

European

INTERNAL AUDIT BRIEFING

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Time to think big

ECIIA delegates in Rome debate how the fallout from the financial crisis is affecting internal audit

INSIDE: Claude Cargou on the ECIIA's strategy, report from the Dresden congress, advocacy corner, news and much more



Dresden hosts German IIA conference

Between 15-16 October Dresden could have been called the city of internal auditing as over 640 participants from Germany and abroad gathered at the International Congress Centre in Dresden for the DIIR-Kongress 2009.

With two general sessions, 41 concurrent sessions and 19 moderated discussion forums, the conference was tailored to provide the attendees with excellent opportunities to learn about and discuss the latest developments and best practices in internal audit. Participants also had a chance to look ahead at future developments and possible changes in the profession.

The conference included topics such as the lessons learnt from the financial crisis, data privacy protection, as well as how internal audit could co-operate with banking regulators and public accountants.

“Our declared goal was the presentation of the most up-



Bernd Schartmann

to-date topics,” said Bernd Schartmann, chief executive officer of IIA Germany and head of corporate audit and security at Deutsche Post, “and to explore important trends that are currently having an impact on the profession of internal auditing. We are very happy to have achieved that goal.”

Editorial

Executives across Europe must be feeling fed-up right now – particularly if they work in the financial services sector. After being the apple in every government’s eye for the last twenty years, their fortunes have suddenly turned sour. From being held in high esteem as wealth creators, they are suddenly regarded as a bunch of irresponsible, gambling fools.

The G20 summit, representing the world’s largest economies, met in Pittsburgh in the US this September to discuss what could be done to curb excessive pay – among other pressing issues, such as climate change and global regulation. The French and German delegates argued for strict caps on bonuses – Great Britain and the US prevaricated. Tough words were spoken. But it became clear, as Axel Weber, a European Central Bank Governing Council member remarked, that any changes to



Arthur Piper – Editor

the global financial structure is likely to be a long time coming.

In the meantime, governments in Europe have been promising their own reforms. Dutch executives, for example, have seen their bonuses capped at 100% of salary, while their severance packages are now limited to one-year’s pay. In France, some executives have been forced to defer the existing bonus that can be guaranteed has been slashed. Bankers in the UK could see the regulators effectively cancel their remuneration agreements

if they have been awarded bonuses that would “cause instability” to the financial system. Some businesses are responding to the crisis voluntarily. Commerzbank, for example, has said that it intends to adopt a new bonus structure for its executives. Others may follow suit.

If you’re not feeling sorry executives, that’s fine, but there is a serious point behind the complaints that they are making. That is because one of the major causes of the credit crunch was not just executive pay, although that played a part, but a failure of risk management. Pay was a symptom of the crisis, not its cause. Banks failed to look at the bigger picture outside of their own organizations. Governments are in danger of doing the same. Punishing executives in the short term may feel good, but if it fails to deal with the longer-term risks posed by a hugely complex global financial system, it is not the complete answer.

Advocacy corner by Roland De Meulder

The European Commission made a commitment to produce a report on corporate governance practices in financial institutions, according to its communication *Driving European recovery*, which was published on 4 March 2009. As part of this exercise, the Commission organised a Seminar in Brussels on 12 October 2009, which is available to listen to via the link below.

The seminar, which was attended by ECIIA representatives, brought together expert panelists from different member states to discuss important issues, such as the role and competences of boards of directors, governance matters on internal control and risk management, shareholder control, supervision and external audit. David Wright, deputy director general DG Internal Market and Services chaired the seminar.

Readers of this column would have been most interested in how

the seminar dealt with the topic of the contribution of internal auditing to effective governance and risk management frameworks. Richard Barfield, a director in the risk and capital advisory services team at the accounting firm PWC's UK Financial Services practice, emphasised the "three lines of

"The responsibility for assessing, controlling and mitigating risks does not rest with the risk management function"

defence" framework, as a way of thinking about what organizations might be doing to monitor risks and associated controls. He argued that the fundamental roles that boards and risk management frameworks have in organisations is to ensure that regulatory risk appetite – the appetite for avoiding downside risks – plays a very strong part in any discussion around risk management and

the ways to enforce risk culture throughout organisations.

Barfield saw business, or front-line, management as a first line of defence. He stated that the responsibility for assessing, controlling and mitigating risks does not rest with the risk management function. It resides with this front line management, which flows through to executive management, and from there to the board.

According to Barfield, the role of the risk management function should be to provide a strong challenge to the front line in terms of how risks are assessed, how risk appetite is articulated and expressed, and how risk has an influence on strategy selection and making decisions. He further claimed that for this second line of defence to work effectively,

it requires many characteristics similar to those required for non-executive directors. That includes risk management having the ability to provide strong challenge and create constructive tension, at the same time as operating effectively as a team within the overall management structure of the organization. In Barfield's opinion, the latter may present a real challenge for each risk management function, as may possessing the right expertise and skills to effectively play this role. Finally, he stressed the importance for the risk management function to adopt a holistic, integrated view of risk, rather than an individual, silo approach through which dependencies between risk types may not be fully understood.

Finally, the third line of defence is internal auditing. According to Barfield, this is all about ensuring that the first two lines are doing what they are supposed to do and that they are working as the governance, management and policy frameworks require them

to. He further stated that the same challenge for competency and expertise, applicable to the second line, exists for internal auditing in terms of providing value added assurance services on an organisation's risk management systems.

The ECIIA supports the three lines of defence framework and appreciates the fact that it is now formally discussed at the European Commission level as a mechanism for ensuring effective governance and risk management in Europe. ECIIA also believes that this framework should not be limited to the financial services industry but may equally apply to other sectors.

Links: For the text of *Driving European recovery*: <http://bit.ly/7Hsg93>

A recording of the entire seminar is available: <http://bit.ly/60Kva4>

For an outline of the three lines of defence framework: [Click Here](#).

Send your advocacy stories to Arthur@sdw.co.uk

Insurance regulation must speed up

Authorities in Europe should hurry up and agree on a new European supervisory framework for the insurance sector the European Central Bank President Jean-Claude Trichet told an industry conference in Frankfurt in November.

“The European Commission’s proposals to enhance the EU’s financial architecture are aimed in precisely the right direction,” he said. “I strongly encourage a political agreement to be reached by the end of the year.”

He said that the European Systemic Risk Board and the European Supervisory Authorities would provide a decisive contribution to financial stability in the EU. He described the proposed setup as a “quantum leap” in the European Union’s supervisory architecture.

In particular, he said, they would help establish a single European rulebook, enhance the efficiency of supervisory colleagues, help coordination in times of stress, help to translate risk warnings into

action, and assess systemic risks.

He also said that the insurance industry must act to ensure that it has sufficient capital buffers. While he said that there were no current major solvency concerns, he said that insurers should take action on the issue soon. “There is no room for complacency in this environment,” he said. “Insurers will have to be mindful of having sufficient capital buffers in place”

He said that recent improvements in the results reported by insurers should not be a sign that things were getting back to normal. “There are reasons to be cautious about the durability of the recent recovery of insurers’ profitability,” he said. “The supportive environment for investment income is unlikely to continue once market conditions begin to normalize.”

“At the same time, underwriting income is subject to the existing downside risks in the overall macroeconomic outlook,” he added.

Internal audit reaches deeper

Lord Smith of Kelvin, a leading figure in corporate governance reform in the UK, has said that internal audit is the key to effective governance. Speaking at a recent forum of non-executive directors, he said that only internal auditors can penetrate deep into businesses to identify errors and weak procedures at all levels.

He also said that non-executives had to play a bigger

part in the boardroom, and had to have the personal qualities that would make that possible. “The personal ability to challenge strong boards and chairman, particularly over high-risk decisions, is a quality that should be valued as highly as any other,” he said. “It should be a key factor when it comes to appointing non-executive directors.”

Lord Smith said that non-executives needed an effective induction, but said that they should do their own

due diligence before joining an organisation – including site visits, if necessary.



Lord Smith of Kelvin

Fraud grows

Fraud is a growing problem across Europe, according to a recent survey by the accountancy firm PricewaterhouseCoopers and the Paris-based business school INSEAD.

Four out of ten respondents to the survey said that they had suffered from economic crime

in the past twelve months, with almost 10% of crimes costing them over €3m. The most common types of crime were theft, financial statement fraud and money laundering.

“Organisations need to ensure that when a fraud or economic crime occurs, they have enforceable and enforced policy where people do not appear to get away

with it,” said PwC forensic expert Billy O’Riordan. He said that appropriate forensic investigations should be carried out.

About half of serious crimes were detected by risk management systems and internal audit, with one quarter of fraud detected through tip-offs.

Making the most of uncertainty

The ongoing financial crisis has thrown up a unique opportunity for internal auditors, as Claude Cargou tells Arthur Piper

When Claude Cargou, the ECIIA's president, talks about internal auditing, it is with a sense of urgency. He believes that the current uncertainty about the future of corporate governance has created a unique opportunity for the ECIIA to get its voice heard.

"In two year's time new directives will be published in

Europe on corporate governance, so it is a vital time to put forward the case for internal auditing," he says. "We need to take advantage of this uncertainty."

Cargou is disappointed that the current set of directives issued by the European Council fail to mention internal auditing, or only mention it in passing. He sees this as part of the body's reluctance to get involved with matters concerning how companies decide to organise themselves internally. At present, most directives steer clear of this subject and, as a result, pass over the role that professional internal audit can play in ensuring good corporate governance.

"External audit's role is well-defined in the relevant directives," he says. "But there is an equal

need to clarify and define the role that internal audit plays within organisations. And the point of doing that, is so that internal auditors are put in a better position to do their jobs well."

He hopes that the ECIIA can persuade those responsible for drafting legislation to see the benefits internal audit can provide to organisations of all shapes and sizes. The ECIIA's overarching goal is to make sure that internal audit is mentioned in relevant European Council Directives as a cornerstone of effective governance.

Strengths

Cargou believes that internal auditors have a lot to offer and, as a profession, derive strength from having a well-defined set of *International Standards* and a »



» *Code of Ethics* that every member has to adhere to. “The fact that a single set of professional practices is followed by every internal auditor in the world is a great strength,” he says. “Having worked in IT, where it does not exist, I appreciate just how important that is.” He believes that the ECIIA needs to leverage that strength and use it to demonstrate how internal audit adds real value.

He worries that if the ECIIA does not act now, those in Brussels will define the role of risk management without taking internal audit into account.

Not that the ECIIA has been sitting idle. As part of its mission to be “the consolidated voice for the profession of internal auditing in a widely defined Europe,” it has been working towards achieving its four stated goals: carrying out advocacy work with

other organisations, working on enhancing professionalism, supporting and developing the 36 national institutes of internal audit that make up its members, and communicating its message more broadly.

Relationships

After an initial period of research and discussion with external professional bodies, the ECIIA is now working to build bridges with the five that it has identified as potentially its most important allies. Those bodies comprise ECODA, the European institute of directors; FERMA, the Federation of European Risk Management Associations; EUROSAI, the European Organisation of Supreme Audit Institutions; European Issuers, which represents the interests of companies listed in Europe; and, FEE, the »

“The ECIIA’s mission is to be the consolidated voice for the profession of internal auditing in a widely defined Europe”



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Biography

Claude Cargou is currently the ECIIA's president and former chairman of the French IIA – IFACI. He has 37 years experience as a senior executive in management positions across in a wide range of roles and sectors, including global insurance, banking, consulting and IT companies.

He is currently chief executive officer of Governis, a consulting firm he set up in October 2007. He sits on the boards of AXA Insurance in both Spain and Portugal – where he also sits as audit committee chair. He is also general secretary of Ricol-Lasteyrie, a financial services firm. He was previously executive vice president and group chief audit executive at AXA and before that information officer at companies such as Credit de Nord and Banque National de Paris.

» accountancy bodies' representative in Europe.

Exploring the potential of these relationships should give more focus and depth to the ECIIA's advocacy efforts, says Cargou. In addition, the ECIIA hopes to develop a set of issues about which the bodies can speak in a unified voice to give them a greater say in European affairs.

“Working in the Brussels environment is not that easy,” he says. “It takes time to develop contacts in the European councils and government.” The recent elections in Brussels, for example, have led to changes in personnel, so building relationships is an ongoing project and working in tandem with other professional bodies will give the ECIIA more clout.

Communications

The ECIIA is also enhancing the way it communicates its message to both members and the business community. The website is being refreshed in a way that will make it more attractive and easy to use, as well as making connections with other professional bodies possible.

European internal audit briefing is to

be published on a regular, quarterly basis and distributed more widely.

But the ECIIA can only do so much on its own and is dependent on the ongoing support of its members – the national institutes of internal auditing. In particular, Cargou says that it is essential for the national institutes across Europe to be

their activities to the ECIIA.

The ECIIA aims to give more support to the developing national institutes of internal auditing across Europe. While the ECIIA does not have the financial resources to launch a major initiative in this area, it is drawing on its considerable depth of expertise and knowledge to help

“The fact that a single set of professional practices is followed by every internal auditor in the world is a great strength”

promoting and pursuing their own advocacy initiatives too.

That means continuing to develop stronger links between the ECIIA and those working at a more local level. “If someone is meeting with the head of the institute of directors in their country,” he says, “we need to know so that we can be present and influence the debate as it relates to Europe.” That entails the national institutes becoming more proactive in communicating

the newer institutes develop. It is currently working out its longer-term strategy in this area.

Cargou reflects that just a year in the post of president seems a very short time. His two main objectives are to foster better co-operation between the ECIIA's member institutes, and to work on the profile of internal audit in Europe. “I'd be very happy to see internal audit mentioned in an EU directive before my term as president is over,” he says. ■

Time to think big



Internal audit did not cause the financial crisis, but events of the last 18 months will have an important affect on the European profession for years to come, as Neil Baker reports from the ECIIA's annual conference in Rome

There have been many official reports on the causes of the financial crisis and none of them point the finger of blame at the internal audit profession. This ought to be good news; it

is the profession's claim to be integral to good corporate governance just empty rhetoric? Rod Winters, chairman of the IIA's global board, summed up the problem in his opening comments to the ECIIA's annual

“We need to be a trusted adviser, at the table providing insights, not reports afterwards”

suggests that internal audit did a good job, or the best it could.

But there is another way of interpreting the lack of criticism: nobody is accusing internal audit of underperforming, because nobody expected internal audit to contribute very much in the first place. In which case,

conference in Rome this October. “My fear is that if we are a true cornerstone of good governance, and we have the kind of crisis we have experienced during the last year, it is something we should be held accountable for,” said Winters. “It’s perverse, but I’m kind of disappointed.” »

» Perhaps some organisations – especially in the financial sector – were slow to recognise the value of a professional internal audit function. They did not listen closely enough to what their risk

to be a trusted adviser, at the table providing insights, not reports afterwards,” he said.

But at the same time these stakeholders are also cutting or capping internal audit budgets.

“We have gone through a new paradigm, what I call the life or death paradigm”

and control specialists were telling them. But one thing is clear, from listening to those internal auditors gathered in Rome: attitudes are changing rapidly.

“The questions that audit committees are asking are changing and audit committees themselves are becoming more mature,” said Winters. Audit committees, and senior management also, are asking their internal audit functions to assure them that there will be “no surprises”, said Winters.

Their relationships with internal are changing too, he added. They want an ongoing engagement with the audit function, not just an occasional meeting and report. “We need

Chief internal auditors face the challenge of delivering more with less. To respond, internal auditors need to reconsider how they work, said Winters: “We need to look in the mirror and be honest with ourselves. Are we really as productive as we can be?”

Improvement

This requires a willingness to rethink everything. Farid Aractingi, chief audit officer at Renault, the French car business, and a board member of IIA France, explained how the downturn had encouraged him to transform his internal audit function. “We have gone through a new paradigm, what I call the life or death paradigm,” he said.



Rod Winters

Aractingi has made changes in two main areas. He has introduced greater standardisation into his function’s audit methods and processes. It is now more flexible, both in how it plans and executes audits. He has also rethought how the function’s work is relevant to the company. His conclusion: Renault’s audit team adds value through its capacity to generate fresh insights by working across different parts of the business, something other functions could not do, said Aractingi.

There is another potential response to budget cuts: simply claim that the internal audit function is an indispensable governance tool. Aractingi advised against it. “We had to demonstrate a real solidarity with the company in terms of costs,” he said. “We are not untouchable, we are corporate citizens.”

The governance failings in the financial sector hold lessons for internal auditors in every organisation. Daniel Nelson, assistant director at the International Monetary »

» Fund's Office of Internal Audit, picked out some of the most important ones, using bailed-out insurance company AIG as an example.

The company's internal audit function did not have sufficient access to key parts of the business and there was a lack of clarity around roles and responsibilities relating to risk and control, he said. The lessons: internal must have the right mandate, its role should be clear and it must have an "escape valve" relationship with a non-executive director or independent board, said Nelson.

Regulation

Rising stakeholder expectations and budget constraints are not the only factors likely to change the way internal audit is performed across Europe. There is also the spectre of new regulation, the need for which was hotly debated at the conference.

Carmine di Noia, deputy director general at Assonime, the Italian business association, told delegates that further corporate governance regulation



Carmine de Noia

was not needed, at least not for general corporates.

"The governance problems that we have seen were related to financial institutions," he said. "In general, listed companies have been behaving and the rules were working, so be careful about talking about new rules."

And in any case, he argued, corporate governance practices across the European Union remain highly diverse. As part of its response to the crisis, the European Commission has revamped the supervisory committees that advise it

on financial industry issues, "but they are too big to make decisions and do not have enough power," he said.

However, Marcello Bianchi, chairman of an OECD steering group on corporate governance, said new governance rules might be needed. "Most of the structural weaknesses that we have seen are common to large and complex listed companies, so there are lessons to learn," he told delegates. "It is not the principles that are a problem; we had implementation gaps that caused failure."

The answer: "We need better systems for peer review and dialogue to monitor the implementation of existing principles and to identify any emerging problems," he said. "We failed to identify implementation gaps in the past; we want to prevent future failures."

Key areas of failure were remuneration practices, effective risk management, the quality of board practices and the exercise of shareholder rights, said Bianchi. The OECD wanted to develop guidance for better implementation of its rules on these issues. "What we need are not more rules, but better rules and better implementation of existing rules," he said, adding: "More effective disclosure and enforcement are the most effective tools for policymakers."

However, like di Noia, Bianchi warned about the dangers of writing new governance rules aimed at financial firms and applying them to general corporates.

CEO view

A "one size fits all approach" would create problems within »



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Corrado Passera

» sectors, not just across them, argued Corrado Passera, managing director and chief executive officer of Intesa Sanpaolo. He warned regulators and policymakers to create any new rules with caution because not all financial firms are the same.

“We might end up with solutions that are not the right ones for any of the segments in our industry,” he said. “We could simply have an easier to use tool for regulators but not a way to manage the different sectors of a very important industry.”

Passera argued that unnecessary regulation could block innovation or create incentives for regulatory competition. But he did believe that some regulatory change is needed. He wanted better harmonisation of regulation across the European Union, arguing that one rule agreed at a European level still becomes 27 different rules when implemented by national governments.

And he called for the introduction of “some very important rules that were missing: not volumes and volumes of

detailed rules, but some very basic rules.” Leverage, for example, “had been allowed to go to the moon,” he argued, adding it was obvious that the

corporates, had tried to manage this complexity by creating a greater number of specialised risk and compliance functions, said Passera. But that was the wrong

“Those that were the most arrogant in terms of ‘I will do everything, everywhere’ are the ones that have folded”

funding strategy deployed by a bank such as the UK’s Northern Rock would lead to disaster.

Regulation aside, Passera argued that attitudes in the financial industry needed to change. The crisis had shown that markets do not always self-correct and that size and diversification were not virtues in themselves. “Those that were the most arrogant in terms of ‘I will do everything, everywhere’ are the ones that have folded before others that were more focused,” he said. “The cost of complexity that comes with growing size and growing diversification at a certain point makes companies weaker, not stronger.”

Financial firms, and general

response. “If control functions become too specialised you can miss the bigger picture,” he said, “And if you subdivide too much between those that manage the business and those that control, you can end up with some people who want to say ‘no’ to everything and some who want to say ‘yes.’”

Passera told delegates that was a “politically incorrect” view to hold just now, but it was one that captured the tone of the conference. As Winters argued at the beginning, the challenge for internal auditors is to make sure that, despite budget cuts or regulatory changes, they provide that independent, “big picture” view. It’s something organisations need now more than ever. ■

Our mission

- » To be the consolidated voice for the profession of internal auditing in a widely defined Europe by dealing with the European Union, its Parliament and Commission and any other European or global institutions of influence.
- » To represent and develop the internal auditing profession throughout the wider geographic area of Europe and the Mediterranean basin.
- » To represent the European internal auditing profession on the global stage in tandem – and in consultation – with IIA Inc.
- » To promote the profession in economically emerging countries, as appropriate, within the wider geographic area of Europe and the Mediterranean basin.

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