Evolution of internal audit

Introduction

On 25 June 2008, the European Audit Committee Leadership Network (EACLN) met in Stockholm for its 10th stand-alone meeting. Members were joined by Mr Mauro Di Gennaro, chief audit executive and compliance officer of Fiat S.p.A and president of the European Confederation of Institutes of Internal Auditing (ECIIA), for a discussion of the evolution of internal audit. Biographical information for Mr Di Gennaro can be found in Appendix 1, on page 10. In a separate session, members also discussed best practices for navigating challenging situations.1

For further information about the network, see About this document, on page 9.

Members focused on the following three areas in their discussion on the evolution of internal audit:

- The scope for internal audit
- Resourcing the function
- Oversight of internal audit

The members of the network participating in the meeting sit on the boards of over 45 large-, mid- and small-capitalisation public companies. Network members participating in the meeting included:

- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Per-Olof Eriksson, Former Audit Committee Chair, Volvo
- Dr DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr Daniel Lebègue, Audit Committee Chair, SCOR
- Mr Anders Nyrén, Audit Committee Chair, Sandvik and SCA
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, Areva
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa
- Mr Gerhard Schumeyer, Former Audit Committee Chair, Zurich Financial Services
- Dr Bernd Voss, Audit Committee Chair, ABB

Ernst & Young was represented by Mr Tom McGrath, Sub Area Managing Partner, Europe, Middle East, India and Africa, Financial Services.

ViewPoints reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or companies. However, Mr Di Gennaro has given permission for his comments to be attributed.

Executive summary

While European regulatory guidelines remain vague on the role and workings of the internal audit function, clearer role definitions and standards appear to be emerging across Europe, driven by the profession itself. Simultaneously, boards and audit committees across Europe have been shifting the reporting lines of the internal audit function in order to augment its independence from management and objectivity as an assurance and compliance function. Members discussed the following aspects of the internal audit function, which are covered in more detail in the following pages:

- **The scope for internal audit** *(Page 2)*
  While recent research\(^2\) indicates that European internal audit leaders believe the function should broaden its role to include a focus on business effectiveness, many audit committee chairs do not share this view. Members agreed that internal audit should not be distracted by a desire to “add value” by offering consulting services; instead, it should focus on financial assurance, compliance and risk management. They also believe that the internal and external auditors should be working together, with one benefit of co-operation being the ability to control external audit fees.

- **Resourcing the function** *(Page 6)*
  Hiring and accessing the right talent for internal audit is an ongoing challenge for public companies in Europe. Members differ in their views on whether the leader of internal audit should come from the business or be a professional auditor. They agree, however, that staffing the function properly requires people with a mix of internal control expertise, knowledge of the business sector and understanding of the company. Rotations to and from the business provide one way of enhancing sector and company knowledge in internal audit. Outsourcing or co-sourcing arrangements can also provide access to specialist skills and offer the benefits of methods and practice development.

- **Oversight of internal audit** *(Page 7)*
  In order to provide for a greater degree of independence and objectivity on the part of the internal audit department, more and more companies in Europe are shifting the reporting lines of their chief audit executives from the CFO to the CEO. In addition, many network members report an additional dotted-line reporting relationship with the audit committee. Whether or not that reporting line is explicit, it is the role of the audit committee to reinforce the independence of internal audit and to provide the support internal audit needs to perform its duties.

The scope for internal audit

The Institute of Internal Auditors (IIA), a global professional body for all internal audit executives, defines internal auditing as “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by

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Bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”3

The European Union’s (EU’s) 8th Directive does not go so far as to recommend that companies maintain an internal audit function, but it does direct the audit committee to “monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems.”4 The national corporate governance codes for countries represented by network members vary in their guidelines. An analysis of what selected national corporate governance codes say about internal audit can be found in Appendix 2, on page 11. For European companies listed on the New York Stock Exchange (NYSE), however, the rules are clear: “Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control.”5

Mr Di Gennaro highlighted a growing trend towards convergence of the scope and approach of internal audit functions across Western Europe, led by the profession itself: “Internal audit functions in Western Europe are aligned with the Institute of Internal Audit (IIA) globally and are well structured, with clear reporting lines and activities (including what we do and don’t do) ... Internal Audit is the source for objective assurance regarding the effectiveness of an organisation’s financial processes, governance, risk management and control processes, and can also provide professional advice on potential process improvements ... Internal audit must have independence and autonomy [in order to] to give management advice on internal controls. Internal audit should be experts on risk management, but not be responsible for risk management.”

Members went on to discuss the following five priorities for the scope of internal audit:

1. Auditing financial processes
2. Oversight of compliance
3. Contributing to risk management
4. Working with the external auditor
5. Adding value to, but not consulting to, the business

Each of these five roles is explored in more detail below.

1. Auditing financial processes

How involved the internal audit function is in financial assurance depends on the preferences of senior management and the audit committee, as well as on the industry, company structure and historical practice. One network member remarked before the meeting: “At one extreme, [you have internal audit functions] that are police looking at the financials, and at the other [extreme], they are like consultants looking at the business.” At the meeting, members agreed the primary role of internal audit

should be financial assurance. Mr Di Gennaro stated: “The ECIIA is trying to work with the European Union to clarify the role of internal audit that the 8th [Company Law] Directive does not.”

More than two-thirds of the internal audit leaders interviewed for a March 2008 issue of InSights confirmed that their responsibilities include the monitoring of internal controls over financial reporting. Members emphasized how important that responsibility is: “The most important objective is to check internal control systems.” For current and former SEC registrants, Section 404 of the Sarbanes-Oxley Act (SOX) requires a significant focus on internal controls, with internal audit often being one of the key functions to take responsibility. Members were careful to distinguish, however, the role of assessing internal controls, which they feel is clearly within the scope of internal audit, from implementing changes to internal controls, which should be management’s responsibility.

2. Oversight of compliance

Internal audit’s responsibilities for compliance often extend beyond financial reporting. One member commented: “We have to check that governance principles, standards [and] codes are implemented by the different levels of the group and especially in the affiliated companies or joint ventures.” Regulatory compliance may also fall to internal audit, and even when it is handled by another specialist function, that function may also be managed by the leader of internal audit. Another member stated: “… a financial internal audit system [may] have value added in, for example, assessing compliance with external and internal rules.”

Members discussed the structural implications of having internal audit assume broader compliance roles. One member stated: “We have recently established the audit and compliance leadership team, where all different compliance and audit functions [can coordinate their activities].” Mr Di Gennaro gave an example of a company that created a committee between three separate functions – risk, legal and internal audit – to ensure a common understanding of compliance and to avoid duplication.

3. Contributing to risk management

A 2007 global study by Ernst & Young reported that there is an increasing expectation among audit committees and senior management that internal audit share “not only the risks covered in the Internal Audit plan, but also risks that are not covered by the Internal Audit plan.” The IIA International Standard 2110 states: “The internal audit activity should assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.” The IIA reported in a study of over 9,000 global audit executives that the internal audit function’s work in risk management includes business viability assessments, support for enterprise risk management and information risk assessment, with internal audit doing the most work in the area of risk assessment.

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Both network members and Mr Di Gennaro agreed that internal audit should play a role in risk management but should not own the risk management process directly. Mr Di Gennaro stated: “I think it is important that risk and control are within the responsibility of management, not internal audit.” Only one-quarter of the internal audit leaders interviewed for InSights stated that they manage the enterprise risk process directly, yet a majority reported that, at the very least, they align internal audit’s annual plan with the company’s risk assessment.

Members tend to agree with the internal auditor who reported that a lot depends on the maturity of the company’s risk management processes: “In talking to colleagues, I’ve seen that the evolution of internal audit functions is moving at very different paces, and I think internal audit’s involvement [in risk] differs very much based on the level of maturity that an organisation has with respect to risk and controls.”

One member noted: “At one of my companies, risk and [internal] audit are separated. In other companies where I am the audit committee chair, I insist that the internal audit plan covers a percentage of the risk area. What happens depends on the quality of resources.”

4. Working with the external auditor

The ECIIA states that the internal audit function “should provide sufficient information to enable external auditors to understand the internal auditors’ techniques, methods and terminology to facilitate reliance by external auditors on its work performed. As a result, internal audit’s work may affect the nature, timing and extent of the annual audit work and could contribute to improve audit’s efficiency and effectiveness.”

The touch points between the internal and external auditors are many and complex. Mr Di Gennaro highlighted the risk of overlap: “There is a risk to focusing internal audit on financial auditing ... With pressure to reduce fees, the focus [can be] more on financial auditing, and then you end up with two similar approaches.”

For their part, members see a clear difference between the roles of internal and external audit. One stated: “We have to avoid internal audit seeing themselves as part of the external audit function. They should be aware that they are part of the company and support the external auditor.” Other members raised another important distinction: “Under [Sarbanes-Oxley Act] Section 404, if the external auditor uncovers a control weakness, it is a legal issue. If the internal audit uncovers one, it’s not a legal issue. This is a huge difference.” Another member commented: “The difference is accountability. The external auditor is accountable to the shareholders, and internal audit is accountable internally.”

Even so, network members report that internal audit often works closely with the external auditor, with the goal of ensuring coordination and avoiding overlap. Members outlined several options for the relationship between internal and external auditors:

- **Coordination of internal and external audit plans.** One member said: “I want to see agreement on the financials ... given audit can just scratch the surface, there is a tonne of work to do.”
• **Use of internal audit to supplement external audit.** A member noted that when both internal and external auditing focus on financial auditing, “if internal audit is done well and the external audit has confidence in those processes, then the external fees go down.”

• **Cooperation after separate audits have been completed.** Another member said: “There is communication when the audit work is being planned, so the analysis can be done together [at the end]. At [my company], they [audit] separately and then compare.”

5. **Adding value to, but not consulting to, the business**

Earlier this year, *InSights* reported that leaders of internal audit across Europe see the function evolving beyond its traditional role of assuring financial processes and statements to include a focus on business effectiveness and a greater involvement in risk management.11

However, members were interested in limiting this trend. They stated that the primary focus of internal audit should be assurance of financial processes and internal controls, and if there is work beyond this in adding value to the business, it should be restricted to 10-20% of the internal audit group’s time. One member said: “There is a tendency to want to take on business advisory stuff because it is more exciting. We need to limit this exposure.”

In addition, members raised the issue that if internal audit plays a role in business effectiveness, the work would detract from internal audit’s objectivity. Mr Di Gennaro told members, “Internal audit has an opportunity to go beyond financial assurance, but there is a risk to our independence. If you give advice on the business side, then you can’t audit it.”

Despite these inherent limitations on internal audit’s role, many members noted that internal audit has a unique and broad view of the company and therefore should be expected to provide feedback to the local business when it can add value. One member stated: “Internal audit’s role is to help management get a holistic view [of the company], and this is critical.” Another said: “Like all people in the company, [internal audit] is expected to tell what they see and give advice to local management.”

**Resourcing the function**

According to the Ernst & Young survey mentioned earlier, “Recruiting, retooling, developing and retaining the right skills” remain the foremost challenges for internal audit functions across Europe.12 Similarly, internal audit leaders who participated in the *InSights* research stated that regardless of the size of their internal audit function, they regard themselves as being in a “war for talent” that is being fought on many fronts. Mr Di Gennaro pointed out that as a result of the Basel II international capital framework,13 banking institutions are creating larger internal audit departments that “will require enormous manpower.” With Basel II implementation still in early stages, its impact on the availability of internal audit talent has not yet been tested.

**Hiring the best talent**

Members had different views on the right focus of expertise required by the leader of internal audit.

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11 Ernst & Young and Tapestry Networks, “The European internal auditor’s perspective.”
12 Ernst & Young, *Global Internal Audit Survey*, page 2.
13 The Basel II framework is available at http://www.bis.org/publ/bcbs128.htm.
• **Focus on professional skills.** Some members felt strongly that “you should have an auditor to do internal audit.” Another ranked expertise in this way: “As a general rule, I think internal audit needs to understand first the internal control framework, second, the sector, and third, the company. You can’t learn [the internal control framework], [but] you can learn the other two.”

• **Focus on business experience.** Others agreed with the member who said, “I believe I would still go for a good business [person] from the company. If you have an internal audit leader who knows how the business works, [he or she] will learn the other side.”

Despite the variability of views, most members agreed that the need to attract talent to the department as a whole means expending effort to make the role attractive and offering opportunities for personal growth and development. One member said before the meeting: “In order to attract the right people to the audit team, you need to give them business experience and scope to add value.”

Members also discussed the rotation of staff from the business into internal audit, and vice versa, as a way of providing business education to staff from both sides and as a way of elevating the perception of the function. One member reported difficulty in getting management to support such a model: “I tried to get people to spend three years in internal audit for their career [growth] and never succeeded.” Mr Di Gennaro recommended a period of 12–24 months as an effective term for rotation.

**Outsourcing and co-sourcing to ensure adequate capabilities**

When its in-house auditors cannot meet all the organisation’s needs, many companies decide to outsource or, more often, co-source some of the activities. Many leaders of internal audit interviewed for *Insights* find co-sourcing useful when “you have a very short-term, focused need.” Specialty areas are a particular focus for outsourcing or co-sourcing solutions when companies are looking for specific capabilities, such as IT auditing or actuarial auditing for a pension fund. According to the IIA, the three most commonly outsourced audit areas are financial auditing, information technology (IT) department assessment and quality/ISO audits.

Outsourcing providers are convinced there is long-term strategic value as well. A long-term strategic relationship with an internal audit service provider can help an internal audit function address challenges on three fronts: personnel, methods and practices. One member stated: “When I think about the people side, the best I’ve seen is when we outsourced the whole function.”

**Oversight of internal audit**

Typically, leaders of internal audit report both to management (often the CEO or CFO) and to non-executive directors of the company (often the audit committee). The specific person or body to whom they report varies by company, national corporate governance code and local custom. The ECIIA states that “to guarantee the sustainable independence [of the internal audit function], the chief audit executive should report functionally to those responsible for governance and administratively to an appropriately senior level within the organisation.”

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14 Ernst & Young and Tapestry Networks, “The European internal auditor’s perspective,” page 7.
Reporting to the CEO or CFO?

While some network members have internal audit departments that report to the CFO, many members said their companies had moved beyond this reporting relationship. One member stated: “It is not a good solution for the leader of internal audit to report to the CFO. It could be a conflict of interest. Internal audit covers the financial activities of the company. The usual solution is reporting to the CEO in [my country].” Another member stated: “There is a growing trend over the past ten years where the reporting line has become less to the CFO and more the CEO, with a functional dotted line to the audit committee.”

More than two-thirds of leaders of internal audit interviewed for InSights are already reporting directly to their CEO. In response to concerns that reporting directly to the CEO might compromise the objectivity of the function, one leader of internal audit said: “I think you are more independent when you can go directly to the head of the company and ask them to talk.”

One member reported that in one company, in an attempt to create more objectivity, the reporting line had been shifted to the non-executive chairman: “The ideal oversight is when a former CEO becomes [non-executive] chairman.”

Ensuring internal audit’s objectivity is also a responsibility for audit committee chairs. One member said: “It is the role of the audit committee to assess and create the condition for a really independent internal audit department.” Members agreed that one important way to support internal audit objectivity is to hold an executive session with the internal auditor in every audit committee meeting, thus protecting the leader of internal audit from being seen to request a meeting.

Reporting to the audit committee?

Provisions within the 8th Directive state that the audit committee should take a greater degree of fiduciary responsibility for monitoring the effectiveness of a company’s internal audit function, if such a function is present. Five of the eight countries represented in the EACLN network have corporate governance codes that recommend a relationship between the audit committee and the internal audit function. Almost all of the leaders of internal audit interviewed for InSights said that they do report, in some way, to the audit committee. Network members often report a dotted-line relationship between internal audit and the audit committee.

Even when a clear reporting line does not exist, internal audit leaders should report on the internal audit plan to the audit committee and should be able to rely on their audit committee chair for support. Mr Di Gennaro, answering a member’s question about what he expects from his audit chair, said: “Bilateral communication. I want [internal audit] to be as transparent as we can be ... and I expect the audit committee to give me advice on what [they] want, and if my work is not good, [what] should be different.” Many members meet with their leaders of internal audit prior to the audit committee meeting, often in coordination with the external auditor, and feel this is an important opportunity for candid discussion regarding the audit plan and other pertinent issues.

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17 Ernst & Young and Tapestry Networks, “The European internal auditor’s perspective,” page 8.
While some audit committees are involved in reviewing and assessing the function’s performance against the audit plan, the extent to which audit committee chairs become involved in assessing the performance of the internal audit leader is less clear-cut, with most members saying they have little say on performance evaluation or remuneration.

**Conclusion**

The internal audit function has long suffered from the reputation of being an “elephant’s graveyard” for talent, often being seen as a compliance activity but not a significant source of value for the business. Over the past few years, internal audit functions in Europe have sought to elevate the work they do for their companies by setting standards and pursuing innovative resourcing techniques to bring business knowledge into the function. Some leaders of internal audit now believe the function is well positioned to provide advice on improving business performance. Most of the European audit chairs in the EACLN respectfully disagree. The discussion highlighted the need for an ongoing dialogue between audit chairs and leaders of internal audit on the preferred scope for the internal audit function. While the solution will be unique to each company, an explicit agreement on scope and clarification of mutual expectations will make it possible for internal audit to add real value to the business, while reassuring the audit committee that internal audit’s assurance role is not forgotten.

**About this document**

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.*

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Appendix 1: Biography of Mauro Di Gennaro

Mauro Di Gennaro is chief audit executive and compliance officer of Fiat S.p.A., a position he has held since 1 January 2004, heading up a global team of 200 people and reporting directly to the CEO of Fiat. Mr Di Gennaro started his career at Price Waterhouse in 1987. In 1994, he became head of internal audit at Stet S.p.A. Three years later, he joined Telecom Italia, where he held several positions, including head of international operations and head of international internal auditing. In 2002, he was appointed head of internal audit at the RAS Group. Mr Di Gennaro is vice chairman of the Italian Institute of Internal Auditors and president of the European Confederation of Institutes of Internal Auditors (ECIIA), which has 32 chapters in Europe and the Middle East. The ECIIA acts as advocate for the profession with EU institutions and sets rules and recommendations for professional practice.
### Appendix 2: What national corporate governance codes say about internal audit

The following table examines internal audit in eight countries represented by network members.

<table>
<thead>
<tr>
<th>Country</th>
<th>What the corporate governance code says</th>
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<tbody>
<tr>
<td>Belgium</td>
<td>The audit committee should review the internal auditor’s work programme, keeping in mind the complementary roles of the internal and external audit functions. It should receive internal audit reports or a periodic summary, and it should review the effectiveness of internal audit. In particular, it should make recommendations on the selection, appointment, reappointment and removal of the head of internal audit and on the budget allocated to internal audit, and it should monitor the responsiveness of management to the committee’s findings and recommendations.</td>
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<td>France</td>
<td>The audit committee should monitor the internal audit function, review the material risks and off-balance-sheet commitments, interview the person in charge of internal audit, issue an opinion regarding that department’s organisation and be informed of its programme of work. The audit committee should receive internal audit reports or a summary of those reports.</td>
</tr>
<tr>
<td>Germany</td>
<td>No information regarding the internal audit is found in the German code.</td>
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<tr>
<td>Italy</td>
<td>The person responsible for internal control will usually be the person responsible for the internal audit function. The internal audit function may be entrusted to persons external to the issuer, provided that they are adequately professional and independent; these persons may also be responsible for internal control. These organisational choices should be disclosed to the shareholders and the market in a company’s corporate governance report.</td>
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<tr>
<td>The Netherlands</td>
<td>The internal auditor should operate under the aegis of the management board. The internal auditor can play an important role in assessing and testing the internal risk management and control systems. The audit committee should focus on supervising compliance, including compliance with recommendations and observations of internal and external auditors, and on oversight of the internal audit department. The external auditor and the audit committee should be involved in drawing up the work schedule of the internal audit function.</td>
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<tr>
<td>Sweden</td>
<td>The audit committee should meet regularly with the company’s auditors to keep informed of the aims and scope of the audit work and discuss coordination between external and internal audit and views on the company’s risks. The board in companies that do not have an internal audit function should annually evaluate the need for such a function and explain its position in its report on internal control.</td>
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<tr>
<td>Switzerland</td>
<td>The company should set up an internal audit function, which should report to the audit committee or to the chairman of the board. The audit committee should form an impression of the effectiveness of external audit and internal audit, as well as of their mutual cooperation. The audit committee should discuss with the internal auditor the review of individual and consolidated financial statements, as well as interim statements intended for publication.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>The audit committee should monitor and review the effectiveness of the company’s internal audit function. If there is no internal audit function, the committee should consider annually whether there is a need and make a recommendation to the board; the absence of such a function should be explained in the annual report.</td>
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</tbody>
</table>