

European

INTERNAL AUDIT BRIEFING

March 2010 · Issue 17

A fine line

The division of labour between external and internal audit is not an easy one to make

INSIDE: Interview with Brian Gray, head of the European Commission's Internal Audit Service, UK and Ireland's charter award, ECIIA web revamp, news, elections, and more



UK body awarded chartered accolade



Sarah Blackburn signs petition for chartered status

The IIA UK and Ireland has been approved for Chartered status by the UK's awarding body the Privy Council. When the Chartered Institute of Internal Auditors is

launched on 1 October 2010, it will be joining the ranks of the four hundred or so other active chartered bodies.

Achieving chartered status is

a milestone in the development of the internal audit profession in the UK and Ireland. It also represents a major advocacy success and will increase the profile of the body in both its home territories, in Europe and beyond. The IIA UK and Ireland had to seek the support of many other professional bodies and of those working at the highest levels in business and government during its campaign for the award.

"Whilst chartered status shouldn't be considered an end in itself," said the Institute's president Sarah Blackburn, "members will appreciate the advantage of being part of a professional body that carries the ultimate marque of public approval."

She said that the award was recognition of the profession today:

as a body of expert knowledge and skills, which is so crucial to the public interest, and that is best regulated by a professional body under the auspices of the Privy Council.

IIA members in the UK will have the opportunity to become chartered internal auditors. And employers will be able to employ chartered internal auditors as a way of sending a positive message to their stakeholders internally and externally.

"With chartered internal auditors on the payroll, or the supplier list, an organisation is showing by example that it takes its responsibility for good governance and the management of risk seriously," said Blackburn.

Launching the Institute with its new name is part of a broader strategy for the body.

Conference in Bosnia Herzegovina

The fourth annual conference of the IIA Bosnia Herzegovina takes place at the Grand Hotel

Park in Dubrovnik between 15 and 17 April 2010.

Alma Malinović, president of IIA Bosnia Herzegovina is opening proceedings on the morning of 15 April, followed by a plenary panel discussion including,

Philip Tarling (IIA Global), Roland de Meulder (ECIIA) and other representatives of European national ECIIA bodies.

The following day sees debates on the economy, the financial services sector

and budgeting for not-for-profit organisations. There are social events and networking opportunities, including a gala dinner on the evening of 16 April.

For more details contact: info@revsar.info

Global officers' elections

The election of the next cohort of officers to run Global IIA was announced in January 2010. The election of candidates takes place at the annual business meeting in Atlanta, Georgia, USA on 9 June 2010. The new leaders will take office immediately upon election.

All IIA members are invited to attend and may vote in person or by proxy.

Under IIA bylaws, additional nominations may be made by the members provided nominations are submitted in writing by no fewer than 100 members. The secretary must receive such nominations at least 90 days prior to the annual business meeting.

The full list of nominations can be found here: <http://www.theiia.org/recent-ia-news/?i=12582>

Internal control task force



Madrid Stock Exchange

IIA Spain is playing a key role in helping the Spanish stock exchange regulator, CNMV, improve market transparency – particularly on the issue of reporting internal control over financial reporting.

It has been part of a taskforce put together by the regulator to produce guidance that should help listed companies to improve the reliability of internal control systems over financial reporting. The group also includes experts

from listed companies.

A draft version of the guidance was published on the CNMV website in February for consultation. It includes a framework of 30 recommendations based on COSO, a guide of indicators to help public companies report on their internal control systems, as well as a guide defining the role of audit committees and internal audit regarding internal control over financial reporting.

Advocacy corner by Jean-Pierre Garitte

All public-interest companies need to have an audit committee, under article 41 of the 8th European Company Law Directive. These audit committees will monitor the effectiveness of the company's internal control, risk management and internal audit systems, where applicable.

Most European Union member states have already ratified this directive into national legislation, but the companies and audit committees that have to comply with the law are still struggling over how to implement and apply its principles.

As a result, the Federation of European Risk Management Associations (FERMA) and the European Confederation of Institutes of Internal Auditing (ECIIA) have set up a working group to develop a common position paper. The document will clarify the concepts of risk management, internal control

and internal audit. In particular, it will focus on the roles and objectives of those involved in complying with article 41 and the global and regional models and standards that have developed to implement it. It will also set out companies' responsibilities, including those of their oversight bodies, and the reporting lines and the relationship needed based on the three-lines-of-defense model.

The position paper will also set out the minimum compliance requirements and best practice for audit committees in their role of effectively monitoring risk management, internal control and internal audit.

The paper will be presented for approval to the management boards of FERMA and ECIIA in June 2010. After its official release, ECIIA and FERMA intend to organize a joint event in Brussels to present

the conclusions. The official launch will be followed by a series of road shows in the member countries of both bodies, organised by the member bodies.

The current working group consists of six people, including three members representing FERMA and three members representing ECIIA:

- Marie Gemma Dequae (former president of FERMA)
- Michel Dennery (risk management director GDF Suez)
- Paul Taylor (risk assurance director Morgan Crucible Company)
- Flemming Ruud (president IIA Switzerland)
- Chantal Pierre (former president IIA Benelux)
- Jean-Pierre Garitte (former president ECIIA).

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

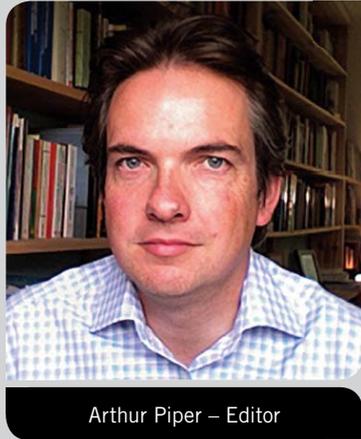
Editorial

Europe is still in turmoil in the wake of the financial crisis. According to European media, the German and Greek authorities were recently at loggerheads over how to approach Greece's unexpectedly high debt levels. They also say that Portugal, Spain and Ireland could face similar issues.

Each of these countries government's has offered robust defenses of their financial positions and the strategies they have in place for getting debt down.

Meanwhile, the European Central Bank (ECB) is in the middle of dismantling the emergency support it made to the financial markets in the immediate aftermath of the collapse of the US investment bank Lehman Brothers. In September 2008, the ECB provided extra liquidity for up to a year at fixed rates of interest. It will now be harder for banks to access such money.

The move was based on the idea, voiced by the ECB, that market conditions were returning



Arthur Piper – Editor

“progressively to normal.” But it also left interest rates at a record low of 1% in March. According to the *Financial Times*, the president responsible for assessing the eurozone's growth prospects at the ECB said that while recovery was on track, “it is likely to remain uneven.” So, are market conditions progressive, or are they also sometimes still regressive?

Internal auditors are having to live increasingly with such uncertainties. But those of a progressive bent may decide that that is something to welcome.

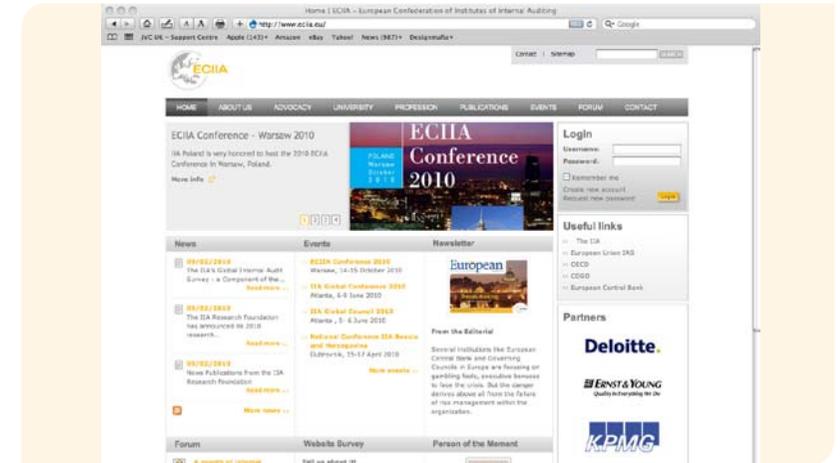
The World Economic Forum's (WEF) recent report, *Global risks 2010*, argues that the macro and

micro levels of the economy – and, incidentally, everything else in society – are more intimately connected than was previously thought. This has uncovered what it calls an “awareness gap” in the way that people treat risks they believe are unlikely to materialise.

Instead of looking at risk in isolation, what they need to think more about is that two fairly apparently minor risks can combine to create a major one. Or if a major risk and a minor one get together in an unexpected way, all hell can break loose.

Plotting risks on a risk register does not give the internal auditor any more certainty than before – but it does allow him or her to assess the levels of risk in between the gaps. In other words, it allows us to think that uncertainty is the norm. Internal auditors who are prepared to embrace the chaos and read between the lines are in a better position to see new opportunities in unusual places and avert some unexpected risks. They might even win more friends in high places.

Window to the world



The new ECIIA website

This year marks the launch of the ECIIA's new website. Since the website is the body's window to the world, it is vital that it provides a good first impression to members.

“Our goal was to design a successful website,” says Amra Alagic, head of the ECIIA website task force, “a site that inspires, builds credibility and trust, promotes our services, and motivates our members. It is a medium that must strongly communicate the ECIIA's

values, goals and messages.”

The website task force paid close attention to only a few key elements: a design that has a professional look and feel, fast and user-friendly access, a well-structured and intuitive interface, and well-organised and categorised content.

Take a look and explore the new features, new structure and new key concepts and join the discussions on the forum.

Members can vote in the website survey at www.eciia.eu



Moving onto new territory

The European Commission's Internal Audit Service has come a long way since its creation amid financial scandal a decade ago. Neil Baker talks to its leader, Brian Gray

Ten years ago the European Commission's reputation for financial management was in tatters. Allegations of corruption had prompted all its leaders to resign. An incoming Commission, led by then Italian prime minister Romano Prodi, insisted on a series of fundamental reforms. Among them, the creation of an independent Internal Audit Service (IAS).

The IAS has come a long

way in its first decade. Charged with providing assurance over the Commission's risk management, control and governance arrangements, the IAS has grown to also audit 25 independent community

agencies. It services 46 bodies in total and employs around 100 staff, making it one of the largest internal audit functions in Europe.

Brian Gray, a Deloitte-qualified British chartered accountant, has led the IAS since last year. »

“The IAS has covered all of the territory that it should look at, so the question is what do we do next?”

» Its first decade slots into two distinct phases, he says. Up to 2003, it focused on auditing management and control systems at the Commission's directorate generals. Between 2004 and 2009, it turned attention to efficient management in the Commission, and then looked more widely at governance and non-financial issues. Now it is about to enter its third phase, he says.

"The IAS has covered all of the territory that it should look at,

your control structure is good and that compliance is good, the next step is value for money," he says. "Are our programmes being managed in such a way that spending is going to be efficient, effective and economical?"

Finishing touches

Gray is just putting the finishing touches to the three-year plan that will steer the IAS through this next phase of development. A key change is that from 2011 the IAS will provide an overall

"Once you are confident that your control structure is good and that compliance is good, the next step is value for money"

so the question is what do we do next?" says Gray. A lot of effort will go into following up previous audit recommendations, but "The next challenge will be to spend more time on performance and value for money auditing."

"Once you are confident that

opinion on the Commission's controls and management.

This is a big step, but the challenge will be familiar to many internal auditors elsewhere: boards and audit committees are increasingly looking to their auditors for »



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» a “big picture” view on the overall quality of controls, risk management and governance.

The idea for an overall opinion came from the Commission’s Audit Progress Committee, one of Gray’s key stakeholders. This group comprises seven Commissioners and two external experts. Among its responsibilities, it produces an annual report on the quality of internal audit. “They invited us to consider giving an overall opinion. We thought we could, so our mandate was changed to include it as a requirement,” says Gray.

A statement of overall assurance should enhance the Commission’s reputation for fiscal rectitude, provided that any reservations are properly addressed. Gray doesn’t underestimate the challenge. While the requirement doesn’t kick in until next year, his team is performing a “dry run” in 2010.

“The commission’s governance structure is sufficiently solid for us to give an opinion, so I’ve not any worries about the basis for it,” says Gray. “But obviously we need to make sure that we do enough work. That’s what we’re doing with the trial run – seeing



where our work might be missing. If there are any significant gaps, we’ll fill them in the coming year.”

Same wavelength

To provide the opinion, Gray says he needs to get all of his auditors “working on the same wavelength”. Their audit work needs to focus on the Commission’s specific responsibilities for dealing with risks, he says. “If as an auditor you are asked to provide an overall opinion of agricultural expenditure, you won’t be looking at farmers’

fields and counting cows,” he says, even though that might be the natural response of some auditors. “You have to rephrase the question and ask whether the directorate general responsible for agriculture is effectively addressing the risk of errors in claims. You form your opinion on that. It’s a different way of looking at it.”

This would have been more difficult – if not impossible – in the early years of the IAS. It used to lack a common internal audit methodology and was still

learning how to work effectively with the Commission’s other internal audit resources. Each of its Directorates General – which function like government ministries – has its own Internal Audit Capability, like a standalone audit function. They work under

“If as an auditor you are asked to provide an overall opinion of agricultural expenditure, you won’t be looking at farmers’ fields and counting cows”

the umbrella of the IAS, and can be a powerful force when operating in tandem, but getting to that point has taken time.

But since 2007 all of the Commission’s internal auditors have been following the IIA’s *International Standards* and Code of Ethics and cooperating closely with each other – a conclusion supported by an independent quality review. “The actual audit work is different,” says Gray, “but everyone uses the same professional approach.” »

» Another challenge when giving the opinion, says Gray, is “being not afraid of having a few reserves if we need to.” The idea is that the IAS opinion will state that the Commission’s

In the complicated political environment of the European Commission, giving a qualified internal audit opinion could become a sensitive exercise. The European Court of Auditors

“In general, I think we are seen as a necessary nuisance that can come up with things a Director General would want to know”

governance, risk management and internal control systems give reasonable assurance, and that any exceptions – or “reserves” – are then set out in detail.

Reserves

The IAS opinion will include any reserves that the directorates general have identified for themselves, and may well include some disclaimers from the internal auditors, noting the areas they have not had time to cover. “It is all developing,” says Gray. “We are not yet at the point of drafting our trial run opinion.”

receives huge negative media attention when, every year, it issues a qualified opinion on the European Union’s budget. There are always headlines about million-euro holes in the EU’s accounts, of money being paid in error. The IAS has a very different role, and Gray says it will be important to explain just what an internal audit opinion means. Will the internal audit opinion be made public? “We’ll cross each bridge when we come to it,” he says.

The move to providing an overall opinion fits with Gray’s desire to make the Commission’s

Biography



A UK chartered accountant since 1973, Brian Gray first worked for one of the big four firms as an audit manager in Zambia and in London. In 1978, he moved to the public sector, where he worked for the European Court of Auditors, auditing European Commission development aid and then agricultural spending.

Gray has worked for the European Commission since 1992, firstly responsible for audits of agricultural expenditure in the Member States, then for the financing of regional policy. Between 2003 and 2009, he was the Commission’s CFO. That role gave him responsibility for modernising its accounting system and for launching its action plan towards an integrated control framework. He took over as the head of the Internal Audit Service last year.

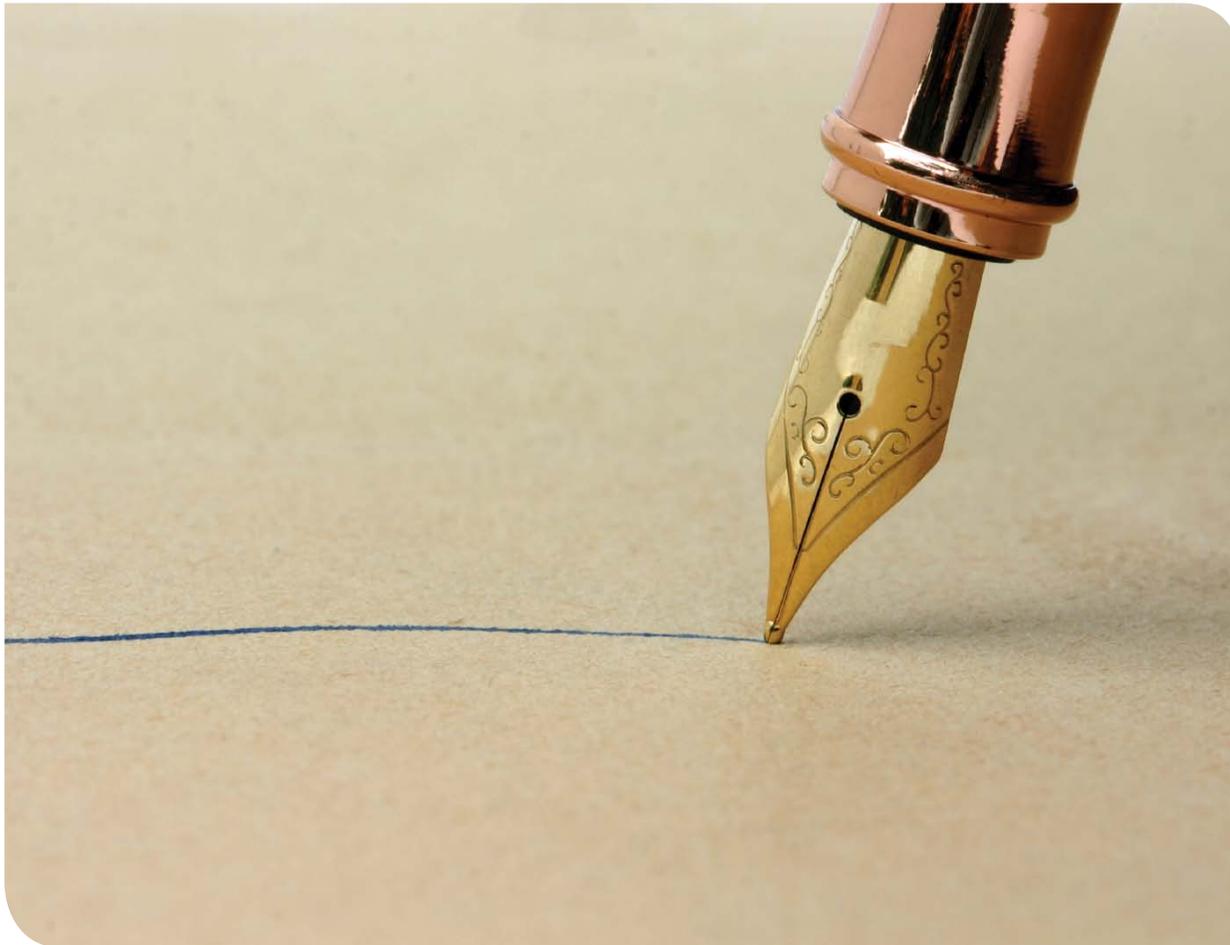
Internal Audit Service an exemplar of best practice public sector internal audit. Inside the organisation, its value is now accepted, says Gray.

“In general, I think we are seen as a necessary nuisance that can come up with things a Director General would want to know,” he says. “In other words, are his services well organised, and if they are not what can be done to

improve them? There might be a bit of a sigh when we arrive to do an audit, because it does disrupt the normal working routine, but our findings are generally found to be constructive.”

It didn’t used to be like that. “At the beginning of the decade there was a lot of hesitation about letting people look at the management systems,” says Gray. “That has certainly gone.” ■

Drawing a fine line



The division of labour between external and internal auditors is not an easy one to make in the post-Enron world. Arthur Piper reports

In October 2009, the Auditing Practices Board (APB) in the UK – which is responsible for setting auditing standards in the country – issued a consultation document on the long-running issue of whether audit firms should be able to provide non-audit services to their clients. The situation in the

UK, at the moment, is that the audit committee is responsible for ensuring that non-audit services are provided on a transparent and open basis.

In the 1990s, this was seen as a thorny issue because some large audit firms were accused of charging relatively small fees for the audit of large corporations on the basis that they would make profits on consultancy. Codes of corporate governance were amended across Europe in the wake of the Enron scandal, where governance failings had led to the collapse of a major energy conglomerate in the US.

While many are happy that audit committees have largely stamped the problem out, the recent financial crisis has put the subject back on the agenda. The APB was asked to consult on the »

“We strongly believe that investor confidence and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company”

Key findings

- Stakeholders are always better supported by internal audit and external audit when a broad overall audit scope and a clear division of roles are provided
- Co-operation between external and internal auditors is good practice and goes beyond current limited national requirements – although it varies in terms of intensity
- Further improvement is possible with respect to both the efficiency and effectiveness of co-operation, especially with regard to the organisation's broad governance objectives

Source: *Impact on governance*

» provision of non-audit services by the UK government. A report published in summer 2009 by its Treasury Select Committee – *Banking crisis: reforming corporate governance and pay in the City* – said: “We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company.”

Split views

Not surprisingly, large firms, such as Ernst & Young, that responded to the consultation said that the problem was more

one of “perception,” rather than a view based on “hard evidence.” Investor bodies, on the other hand, such as the UK's National Association of Pension Funds, which represents £800bn worth of invested assets, said that a problem remained. “There is an underlying concern that audit committees need to be more robust in their assessment of the services provided by their auditors and more transparent in how they describe that process to shareholders,” it said.

The crux of the matter is independence. The IIA – UK and Ireland, in response to the

APB – said that it remained sceptical about the efficiencies that could be achieved by a single supplier providing, say, internal and external audit services to the same customer. Jackie Cain, the IIA's technical director in the UK wrote to the APB, saying: “We are concerned about the impact on the independence of the external auditor – and on the quality, or on the perception, of the quality of the external audit – if the audit firm also provides internal audit services.”

Separate roles?

External auditors provide assurance to shareholders and customers that the financial statements are credible and reliable. Internal auditors, on the other hand, provide members of the board and senior management with assurance over the business processes in the company.

But these roles have become less distinctive in the wake of Enron. Bernd Schartmann in his book *The role of internal audit in corporate governance in Europe*, says: “The financial statement audit with its resulting

opinion, has been the major corporate governance role of external auditors. But financial reporting matters and policies regarding earnings measurement should not be left to the external auditors alone.”

He says that external auditors often rely on work performed by internal audit, and vice versa. In rare cases, internal audit may be asked to complete work on behalf of the external audit team. Under Audit Standard No. 2 (PCAOB 2004), external auditors can rely on internal control work performed by the organisation's internal audit function.

“Financial reporting matters and policies regarding earnings measurement should not be left to the external auditors alone”

In the end, organisations will make their own decisions about who is responsible for doing the actual audit work, but given the complexity of the »

» relationship between these two important groups of assurance providers, one would be forgiven for thinking that there would be

be independent and report to the chairman of the management board (or equivalent) and the audit committee – and that this should

“Stakeholders are always better supported by internal audit external auditors when a broad overall audit scope and a clear division of roles are provided”

a welter of material available to help organisations get it right. In fact, there is very little.

Improved co-operation

The most recent publication – *Impact on governance* – has been produced by IIA Netherlands in conjunction with the Royal Dutch Institute of Chartered Accountants. The study showed that there is plenty of room for improvement when it comes to co-operation between external and internal audit (See *Key findings*).

The report says that the internal audit department must

be enshrined in its charter. The function should be well managed and trained and have the right skills for the business. The audit work should “have a broad task and scope,” covering all parts of the business and its systems.

The document includes a number of best practice check lists on all of these areas, including the level of transparency that should be expected while the two functions are working together (See *Transparency and communication best practice*).

Whether the current financial crisis will result in further corporate governance

Transparency and communication best practice

- Inventory, document and detail mutual information needs
- Exchange files and reports with each other to the extent possible
- Provide one another with the control approach and control programmes
- Assure direct communication line between internal audit and external audit by means of clear agreements
- Deliberate on and co-ordinate plans, agreements and agendas with each other
- Ensure and promote (by both parties) the attendance of both at important meetings, such as clearing meetings
- Include a remark in reports, if applicable, in the event that findings have been made by the other auditor
- Organise combined team meetings to exchange information on audit approach, audit planning, clarification of task and responsibility distribution, and so on
- Elucidate for the management board, the audit committee and the supervisory board the assumptions, objectives, structures and intensity associated with the co-operation and request approval from the audit committee in this respect

Source: *Impact on governance*

reform in this area – as it did following Enron – remains to be seen. In the meantime, the paper should help organisations improve the efficiency of and get better results out of the

work of both sets of auditors in what has been a confused and sometimes controversial area.

Link: A summary of *Impact on governance* can be downloaded here.

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- » 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.
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Views and opinions presented in this newsletter are the writers and do not necessarily represent the official positions of ECIIA.



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