

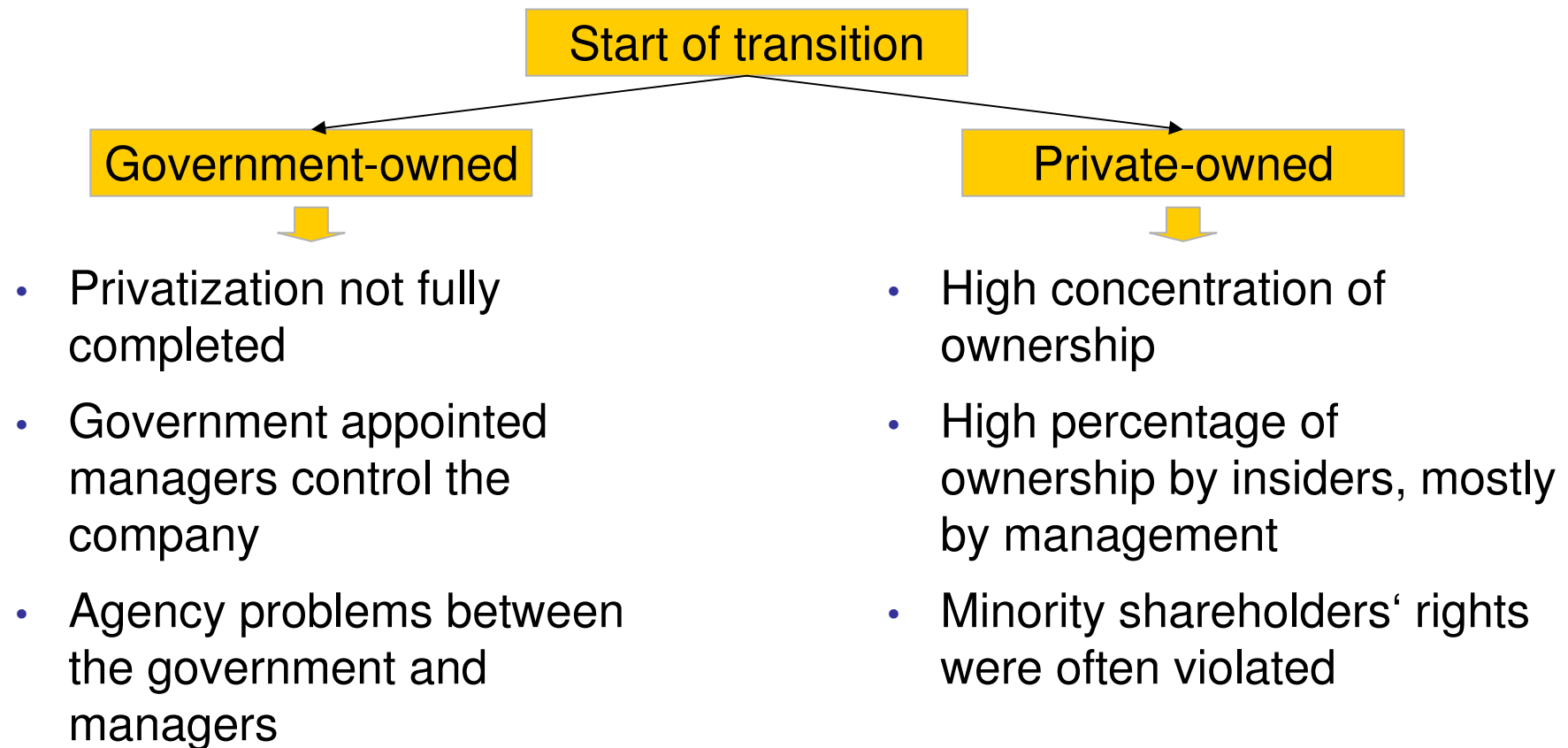
# The evolution of Internal Audit during the transition of Eastern Europe from the Planned to the Market Economy

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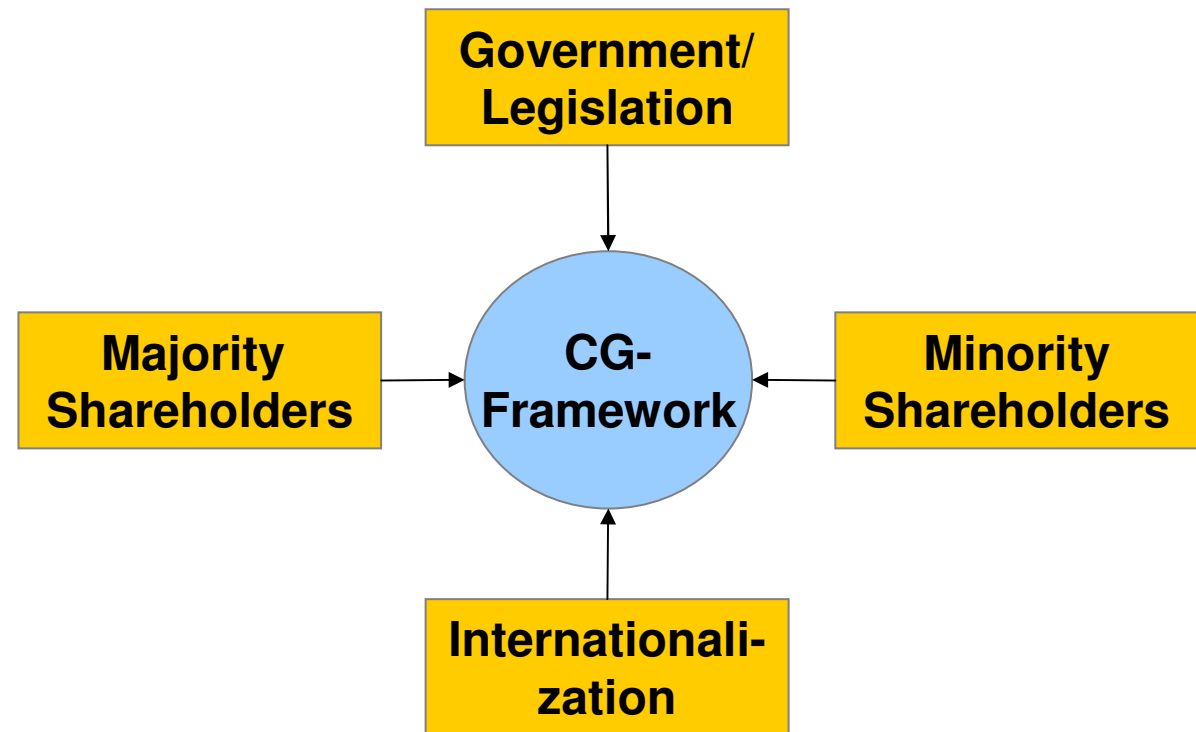
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- ◆ Corporate Governance-Models in Eastern Europe
- ◆ The Role of Internal Audit
- ◆ Chief Audit Executive-Challenges
- ◆ Ernst & Young-Survey  
„Risk Management in Emerging Markets“
- ◆ How Ernst & Young can help

- ◆ At the start of the transition to a Market Economy, governments had to decide on the extent of privatization:

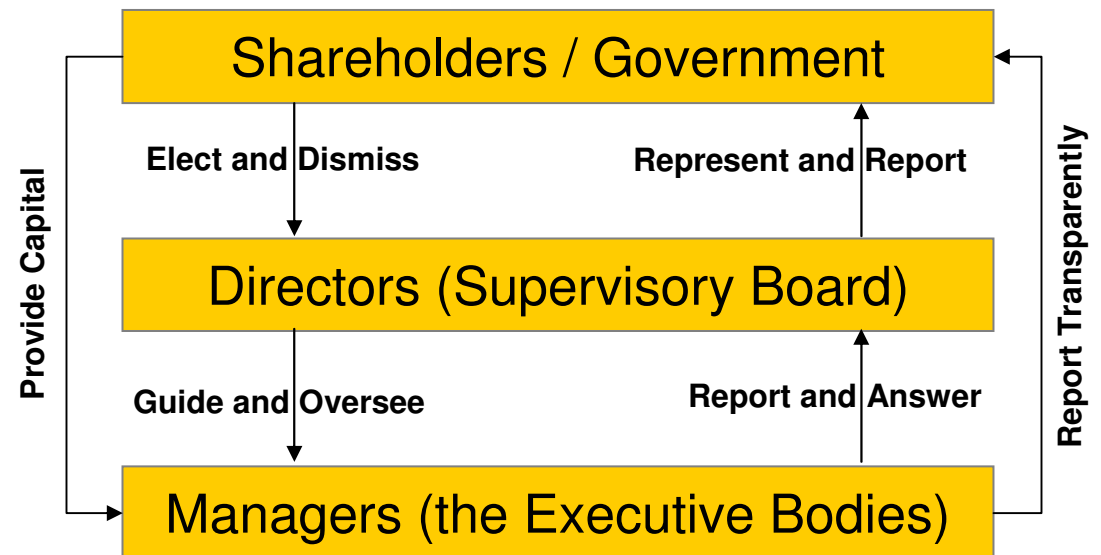


- ◆ The starting point for transition to a market economy for the countries in Eastern Europe was different
- ◆ However CG-Systems in these countries are converging
- ◆ Four factors drive the development of the CG-Framework in Eastern Europe



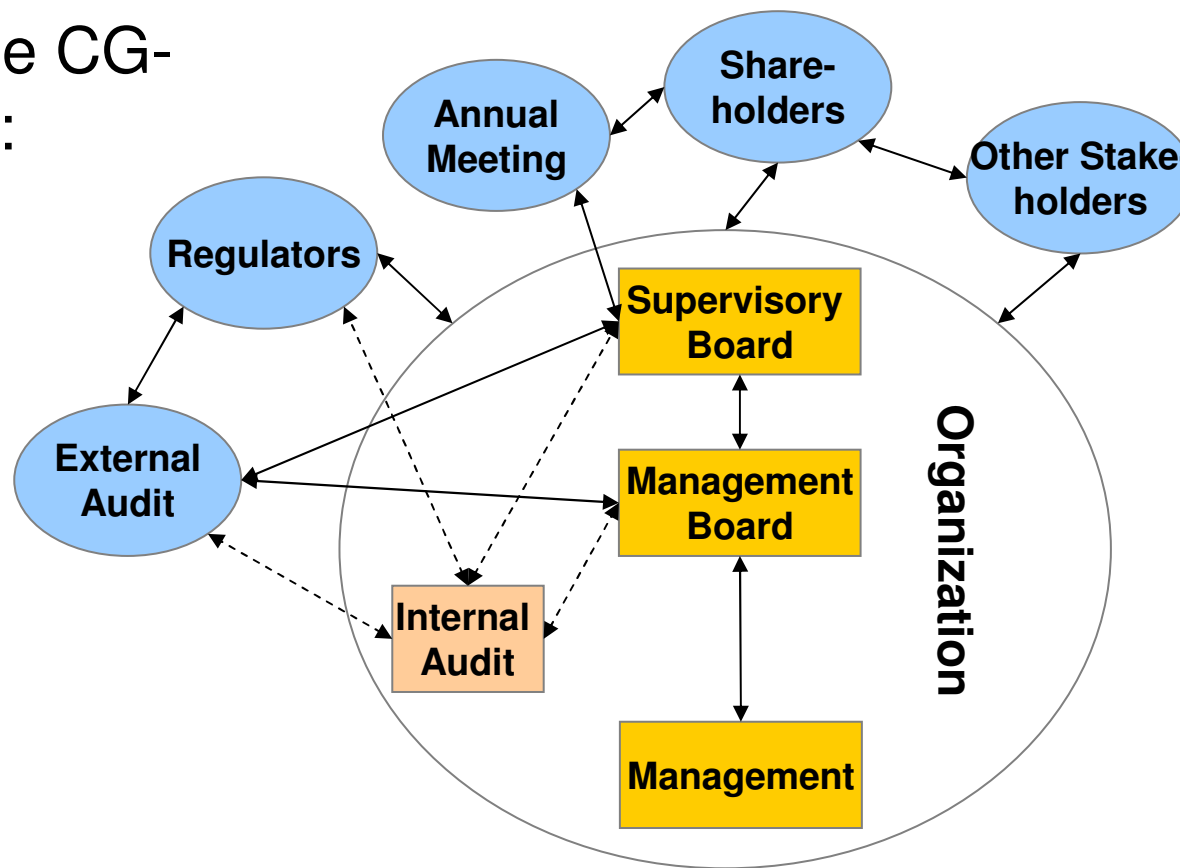
◆ The transition resulted in the following CG-Framework:

- Management was often a majority shareholder in privatized companies
- Management controlled the company in government owned companies
- Ineffective oversight by the Supervisory Board
- Reporting was not transparent
- Internal Audit's role was to police the business



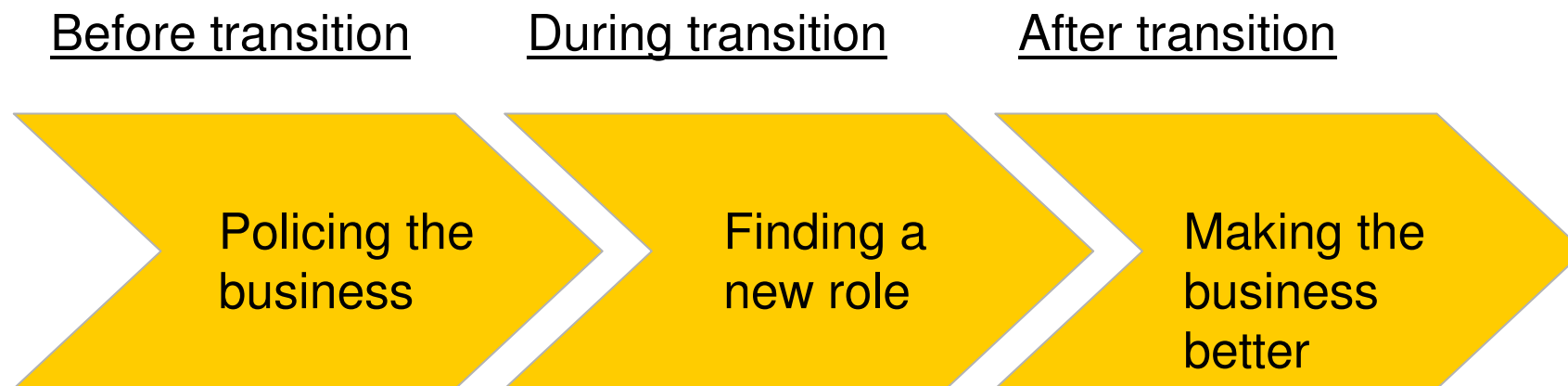
◆ Internal Audit's role in the CG-Framework is as follows:

- In some cases Internal Audit monitors the performance of the Management Board on behalf of the Supervisory Board/ Audit Committee
- The Management Board uses Internal Audit to monitor lower level management



Source: Corporate Governance: The Impact on the Role, Position and Scope of Services of the Internal Audit Function, Paape, L.. 2-008

- ◆ Internal Audit's role within the CG-Framework has changed over time when the transition was in progress
- ◆ However Internal Audit takes on different roles within individual companies depending on the ownership structure and perceived added value of Internal Audit
- ◆ In general the changing role of Internal Audit during transition was as follows:





Policing the  
business

- ◆ Internal Audit's Role consisted of:
  - Verification of compliance with internal regulations
  - Verification of the accurate reporting of financial figures
- ◆ In some cases the Government Audit Offices had the power to fine or punish auditees
- ◆ No emphasis on:
  - Efficiency of the use of resources
  - Detection and prevention of fraud



Finding a  
new role

- ◆ The government lead the way as government regulation became more important:
  - The European Union requested the new member states to implement an Internal Audit function in order to qualify for subsidies
  - Some Central and Eastern European Governments forced the mandatory formation of an Internal Audit function
  - Commercial companies were slow to follow-up as the Board of Directors and Executive Management did not recognize the added value of an Internal Audit function

Making the  
business  
better

- ◆ Leading companies are increasingly focusing on good CG to access international Capital Markets either through bond offerings or via an IPO:
  - The increased focus on CG also increased the need for an Internal Audit function
  - The Board of Directors and Executive Management use Internal Audit to monitor the effectiveness and efficiency of the organization
  - However the Chief Audit Executive (CAE) continues to face challenges

◆ The main challenges that are faced by the CAE are:

- Explaining the difference between what is Internal Audit and what is Internal Control
- Convincing Executive Management and the Board of Directors on the added value of the Internal Audit Function



- The Board of Directors and Executive Management are not yet familiar with Internal Audit practices and mostly see Internal Audit as a cost center

◆ The main challenges that are faced by the CAE are:

- Transforming the Internal Audit function from implementing and executing Internal Controls to monitoring and advising on companies Internal Control framework



- In some companies which are in majority owned by management, management still violates minority shareholder rights

- ◆ The main challenges that are faced by the CAE are:

- Where management is the majority shareholder the CAE could be caught between management and the Audit Committee



- Not in all companies management takes responsibility for the implementation and execution of Internal Controls



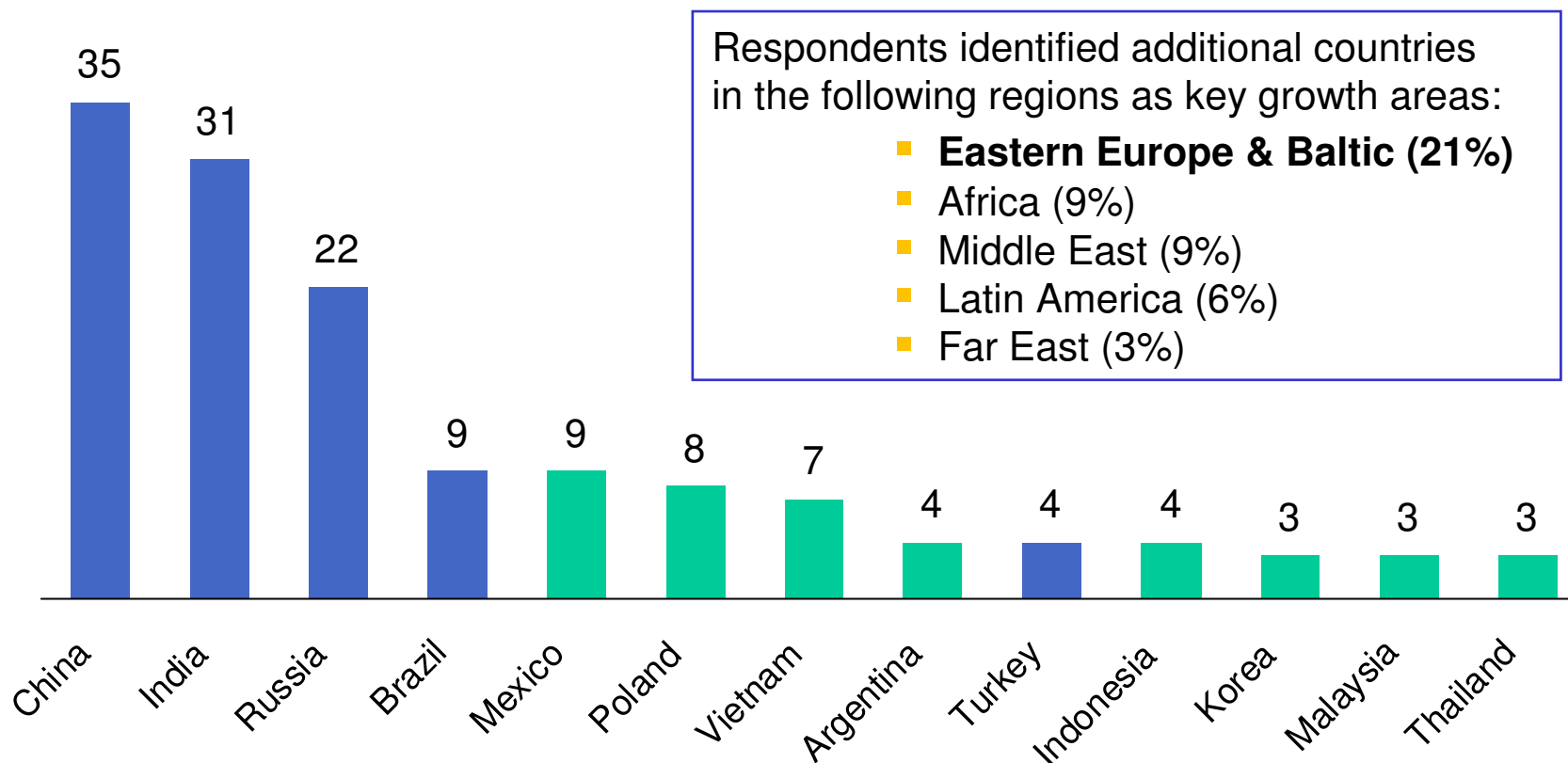
**Additional challenges when the entity in Eastern Europe is subsidiary of a Developed Market Company**

- ◆ Title: „Risk Management in Emerging Markets“
- ◆ Survey objectives:
  - Explore how companies from developed markets are managing risks in emerging markets, including some Internal Audit-aspects
  - Identify best or leading practice and compare the view from both developed and emerging market operations
- ◆ We surveyed
  - 435 multinational Developed Market Companies (DMC) with significant links to emerging markets
  - 501 Emerging Market Companies (EMC) in Brazil, China, India, Russia and Turkey

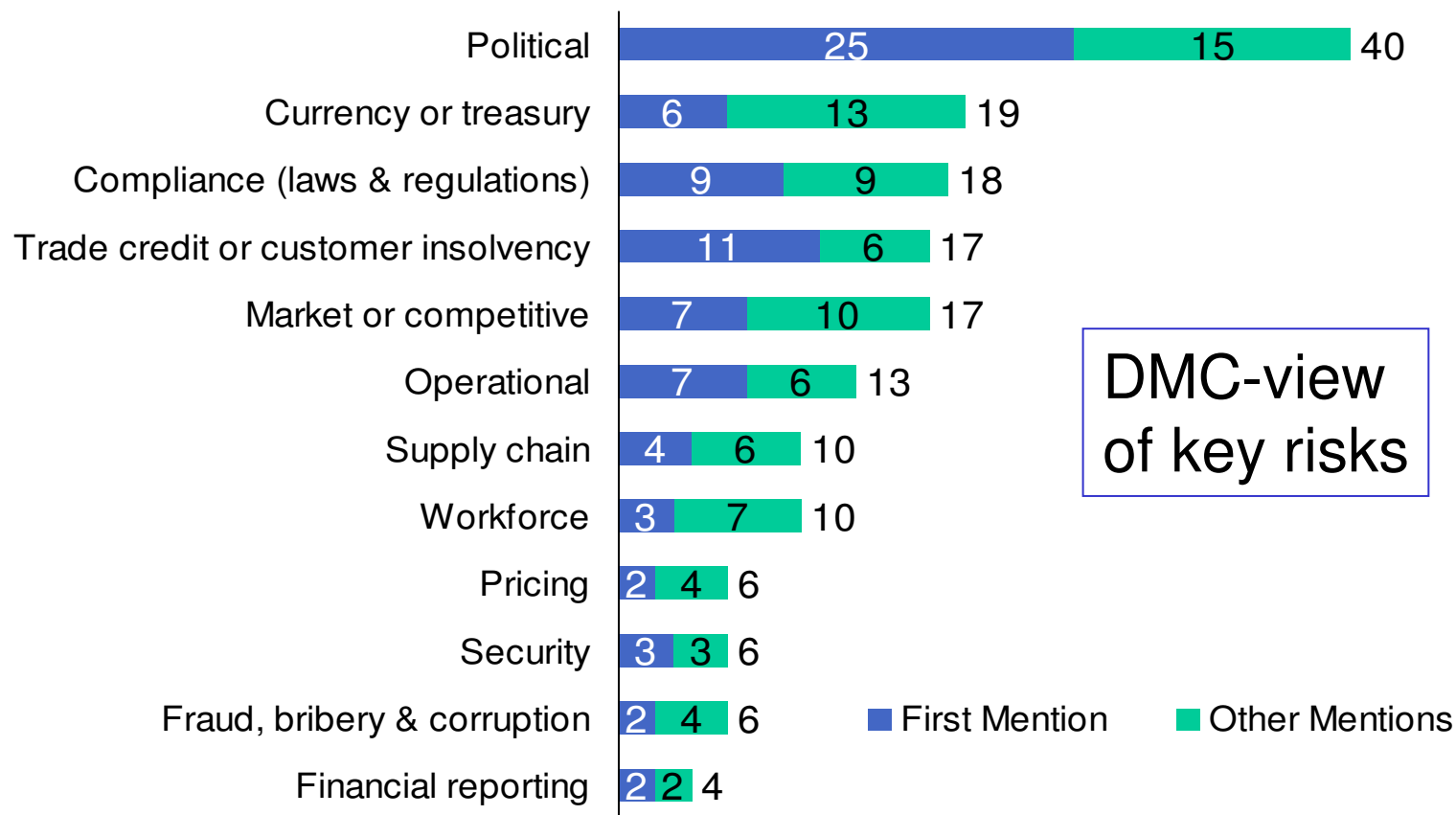
Geography of participants

| Emerging markets | Total      |
|------------------|------------|
| Brazil           | 121        |
| India            | 120        |
| China            | 120        |
| <b>Russia</b>    | <b>100</b> |
| Turkey           | 40         |
| <b>Total</b>     | <b>501</b> |

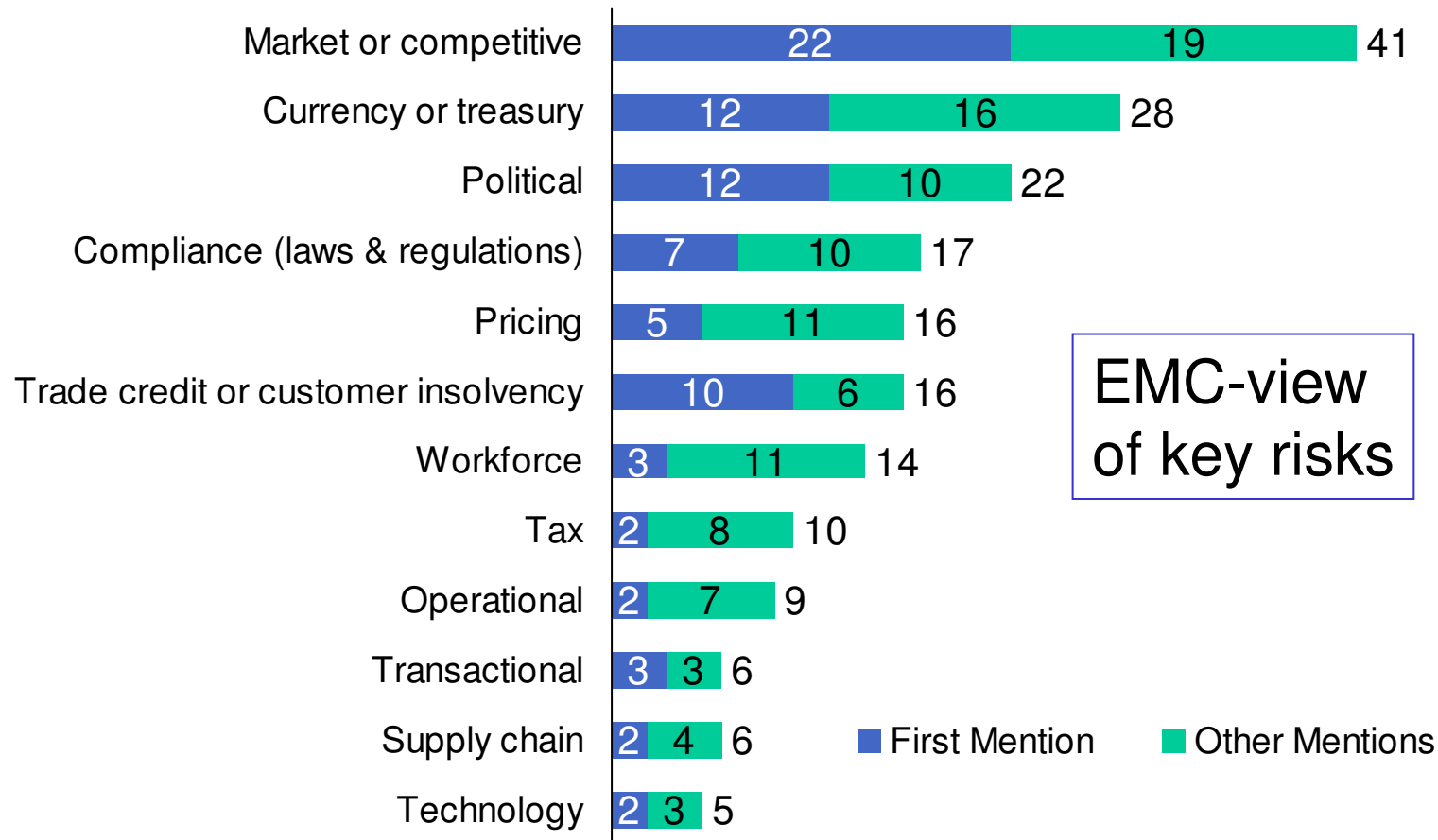
| Developed markets | Total      |
|-------------------|------------|
| US                | 75         |
| France            | 50         |
| Italy             | 50         |
| Spain             | 37         |
| UK                | 36         |
| Canada            | 35         |
| Singapore         | 35         |
| Sweden            | 35         |
| Germany           | 31         |
| Switzerland       | 26         |
| Japan             | 19         |
| Other countries   | 6          |
| <b>Total</b>      | <b>435</b> |



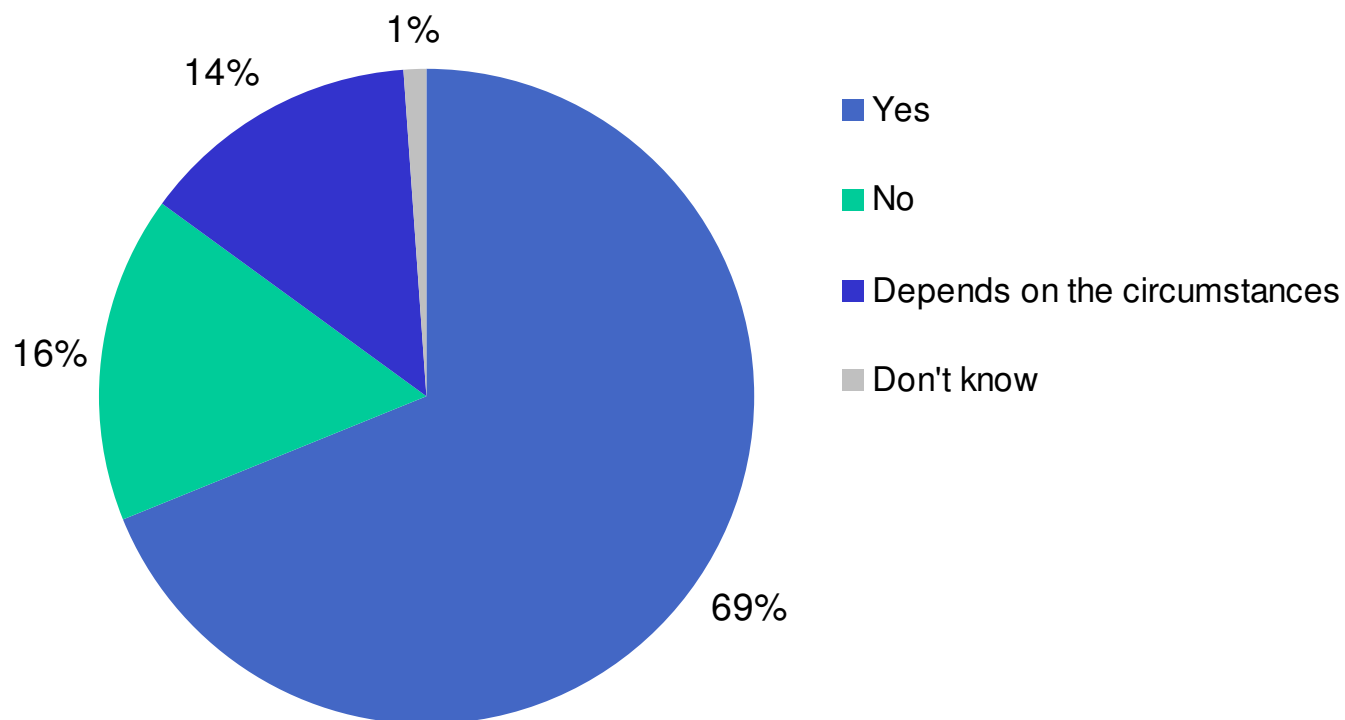
Question: Name three emerging market countries which you see becoming the next key growth areas for your organization? Base: DMC (435)



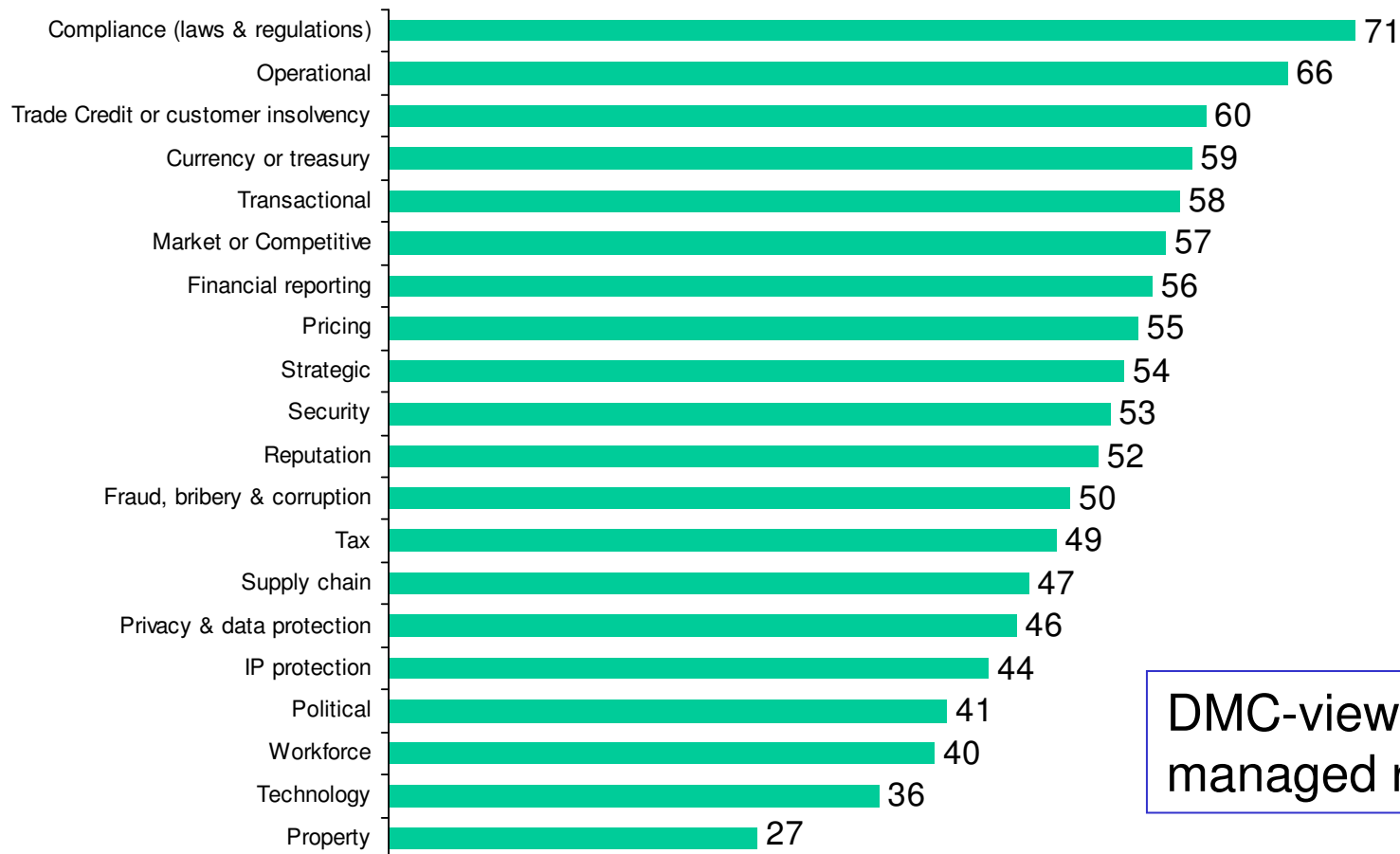
Question: What is the single most important risk facing your organization in relation to its involvement in the emerging market? Base: DMC-relation with emerging markets (557)



Question: What is the single most important risk facing your organization in relation to its involvement in the emerging market? Base: EMC-respondents (501)



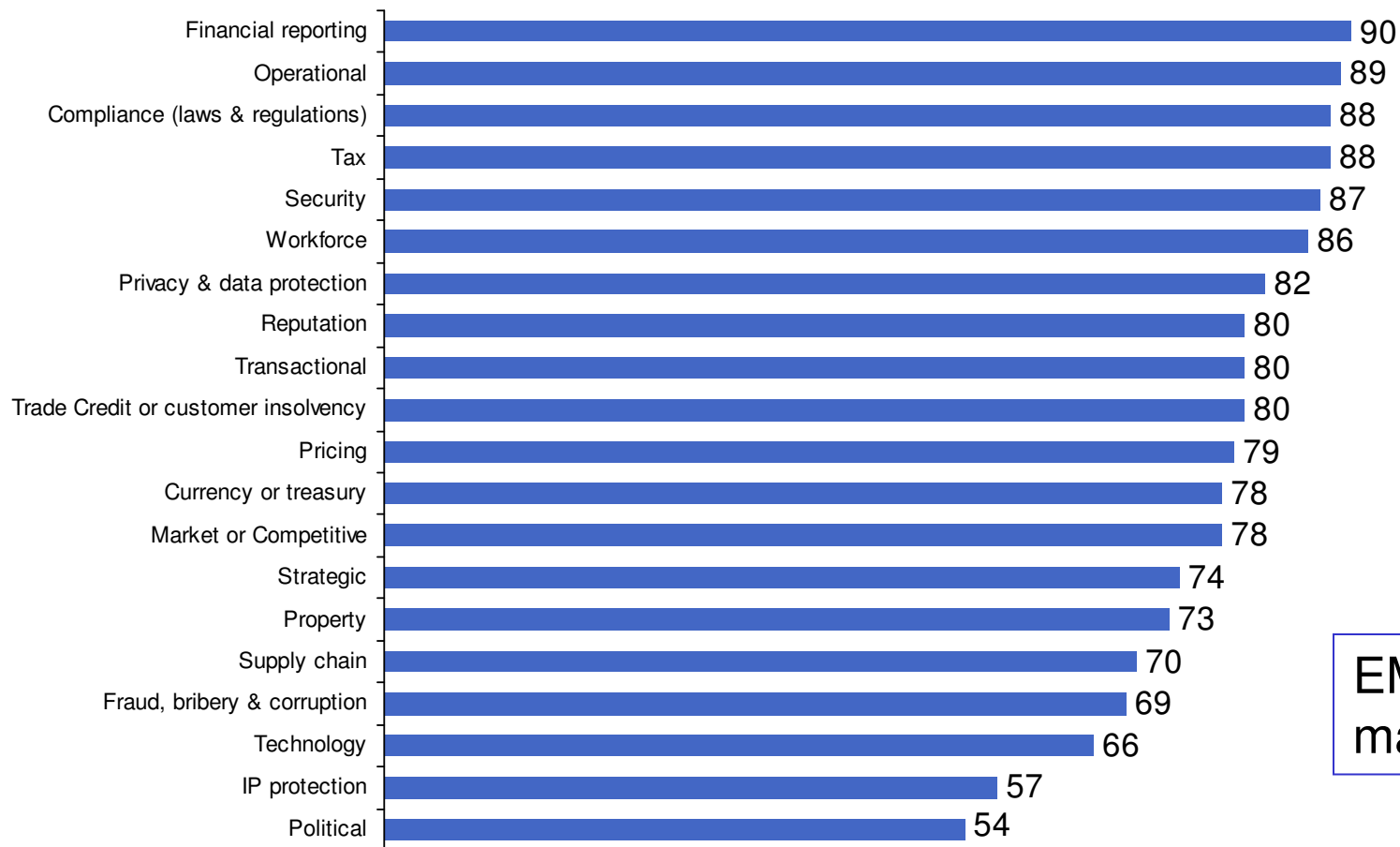
Question: Does your organization conduct a formal risk assessment when considering whether to become involved in a new emerging market? Base: DMC (435)



DMC-view of managed risks

**Question:** Does your organization actively manage the risk in the emerging market?

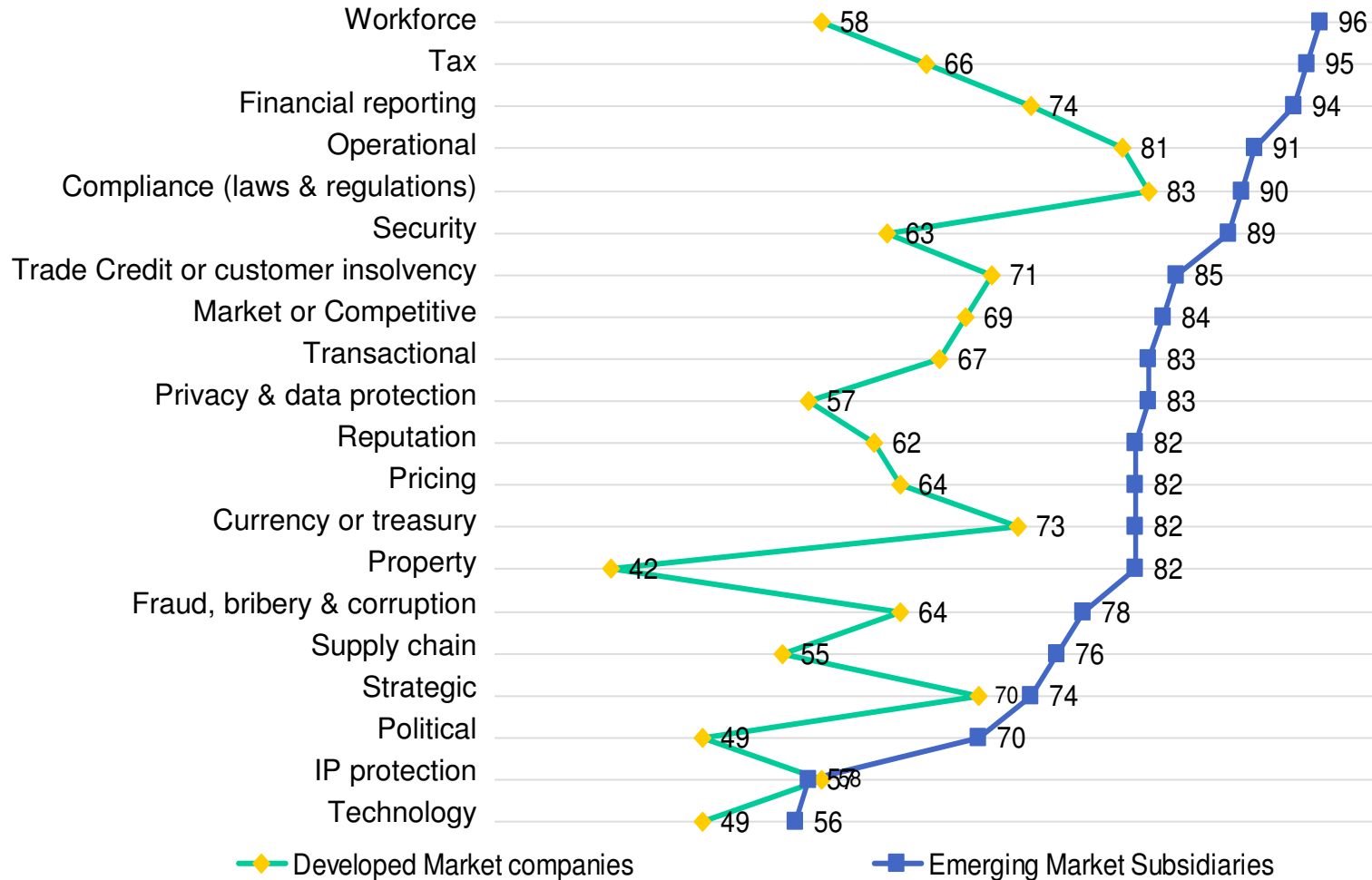
Base: DM-relation with emerging markets (557)



EMC-view of  
managed risks

**Question:** Does your organization actively manage specific risks in the emerging market?  
Base: EMC (501)

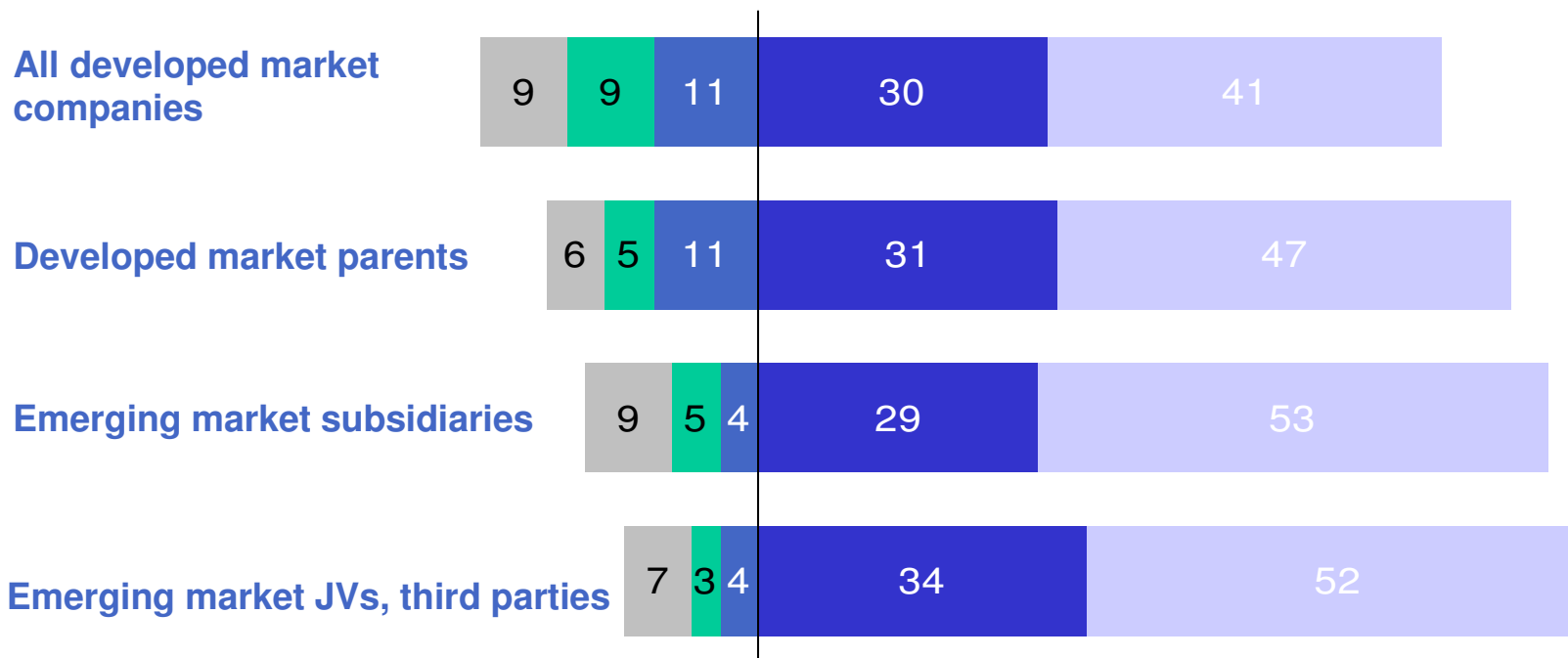
# Ernst & Young-Survey



**Question:** Does your organization actively manage specific risks in the emerging market?

Base: DM-headquarters (272), EM-subsubsidiaries (220)

■ Don't know ■ Strongly disagree ■ Slightly disagree ■ Slightly agree ■ Strongly agree



**Question:** Does the Internal Audit-function of your company in the emerging market conduct sufficient testing of Risk Management systems and processes? Base: All DMC (435), DM-parents (272), EM-subsidiaries (220), EM-joint ventures and -third parties (163)

## ◆ Key Findings

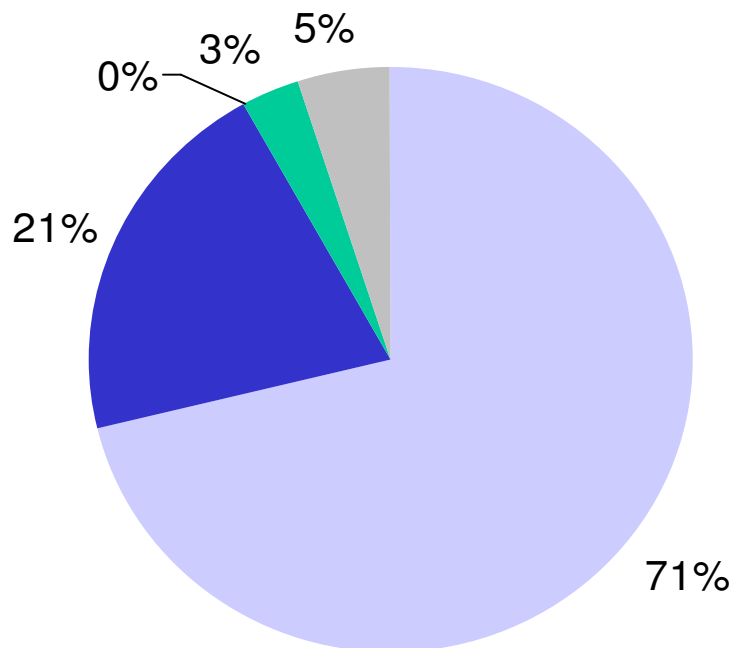
- Risk priorities differ by location
  - DMC see key risks as political, operational and supply chain risk
  - EMC focus on market, currency, workforce, pricing and tax risk
- Boards are focusing on risk in emerging markets
- But this does not translate to consistent risk strategies
- Perceptions differ on quality of risk communications

## ◆ Key Findings

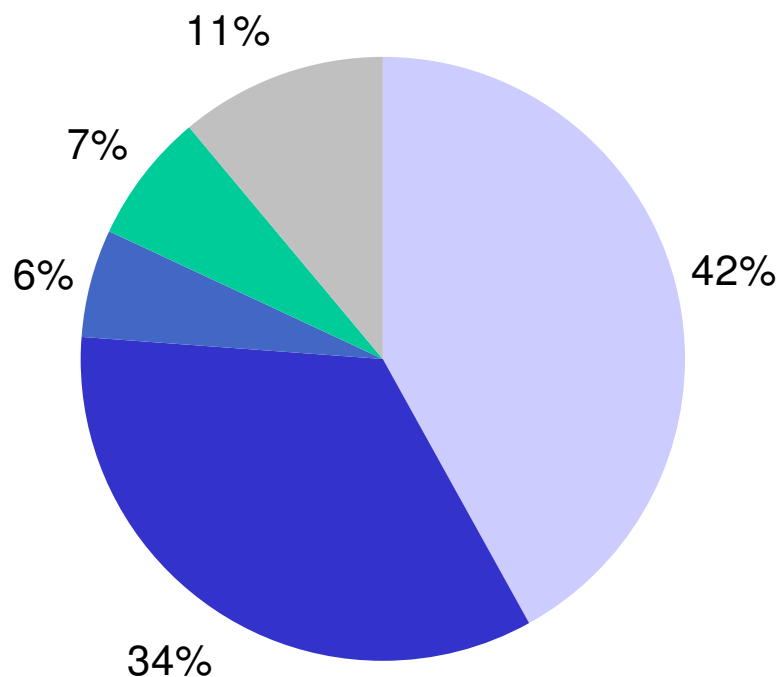
- There is leading practice. EM-subsiidiaries with a documented Risk Management strategy covering both the parent company and local subsidiary are also the most effective at overall Risk Management
- Risks are managed to a greater extent in the local market
- However responsibility is shared for most risks. Only a small number of risks are managed predominantly in local market
- Perceptions differ on the quality of Internal Audit. DMC have less confidence in the quality of Internal Audit of subsidiaries than the EM-subsiidiaries themselves

- ◆ “Aligned” companies have a documented Risk Management strategy that covers both the parent company and the local emerging market subsidiary. In addition they share some other characteristics:
  - They manage shared responsibility for risks at parent and subsidiary level
  - Parent companies have a greater focus on risk in emerging markets
  - A greater level of confidence that the flow of Risk Management information between emerging markets and the global HQ is adequate
  - A greater level of satisfaction among emerging market-based executives with the overall quality of Risk Management
  - A greater level of confidence in local and parent company Internal Audit-functions

**Aligned subsidiaries**



**Non-Aligned subsidiaries**



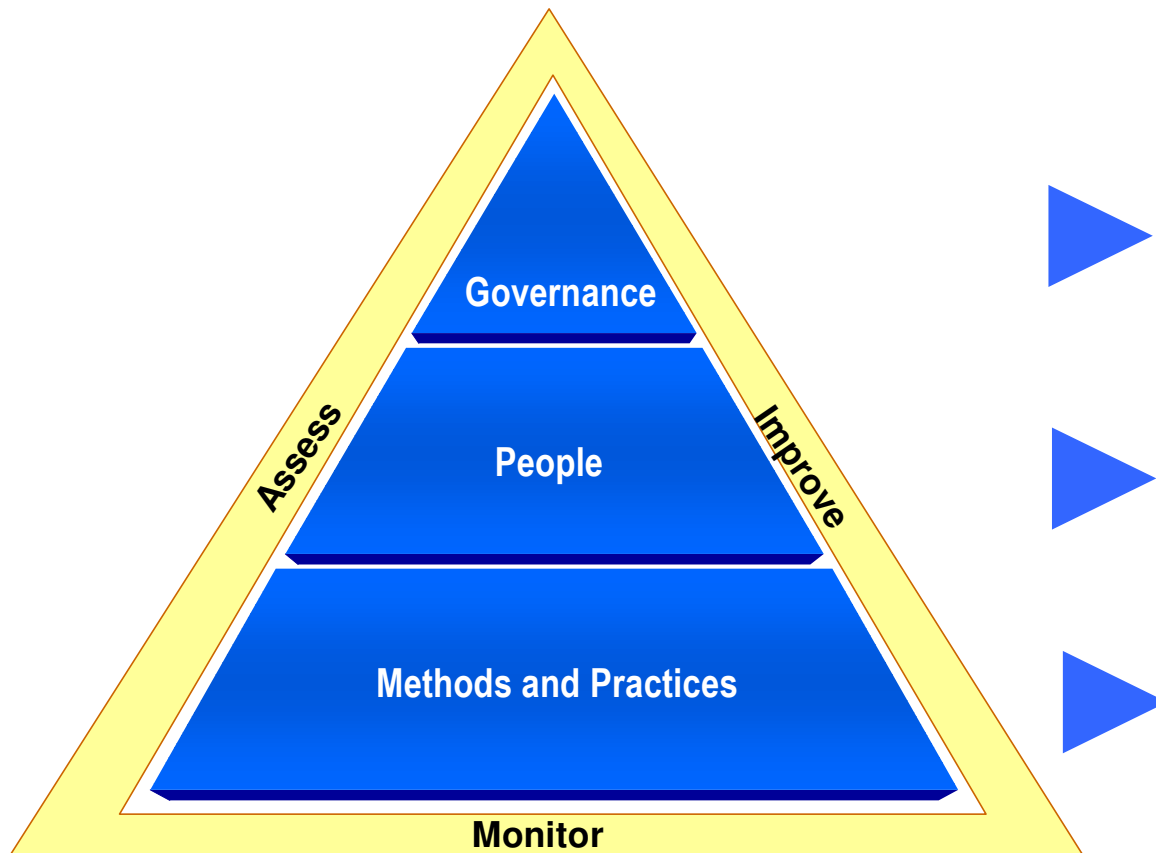
■ Strongly agree   
 ■ Slightly agree   
 ■ Slightly disagree   
 ■ Strongly disagree   
 ■ Don't know

**Question:** Do you agree that company's local Internal Audit-function sufficiently tests Risk Management systems? Base: Aligned subsidiaries (86), Non-Aligned subsidiaries (99)

◆ Internal Audit Services

- Setup of Internal Audit-function / -department
- Risk-oriented Internal Audit-planning
- Quality Assessment of Internal Audit
- Internal Audit-transformation (Restructuring)
- Performance of Internal Audits
  - Standard Audits
  - Special Audits
    - Evaluation of Internal Control System
    - Evaluation of Corporate Governance System
    - Risk, Control and Compliance Framework Assessment
- Expert-Support for selected Internal Audits (i.e. IT, construction, forensic)
- Training for internal auditors

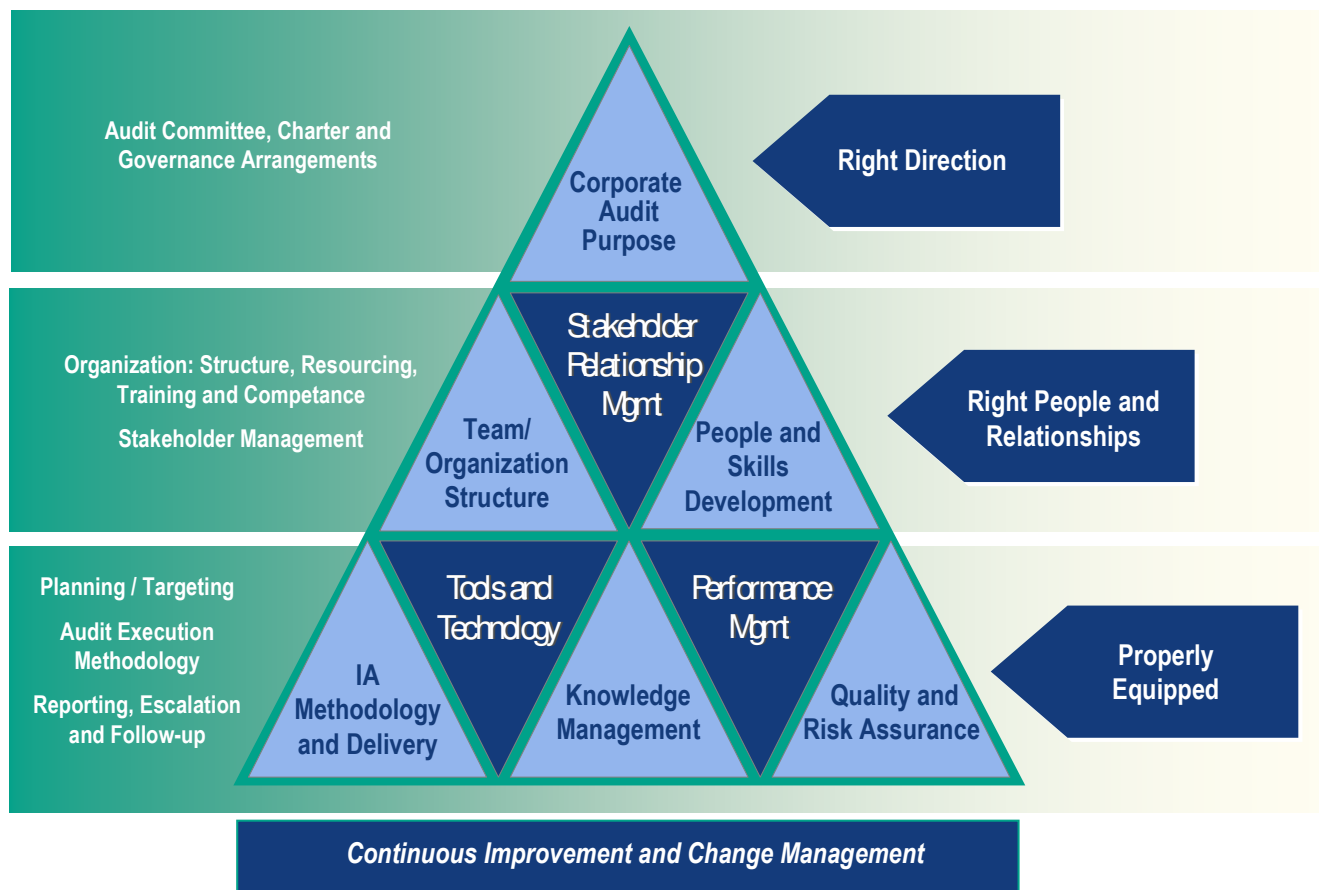
◆ Risk, Control and Compliance Framework Assessment



**15 RCCF Assessment-Sections**

1. **Tone At The Top**
2. **Strategies & Objectives**
3. **Policy & Procedures**
4. **Organizational Structure**
5. **Compliance**
6. **Culture & Performance**
7. **Alignment & Coordination**
8. **Competence & Capabilities**
9. **Roles & Responsibilities**
10. **Communication**
11. **Risk Identification & Assessment**
12. **Control Design & Effectiveness**
13. **Process Improvement & Efficiency**
14. **Monitoring & Reporting**
15. **Technology**

◆ Quality Assessment of Internal Audit

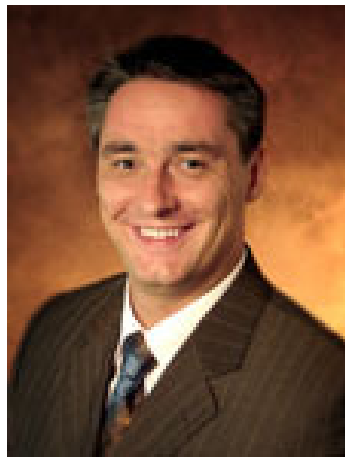


- Purpose
- Skills and Skills Development
  - Overview – Internal Audit Leading Practice
  - 1210 Proficiency
  - 1230 Continuing Professional Development
- Relationship Management Process
- Team Organization Structure
- Operational Management
  - Overview – Internal Audit Leading Practice
  - 2010 Planning
  - 2030 Resource Management
  - 2230 Engagement Resource Allocation
- Tools and Technology
- Support and Development
- Knowledge Management
- IA Methodology



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