



THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA

Bangalore Branch

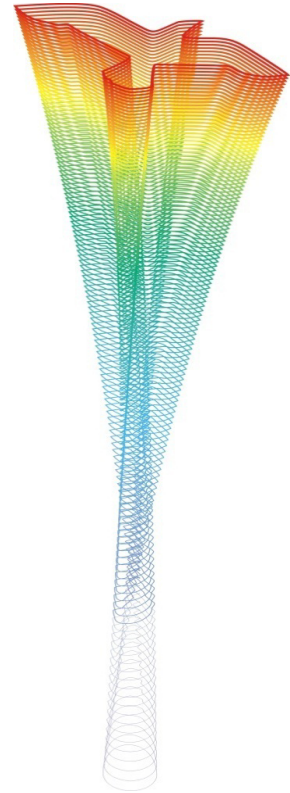
Internal Audit of Operations in SME's

2 July 2014

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Agenda

1. About SMEs
2. Internal Audit - Evolution
3. Key challenges faced by SME's
4. Major areas of focus for Internal Auditors
5. Internal Audit of Operations
 - ❖ Procurement
 - ✓ Case Study
 - ❖ Inventory / Stores
 - ✓ Case Study
 - ❖ Working Capital Management
 - ✓ Case Study



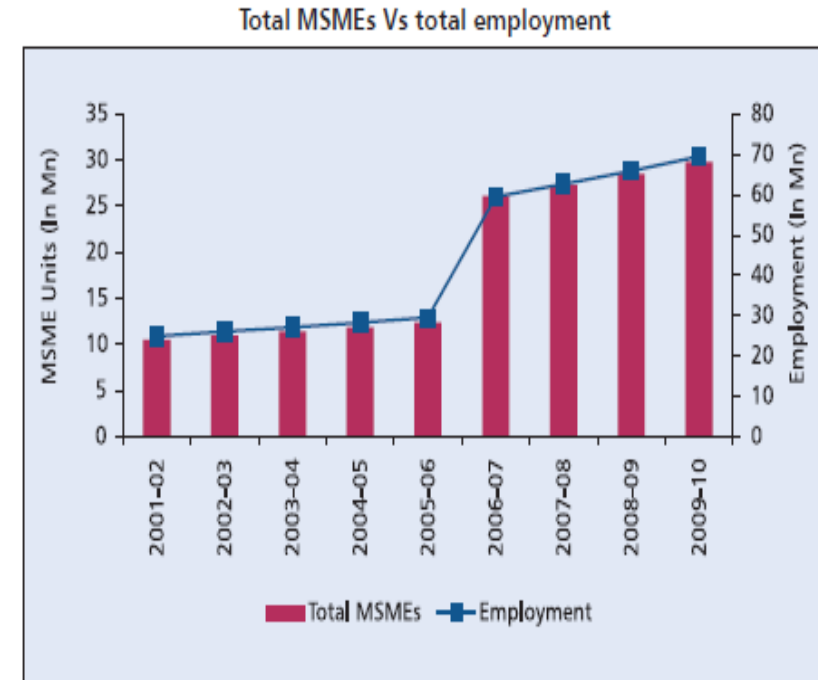


1. About Small and Medium Enterprises (SME)



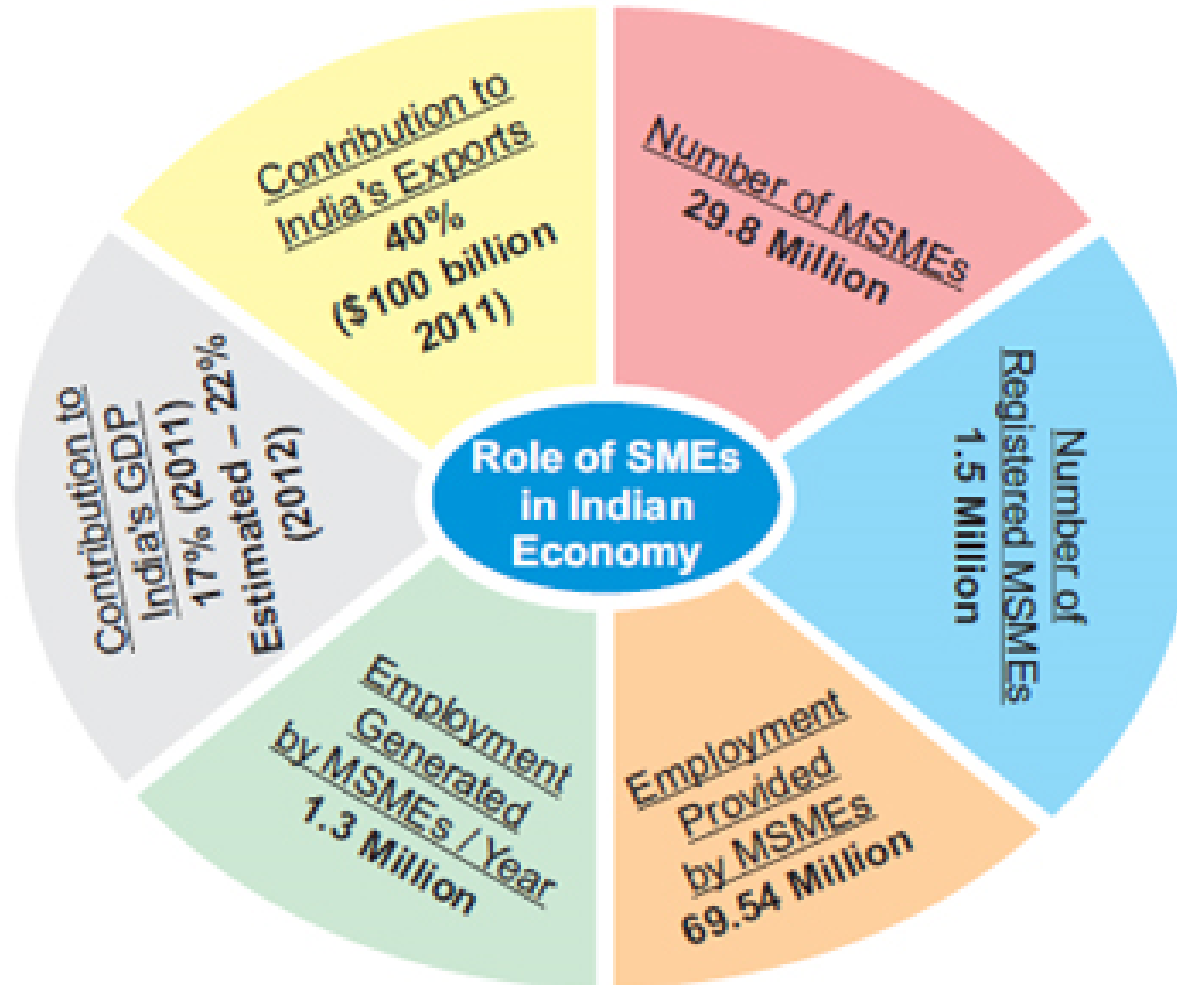
About SMEs

- **Majority** of companies in India are small-to-medium enterprises
- Largest **employment** generators
- Generally referred to as Micro, Small and Medium Enterprises ("**MSME**")
- Regulated by the Ministry of Micro, Small and Medium Enterprises
- Has grown faster than the overall industrial sector
- High growth potential
- Critical to the Manufacturing and Value chains
- Highly **unorganised**
- Pre-dominantly **promoter** driven



Source: Ministry of Micro, Small and Medium Enterprises, Govt

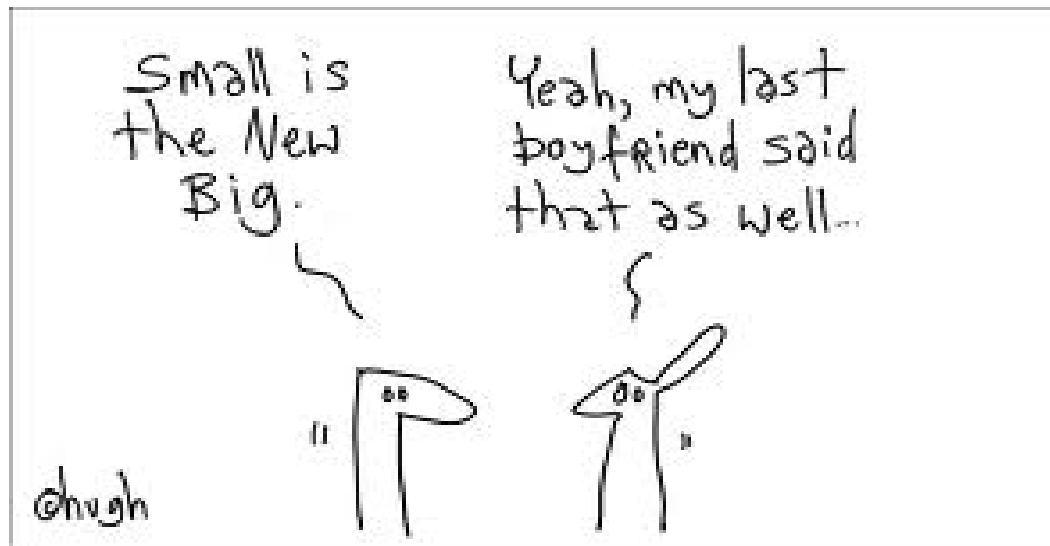
Role of the SMEs in the Indian economy



SMEs are *predicted* (according to a report from the ASSOCHAM) to contribute to **22 percent** of the Indian GDP by 2012

Some key statistics...

- Nearly **35%** of the gross value of output in the **manufacturing** sector comes from SMEs
- SMEs account for **over 40%** of the exports from the country
- As of 2011 the estimated SME market size in India was **\$5 billion**
- Estimated to grow at **20%** over the next 3 – 5 years!





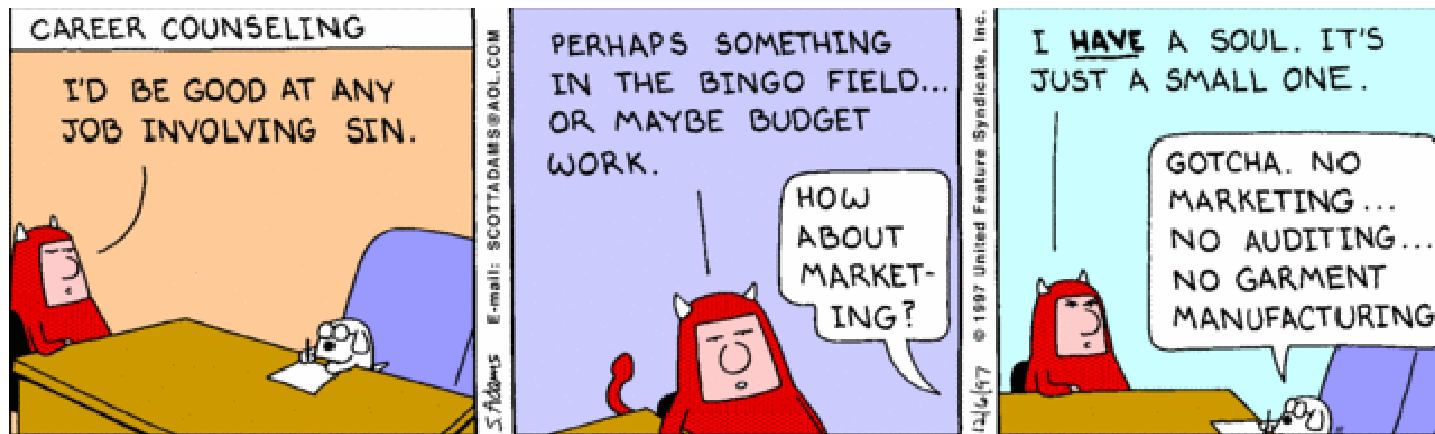
2. Internal Audit – Evolution



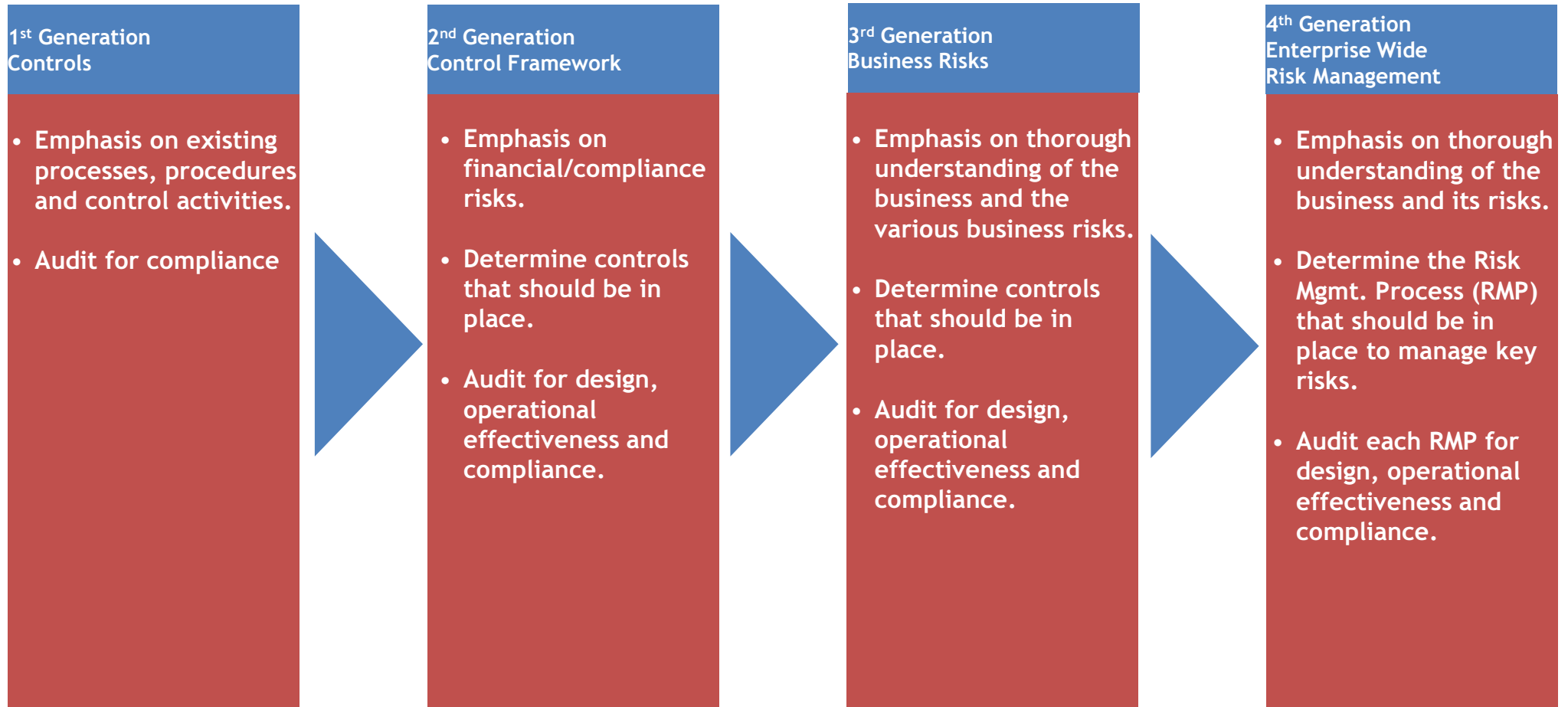
Internal Auditor as viewed worldwide... (On the lighter side)



A Group Financial Controller reacts badly after a call from reception to say the auditors have arrived...



Gradual evolution of IA



Changing face of IA

Changing Expectations

	From	To
Audit Committees and Boards	<ul style="list-style-type: none"> • No surprises • Cost effectiveness 	<ul style="list-style-type: none"> • Risk intelligence (including better risk assessments) • True focus on what is important • Clear communication of important issues • Direct and frequent interaction
Senior and Line Mgt.	<ul style="list-style-type: none"> • More results with less expense • Tangible return on investment • No surprises 	<ul style="list-style-type: none"> • Actionable recommendations • Assistance with risk management initiatives • Lead, follow or get out of the way

The 21st Century Internal Auditor

- Risk-based orientation
- Global perspective
- Governance expertise
- Technologically adept
- Business acumen
- ***Creative Thinking and Problem Solving***
- Strong ethical compass
- ***Fraud awareness***





3. Key Challenges faced by SMEs



Key Challenges

- Absence of *policies* and *procedures*
- Inability to cope with the stringent and ever increasing *compliance* regime
- *Inadequate* working capital
- Lack of financial *support* from banks and government departments:
 - ❖ Non-availability of *credit* facilities;
 - ❖ High interest rates;
 - ❖ Difficulties in obtaining project and working capital *finance*
- *Absence* of skilled manpower to recognise and “grab” business opportunities at the right time
- Controlling expenditure when business is down
- Access to modern *technology*
- *Competition* from big players





4. Major areas of focus for Internal Auditors - SME



Areas of Focus



Areas of Focus



Areas of Focus

❖ *Operational*

- ✓ Procurement
- ✓ Inventory Management
- ✓ Revenue
- ✓ Sales and Marketing
- ✓ Logistics
- ✓ ERP, Information Technology MIS
- ✓ Accounting and Finance
- ✓ Resourcing
- ✓ **Compliance**
- ✓ Working Capital Management



Point for discussion

Who owns the Internal Controls in a SME?





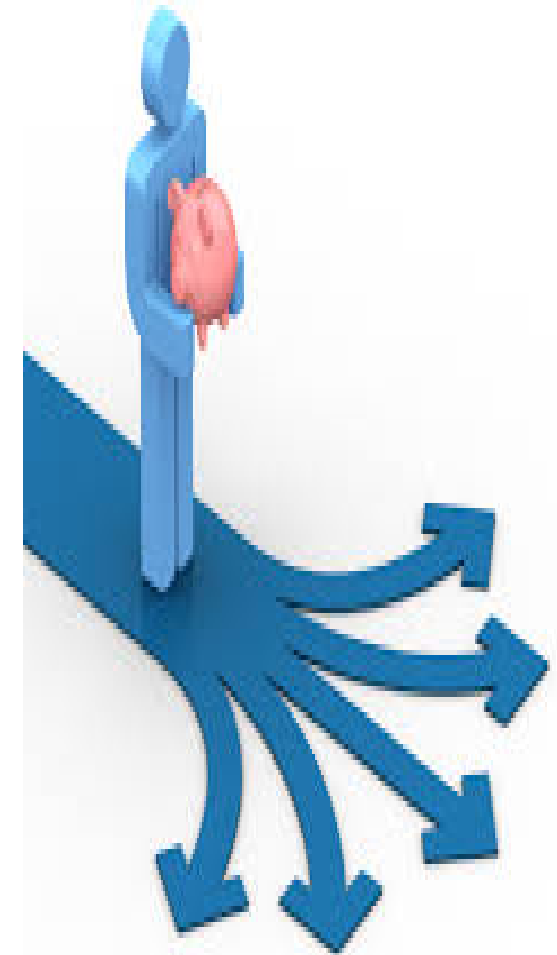
5. Internal Audit of Operations - Procurement



Procurement

Major risks and challenges:

- Generally handled by promoters / family members
- Absence of robust *policies* and *procedures*
- **Fraud**
- Focus on *least cost* quote; thereby compromising on quality
- *Knock on* impact on Production
- Inadequate vendor selection and evaluation procedures
- Less *negotiating* power
- *Traditional* approach to vendor selection
- Segregation of Duties between incompatible functions
- Supplier concentration
- Absence of *3 way / 2 way* match



Case Study

Client Background

- Research, development and manufacturing company of specialty chemicals based in Maharashtra.
- Today the company serves the Agro, Coatings, Inks, Explosives, Electronics Pigments, Defense, Under-ground Mining and, in particular, the Pharmaceutical industries.
- Founded by a chemical engineer in 1980 by an IIT Alumnus

Objective


To independently review the operations to add value and improve business performance, governance, risk management and control processes.

Case Study

Issues	Resolution
<ul style="list-style-type: none">• Company selected vendor to supply critical raw material based on lowest quote• The quality of the material supplied was very poor due to which the production line failed• The production facility was shut down for over 2 months• The company lost the multi crore contract due to this incident	<ul style="list-style-type: none">• Alternate suppliers sourced and 5-10% business given in order to have backup in case of uncertainties.• E-procurement for competitive bidding. Availability of suppliers at competitive prices.• Proper framework of resource allocation which will define the concentration of resources on core activities. Divert the resource concentration on core activities.

Case Study

Value delivered:

- Cost saving of USD 125,405 in purchase of critical raw material
 - Identified alternative suppliers whose quality was 0.5% superior (as certified by the QA department) to that which was currently supplied
 - Procurement department downsized from 5 staff to 3 thereby resulting in immediate savings
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Point for discussion

How would you react to a serious control breach in your SME client as an auditor?





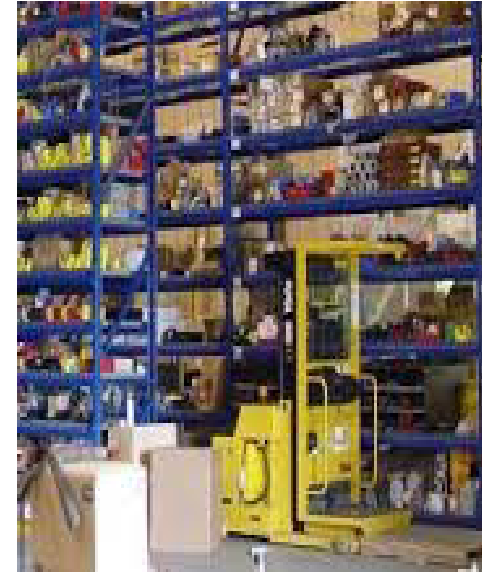
5. Internal Audit of Operations – Inventory Management



Inventory Management

Major risks and challenges:

- Absence of robust *policies* and *procedures*
- Segregation of Duties between incompatible functions
- **Fraud**
- Inadequate focus on inventory based on criticality (ABC analysis)
- Inadequate physical verification procedures
- Storage and holding period (*inventory turnover*)
- Inadequate controls over Receipt and Issue
- Scrap process
- Insufficient insurance cover
- *Inconsistent* valuation procedures (RM, FG and Scrap)



Case Study

Client Background

- Real Estate company in Bangalore, one of India's leading construction houses
- Instrumental in creating over 40,000 residential apartments in and around major cities in India.
- Headquartered in Mumbai; founded in the 1960's
- Regarded as one of the oldest and most respected companies in the Real Estate sector in India

Objective

To independently review the operations to add value and improve business performance, governance, risk management and control processes.

Case Study

Issues	Resolution
<ul style="list-style-type: none">• No controls over inventory storage. Inventory stored in a car park and not maintained in a manner that would facilitate easy access• No physical verification controls• Scrap material sold without proper records and all proceeds obtained in cash; no entries in the books• Identified fraudulent practices in procurement and inventory	<ul style="list-style-type: none">• Separate storage area for project inventory identified• Introduction of physical verification controls• Maintenance of scrap records and follow a bid system of selling• Detailed indepth investigation of alleged malpractices

Case Study

Value delivered:

Discontinuance of scrap sale in cash resulted in company getting the benefit of the scrap sale (approximately Rs. 25 lacs recovered from previous sales made by employees)



Point for discussion

Internal Audit: Value enhancer or value preserver or both?





5. Internal Audit of Operations – Working Capital Management



Working Capital Management

Major risks and challenges:

- Absence of reconciliation of loan accounts
- No track of interest charges
- Cash flow issues
- Inappropriate debt structure
- Manual processes
- Inadequate ERP and reporting systems



Case Study

Client Background

- Real Estate major based in Bangalore with large land bank
- Credited with several of Bangalore's landmark developments
- Founded in the 70's
- One of the oldest and most respected companies in the Real Estate sector in India

Objective

To independently review the operations to add value and improve business performance, governance, risk management and control processes.



Case Study

Issues	Resolution
<ul style="list-style-type: none">• 52% of total expenditure comprised interest on borrowings• Delays in repayments leading to heavy penal charges• Funds borrowed at interest rates as high as 24%• Excess interest payment of Rs. 25 lacs• No reconciliation of loan accounts	<ul style="list-style-type: none">• Restructured debt portfolio to reduce interest burden• Implementation of loan module in the ERP to facilitate interest calculation and reconciliation thereby reducing manual intervention

Case Study

Value delivered:

Immediate impact of approximately Rs. 25 lacs due to debt restructuring resulting in freeing up working capital and facilitating cash flow management





QUESTIONS



Thank You

