to upgrade to face competition from within and outside. This is reflected in their reserves constantly going up to Rs. 605,648 crore in 2009-10 from the earlier levels of Rs. 536,212 crore in 2008-09 and Rs. 485,540 crore in 2007-08. One reason for this phenomenon is the risk-averse nature of top management in CPSEs. CPSEs are considered an instrumentality or an agency of the State under Article 12 of the Constitution. They are accountable to Parliament, Parliament Committees, and Constitutional authorities, Line Ministries, CVC, CAG, Ministry of Finance, and Ministry of Corporate Affairs etc. CPSEs have to comply with all the legal and regulatory processes too as any private corporate entity. The additional issues of oversight arise because of them being public entities. Certain elements of over governance arise because of ambiguities in the roles of various stakeholders.

A complex legal and institutional framework governs Indian central public sector units. The Companies Act, Clause 49 of the Listing Agreement, and DPE guidelines mainly govern them. In addition, CPSEs are subject to various other laws and regulations. Institutional arrangements for exercising the state's ownership rights are complex compared with international practice. The President of India holds government of India shareholding in CPSEs, *ex officio*. The President's powers shareholders are delegated to 38 administrative ministries, each with its own portfolio of CPSEs. Department of Public Enterprises (DPE) serves as the nodal agency. Individual Public sectors have it's management appointed by the government.

Corporate Governance – Principles: The high profile corporate collapses, scams in the recent decades have brought the terms of corporate governance, audit into the spotlight like never before. The conflicts of interests in organizations, management recklessness and greed, corporate dishonesty and ethical breakdowns, weak internal control and poor risk assessments etc. are some of the factors that have caused corporate failures and have been the herald of Corporate Governance discourse. The term of corporate governance is now widely used in professional and its academic sense in domains of Management, Law, Behavioral Sciences , Humanities etc.. It lends itself well to the private and business world just as it is relevant to issues regarding public affairs and the business of governments.

Corporate governance is broadly defined as "a set of relationships between a company's board, its shareholders, and other stakeholders."' According to Cadbury (1992) Corporate Governance refers to a whole system of controls, financial and otherwise, which ensure that a firm is directed in the right way and towards the right direction. The Cadbury Committee's definition focused on the ways in which organizations are controlled and managed so as to achieve their main objectives. It also suggested that Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The Corporate Governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society (Global Corporate Governance Forum, World Bank, 2000). Monks and Minow (1995) defined Corporate Governance in terms of interactions between various players in the corporate environment and the processes used in achieving consensus in the allocation of corporate resources and in the determination of corporate direction to ensure improved performance. Achieving effective Corporate Governance may be impossible in a weak or inefficient regulatory environment (La Port et al, 2002). The definition suggested recently by Rezaee (2009). "the process affected by a set of legislative, regulatory, legal market mechanisms, listing standards, best practices and efforts of all Corporate Governance participants, including the company's directors, officers, auditors, legal counsel and financial advisors, which creates a system of checks and balances with the goal of creating and enhancing enduring and sustainable shareholder value, while protecting the interest of other stakeholders" (Rezaee, 2009,p30)

The Organisation for Economic Cooperation and

Development's (OECD) (1996) approach to defining Corporate Governance is principle based. It provided five principle bases to Corporate Governance assessments which focus on (1) The right of shareholders and key ownership functions (2) The equitable treatment of shareholders (3) The role of stakeholders in Corporate Governance (4) Disclosure and transparency and (5) The responsibilities of the Board. Keasey and Wright (1993) defined Corporate Governance to include the entire paraphernalia of an organisation's culture, ethos, beliefs, shared values, systems and structures that support the successful achievement of corporate objectives. These abstract phenomena play a powerful role in piloting organisational success. They tend to provide enormous depth from which organisations are able to draw strengths and also provide a strong basis on which to build competitive advantage (Johnson and Scholes, 2002).

However, organisations have norms and build culture over time as part of their strategic stance, so this also impacts upon their perceptions and outlook on issues. Keasey and Wright (1993) suggestion that an organizations posture on Corporate Governance depends to a great extent on its culture, ethos, beliefs etc is not implying that Corporate Governance precedes culture but that each organization s culture and strategic behaviors are dynamic and changes in relation to the changing needs and expediencies of society. Organisations need to portray good Corporate Governance postures as these may project a positive image and may impact upon corporate performance (Davidson III et al 2004). On the other hand it may be that firms that embrace Corporate Governance best practices have a culture that places great emphasis on reputation and corporate honesty (Agrawwal and Mandelker, 1990).

Corporate governance, business ethics and effective compliance management are increasingly critical to an organization's reputation and success. All organizations need to embed ethics and compliance into their culture and core business processes to ensure public trust, sustainable growth and enhanced market share. They also need a mechanism so that they can be seen by the public at large to have these processes working effectively. A framework and process for corporate governance, business ethics and compliance management that weaves together a 'top-down' approach to managing accountability with 'bottom-up' compliance processes is a large step in the right direction.

Internal Audit Function: The main thrust of Corporate Governance provision in this respect is how to ensure an alignment of interests between principals and agents (Jensen and Meckling, 1976). Subsisting conflicts of interest between owners and management provide incentives for investment in forms of controls to reduce information asymmetry (Fama and Jensen, 1976). It is expected that the presence of control mechanisms should constrain management and bind them to pursue the profit maximization objective of the shareholders, which is seen as the only objective among classical economists (Friedman, 1957). Equally, such control mechanisms should also enhance reporting quality as organisations become more transparent and accountable and thereby improve the markets confidence in the information provided by the firm (Jensen and Meckling, 1976). Although the primary beneficiaries of investment in control mechanisms are the shareholders (Fama and Jensen, 1976), it has been shown that other stakeholders in the corporate environment such as bondholders and even the management benefit from such diversion of resources into control mechanisms (Fama, 1980). Control mechanisms can either be internal or external (Walsh and Seward, 1990).

Enhanced government scrutiny in the global regulatory environment has incentivized companies to strengthen their anti-money laundering. Effective compliance requires focus on implementation and enforcement Although companies may have a compliance structure in place, such existing intended safeguards are often inadequate: Employees need to be trained on compliance with the FCPA, reporting structures must be properly aligned, and the system of internal financial controls needs to be audited and periodically reassessed and re-evaluated. Companies frequently do not have adequate internal controls to ensure compliance with applicable policies, procedures and practices. Even if such controls do exist, they are often unenforced. Better data generates better information, which in turn leads to better decision-making and improved accountability

One of the main weaknesses of the internal audit system in India is that it has not kept pace with emerging international standards and practices (Ghosh and Jena, 2008). The modern concept of internal auditing goes far beyond its traditional limits. Internal audit is no longer considered as a mere routine review of financial and other records by specially assigned staff. The internal audit is emphasized as a management tool and an integral part of both management controls and communication processes (Diamond 2006). Internal audit is still conducted based on departmental codes and manuals, which are a legacy of the past. These codes mainly emphasize regularity audit and does not encompass management audit and operational audit, they also do not evaluate internal control systems of the units under audit or bind the audited entity to take action on the observations and recommendations of the internal audit.

Interdependence of Internal Audit and Corporate Governance: Public sectors are in a way an extension of the government structure with objectives fixed to enhance national wealth in different sectors to have an equitable resource utilization and distribution and to ensure the quality and equity of services for the stakeholders, the citizens. Hence all public sectors have policies and procedures to direct activities and to provide reasonable assurance that the existence objectives were being met, by the management which holds the reins of control on decisions. The foundations of the public sector governance hence are openness, and clear communication of information.

The other focus areas of corporate governance in public sector are integrity, and objectivity for services and stewardship of public funds. Handling and Spending of the national wealth for improvement requires an effective internal control framework for not only accountability but also optimized and justified expenditure for management of the firm to reach it's objectives. As the management style shifted from central control to a more delegated and distributive control style the effectiveness of resource utilization checking and monitoring, has to be analyzed and monitored by an effective internal control framework like internal audit department. The shift from conventional preventive methodology of resource use waste or misappropriation monitoring by audit to monitoring of effectiveness of resources use, has changed the focus of the internal control framework from financial to performance control analysis. The modern control framework deals with performance in governance and the quality improvement process being measured as a part of responsiveness to stake holders in a public sector has made it necessary that the internal audit interdependence in corporate governance is to be reviewed in the new light. The internal audit function in governance should be nurtured on the idea to be driven by business objectives of the unit or the process internal audit examines.

The government sprouts public sectors so that the national resources are acquired economically and used efficiently to safeguard the assets of an entity to produce wealth for the economy at large. Assets of public entity include human, physical, and financial and information assets, which is to be used efficiently by the custodians termed as management, for development of the entity and the country at large. Internal audit is an internal check to make sure that the actions taken by the managers of public wealth are ensuring that they run the entity in compliance with not only laws and regulations, but also policies, procedures, contracts with efficiency intended to be run.

Public sector internal audit has so far only been involved in carrying out routine checks of financial and operational management activities. But the technology, engineering and financial side has changed in complexity. Hence internal auditors are to comprehend the changes and evaluate and form informed opinion on hitherto new areas of process flows, process optimization, value additions, raw material use ratios, cost benefit analysis, reduction of wastage, environmental compliance issues, best available international practices in the processes, benchmarking standards etc. The internal audit should analyze and get involved in all the systems that are being implemented with an objective, to recommend changes in internal control that can be developed into systems, for improving the effectiveness and efficiency of the corporate to the stakeholders. It should not just function as an add-on at the end , in the list of departments. Internal audit should help and assist management in maximizing opportunities, minimizing threats, and ensuring optimum utilization of all resources. Internal Audit should have not only more scientific monitoring and concurrent evaluation systems but also systems to check that ethical, economical, efficient and effective operations are in place.

Issues in Internal Audit in Public Sector:

The major issues that the internal audit in public sector is facing can be termed as:

- Lack of ownership and empowerment of internal audit
- Focus on transactional, compliance and procedural audit only and audit does not suggest steps to tighten the administrative and financial control systems.
- Change to "cost of decisions taken by management", from the data generated by system is not analyzed.
- More delineation of responsibilities have increased the need to have checks of accountability at various levels
- Staff shortage in internal audit department,
- Lack of systems and methods to measure performance in different fields,
- Inadequate technology resources for internal audit function.
- Lack of ability of audit to highlight & report lacunae on time,
- Lack of benchmarks to compare performances,
- Lack of technical skills and expertise in the audit staff along with financial prowess
- Lack of training for effective audit, as computerization in all spheres requires trained

computer and net savvy auditors.
- Lack of a risk based plan in governance in general etc.

More stress on integrity, objectivity, openness and communication to stakeholders not highlighted in disclosures As in the public sector the internal audit function is under the finance department it is felt in general that audit purview is only the financial and accounts part of a firm. That notion has to change for the audit to have more depth, incisiveness and helpful in the decision making process of governance. Internal Audit requires a major shift in the perception of its scope and should transcend to encompass the entire domain of governance. The internal auditor should not be the financial guy checking the accounts for finding errors of omission or commission, but the internal auditor should analyze the logic and correctness of decisions taken at various levels and their effects on the entity's value addition chain.

Recommendations: The Internal audit information should be accurate, timely, reliable, revealing and should have integrity so that it can support decision-making. Even though the internal audit is expected to help the management as a control for effective governance but what becomes a general practice is that audit is merely ensuring adherence to standards. Internal audit is not taking efforts or a proactive advocacy for formulation of benchmarking standards to compare and lacks the continual improvement by refining the levels of standards. For the internal audit in a public sector to be more effective in governance matrix the following are suggested.

- Internal Audit in public sector has to come out as a more value adding and efficient control in the agent agency relationship as the stakeholders are citizens at large. For the internal audit to be more effective the statutory provisions of law should mandate the internal audit not only in existence but also in terms of disclosure to the stakeholders.
- The concept or design of schemes and hierarchical perspective of internal audit should change from being a mandatory exercise of query of governance in entities. It should be adding value and quality to the corporate governance by the implementation of the opinion and discussions that come as notes of internal audit.
- The corporate governance-computing scheme should have enough provisions by the statutory provisions of the Company act for laying the foundations of a efficient internal audit arm for an introspection and independent view on the governance for value addition in the entity to the stakeholders.
- The internal audit report and the management views should also be disclosed to the shareholders and the auditor's opinion on the management reply should also be highlighted in the annual report of the public sector unit.
- As the problem of inadequate expertise in certain areas do exist for the internal audit staff, the provision for co-sourcing or outsourcing of internal audit in specific areas can help in improving the effectiveness of internal audit in opining on the corporate governance paradigm of that area.
- Development of benchmarks and benchmarking of standards in the various areas of the entity to have a rational & measurable performance checks should be formulated as part of the internal audit function._Risk parameters, risk assessment, risk identification, parameters needs to be independently assessed and reported in a timely manner, leaving enough time for mid course corrections by the internal audit. This requires standardization of internal audit procedures on a national level to ensure that all the aspects of giving effectiveness to audit should be mandatory checked and ensured to be functional. ISO type standards development in auditing for ensuring data generation all areas of governance can help in having an incisive look into the depths of governance in the entity.
- The quality of Internal audit function now is not checked by the entities for it's performance and effectiveness. An quality assessment of the internal audit function by an external statutory body will also help in the development of the internal audit function in a public sector.

Conclusion: The initiative to strengthen Internal Audit has to come from the top administrative level. In all the transactions that become the processes of the management of a public sector, Internal audit should be able to check for the procedural purity, financial propriety, proper accounting, optimal utilization of resources for the purpose it is intended, compliance to the statutory provisions of law, cost of decisions taken by the lineated control hierarchy so that corporate governance sprouts at all levels. Internal audit and Corporate governance are interdependent and intertwined management paradigm in existence and are supposed to nurture each other and co-exist as supplementing functions, so that more accountability comes in the agent-agency relationship in the Public Sector, which in turn will ensure economic and national growth. Disclosures of internal audit if mandated by company act to be reported in annual report will help in enhancing the corporate governance perspective.

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