

The Role of Internal Audit in Corporate Governance. Case: Fiat Group

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History

Recently there has been considerable interest in the Corporate Governance practices of modern corporations. New approaches to doing business have increased the risks connected with the achievement of company's goals. The introduction of new technical devices, for instance, the use of the Internet for carrying out transactions massively took off starting from the 1990s onwards. Subsequently, this increased the risks of intrusive attacks, made the issue of business continuity a more critical one and placed a stronger emphasis on the need for disaster recovery plans. Also, the worldwide spread of business into "new markets", such as the Asian market, has provided new risks as well as refocusing attention on a system of control, for example the Asian financial crisis in the latter half of the 1990s. Moreover, the high-profile collapses of a number of large U.S. firms such as the Enron Corporation and Worldcom in the early 2000s, as well as lesser corporate debacles, such as Adelphia Communications, AOL, Arthur Andersen, Global Crossing, Tyco, and, more recently, Fannie Mae and Freddie Mac, Parmalat, etc. led to increased shareholder and Governmental interest in Corporate Governance which culminated in the approval of the Sarbanes-Oxley Act of 2002 and in the SOX (Sarbanes-Oxley Compliance Projects). Last but not least, the ever stronger institutionalisation of the markets in which buyers and sellers are largely institutions (e.g., pension funds, insurance companies, mutual funds, hedge funds, investor groups, and banks) also reveals an increasing need for professional diligence to protect the community at large in terms of safety and welfare.

Definition

What is meant by "Corporate Governance"?

It is a multi-faceted set of processes which have to:

- Operate and control all company processes at each level in order to achieve long term strategic goals
- Guarantee adequate control over the compliance with all customs, policies, legal and regulatory requirements, institutions affecting the way in which a corporation is directed, administered or controlled
- Monitor whether outcomes are in accordance with plans and motivate the organization to be more fully informed in order to maintain or modify organizational activities
- Design controls to reduce the inefficiencies that arise from moral hazard
- Manage all related problems in a cross-functional manner
- Build a good integrated model of functioning of the internal controls.

Aim

An important theme of Corporate Governance deals with issues of accountability and fiduciary duty, essentially advocating the implementation of policies and mechanisms to ensure good behaviour and protect shareholders. Another key focus, is the view of economic efficiency, through which the system of Corporate Governance should aim to optimize economic results, with a strong emphasis on shareholders welfare. Partly as a result of the separation between ownership and management, in fact, the implementation of a stronger control assists in aligning the incentives of managers with those of shareholders, whose gain is strictly influenced by their share price as well as by their dividends, is required by the Corporate Governance mechanism. The effective performance of the organisation strongly depends on the status of its Corporate Governance, whether direct or indirect. An effective result means for directors, workers and management alike, higher salaries, benefits and better reputation, whereas, for the shareholders higher capital return, for customers increased quality of goods and services, and for suppliers more frequent compensation for their goods or services.

Structure

The Corporate Governance structure specifies the rules and procedures for making decisions with regard to corporate affairs. It also provides the structure through which the company's objectives are set out, as well as the means of attaining and monitoring the performance of those objectives. Corporate Governance also refers to the relationships among all the players involved and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

Players

Among the players we can mention; the:

- CEO
- Board of Directors
- Management
- Shareholders
- Suppliers
- Employees
- Creditors
- Customers
- Community at large

A board of directors often plays a key role in Corporate Governance. It is their responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure the accountability of the organisation to its owners and authorities. Of importance is how directors and management develop a model of governance that aligns the values of its participants and periodically evaluates this model for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports. The shareholder delegates decision rights to the manager to act in the principal's best interests. This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions.

Principles and Issues

Key elements of good Corporate Governance principles include:

- Rights and equitable treatment of shareholders and interests of other stakeholders
- Role and responsibilities of the board
- Integrity and ethical behaviour, disclosure and transparency

Issues involving Corporate Governance principles include:

- Oversight of the preparation of the entity's financial statements
- Internal controls and the independence of the entity's auditors
- Review of the compensation arrangements for the chief executive officer and other senior executives
- The way in which individuals are nominated for positions on the board
- The resources made available to directors in carrying out their duties
- Oversight and management of risk dividend policy.

Application and Control

As a rule, compliance with Corporate Governance principles and recommendations are not mandated by law, although they may have coercive effects if misleading, for instance in the stock exchange market.

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Corporate Governance principles imply a form of self regulation by allowing to determine what standards are acceptable or unacceptable while also transforming them into applications or practice rules (i.e. through codes of conduct and guidelines). One has to afford the complexity of their design. A self-regulation, in fact, may be ill-equipped, new types of transactions may not be covered by the code. Moreover, even if clear rules are designed one can still find a way to circumvent their underlying purpose by not following the aim they were designed for.

Enforcement can affect the overall credibility of a regulatory system but one should well measure it: a greater enforcement can create a too competitive playing field which could ingenerate a win-lose system instead of a win-win one, a light one obviously doesn't motivate anybody.

The Control over the Corporate Governance system can be both External and Internal (self-made or by a third part): the first verifying the financial disclosure of the company weighted though the state of the Corporate Governance; the latter monitoring activities and taking corrective action to accomplish organisational goals or analysing the gap considering that good financial reporting is not a sufficient condition for the effectiveness of Corporate Governance. The Enron and Parmalat collapses, in fact, are examples of misleading financial reporting despite its formal correctness.

“The Corporate Governance requires a strong Internal Control System and the Internal Control System assured, by the Internal Auditing, reinforces the Corporate Governance”.

Internal Audit

One of the main characters of the Internal Control System is Internal Auditing activity. Its mission states that it has to provide independent, objective assurance and consulting services designed to add value and improve the operations of the Company. It must also help the Company accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The scope of Internal Auditing is to determine whether the Company's network of risk management, control and governance processes, as designed and represented by management, is adequate and functioning in a manner which ensures that risks are appropriately identified and managed; interaction with the various governance groups occurs as needed; significant financial, managerial and operating information is accurate, reliable and timely; employees' actions are in compliance with policies, standards, procedures and applicable laws and regulations; resources are acquired economically, used efficiently and adequately protected; programs, plans and objectives are achieved; quality and continuous improvement are fostered in the Company's control processes; significant legislative or regulatory issues impacting the Company are recognised and addressed properly.

Opportunities for improving the management control, profitability and the Company's image may be identified during audits and, if communicated to the appropriate level of management in a timely manner, they can ensure a prompt solution to the problem.

The Internal Audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organization.
 - Ensuring effective organizational performance management and accountability.
 - Effectively communicating risk and control information to appropriate areas of the organisation.
 - Effectively coordinating the activities of and communicating information among the board, external and Internal Auditors and management.
- (see Guidance for the Profession of IA N. 2130 on Governance)

The Internal Audit activity should evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs and activities (see Guidance for the Profession of IA N. 2130.A1).

Consulting engagement objectives should be consistent with the overall values and goals of the organization (see Guidance for Profession of IA N. 2130.A1).

A Corporate Governance model through a Business Case: Fiat Revi – Fiat Group

The Fiat Group is a very composite reality for an Internal auditor due to its:

- Business complexity of the Group that focuses its attention on the production of all forms of people and goods mobility: from automobiles to trucks, from agricultural to commercial vehicles, from naval engines to aeronautical and space shuttles
- Geographical complexity arising from the many different locations of its offices and Plants, placed in all continents and recently gaining “new” and exciting markets like that of the Far East which is, on the other hand, undergoing a process of economic growth and transformation and may be weaker against corruption, abuse of power, and a system of managerial accountability provision (total no. of Plants 180 and Legal Entities 644)
- Strategic complexity, New Worldwide Joint-Ventures and international agreements have recently been held with: Ford (Poland), Suzuki (Hungary and Japan), Severstal (Russia), Saic (China), Pidf (Iran), Tata Motors (India and Argentina)
- Financial complexity in the first half of 2007 as at 30 June: Net Income of €/ml 28.855; Operative Result of €/ml 1541; Net Result: €/ml 1003.
- Organizational complexity (n° of employees 180.031 as at 30 June 2007)
- The Property complexity (n° of shareholders >300.000 among which Institutional Investors, Banks, Insurances, etc.).

Such a variegated industrial Group is increasing its number of auditors in order to strengthen the Internal Audit Function and improve its capability of controlling the state of the Corporate Governance as a “must”. The name of the Internal Audit Function within the Fiat Group is Fiat Revi S.c.r.l. It became an independent Company in 1976 when it was established by Fiat SpA, and the leading group companies, selecting the Consortium as the appropriate legal status. The Group Compliance Officers and the Chief Audit Executive are supported by Fiat Revi to perform their duties. Fiat Revi’s head office is located in Turin, since 1997, it has established branches in certain strategic countries (France, Germany, Poland, Brazil for the Latin American Area and China for the “Far East”). These entities operate with local personnel who are managed and trained by audit managers under the supervision of the Turin HQ.

Let’s have a look to the Governance structure of Fiat Revi.

Accountability

The Chief Audit Executive (CAE), in the discharge of his/her duties, is accountable to Management, the Internal Control Committee (ICC) and the Board of Statutory Auditors of Fiat S.p.A. (Internal Audit Committee - IAC) to:

- Provide annually, an assessment of the adequacy and effectiveness of the Company’s processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work
- Report significant issues related to the processes for controlling the activities of the Fiat Group and its affiliates, including potential improvements to those processes and to provide information concerning such issues through resolution
- Provide information periodically on the status and results of the annual audit plan and the sufficiency of the Internal Audit resources
- Coordinate with and provide oversight of other controls and monitoring functions (risk management, compliance, security, legal, ethics, environmental, external audit).

Independence

To provide for the independence of the Internal Auditing Function, its personnel report to the CAE, who reports administratively to the Fiat Group Chief Executive Officer (CEO) and functionally to the Internal Control Committee (hereafter ICC) and IAC in a manner outlined in the above section on Accountability. It will include as part of its reports to the ICC a regular report on the Internal Audit personnel.

The CAE prepares annually an Audit Plan and submits it to the CEO and to the ICC, afterwards he reports the audit results directly to the CEO and issues periodic reports to the ICC and management summarising results of audit activities.

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The ICC is a key point in granting good Governance within the company, at the same time as being constantly updated and informed of emerging trends and successful practices in Internal Auditing.

The CAE has an operative structure in the main Company within the Fiat Group: the Compliance Officers who reports directly to the CEO and functionally to the Chief Audit Executive of Fiat S.p.A. The Compliance Officers perform their activities in line with the operative sectors in which problems and lack of controls can arise, operating in compliance with the Fiat Group's policies along with the support of FIAT REVI.

The Compliance Officers are in the right position to: assist the CEO in planning, managing and monitoring the Internal Control System of the Sector's Companies; assess the effectiveness of the Internal Control System by verifying the implementation of action plans and informing the CEO about the results, support and assist Sector Management to identify potential areas of weakness and risk (operational, financial, legal, contractual, information or other risks). They also provide general guidance on avoiding or dealing with similar risks in the future; in monitoring compliance of policies, procedures and operational processes concerning the control system; and, finally in periodically preparing a Report on the status of the Internal Control System of the Sectors which is submitted to the FIAT Group's Compliance Officer, the Sector's CEO and Statutory Auditors.

Responsibility

The CAE and the professional staff of the Internal Auditing Function have the responsibility to develop a flexible annual audit plan using an appropriate risk-based methodology, including any risks or control concerns identified by management and to submit that plan to the ICC for review and approval.

The implementation of the annual audit plan includes, as appropriate, any special tasks or projects requested by management and the ICC.

While performing assurance activities, which include audits of a financial, operational, compliance, management nature, etc. and consulting services (include facilitation, process design, training and advisory services etc.) to assist management in meeting its objectives, the Internal Audit can verify the status of Corporate Governance from a privileged point of view thanks to its authority that allows it to have unrestricted access to all functions, records, property and personnel.

In particular the IA is in charge of:

- Assisting the Group in maintaining the validity of the Internal Control System through assessment of its effectiveness and efficiency and by promoting continuous improvement;
- Assisting the Group in identifying and assessing the greatest exposure to risk and contribute to improvements in the risk identification, reduction and management systems;
- Implementing specifically planned oversight activities to verify any weaknesses of the Internal Control System and identify any failings and the need for improvement of the internal control processes;
- Verifying that the rules and procedures constituting the terms of reference of the control processes are actually applied and that all those involved operate in compliance with set objectives.

Other Players Duties and Powers

The Internal Control Committee is a group composed of at least three independent directors in charge of:

- Assisting the Board of Directors in defining guidelines for the Internal Control System
- Assisting the Board of Directors with periodic audits of the appropriate and actual functioning of the Internal Control System, to ensure identification and proper handling of the principal risks faced by the company
- Assessing the operating plan prepared by the Compliance Officer and receive his periodic reports

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- Reporting to the Board of Directors on the adequacy of the Internal Control System at least once every six months, at the time as the annual report and first half report are approved
- Assess the organizational position and ensure the actual independence of the Compliance Officer in the performance of his duties in accordance with, and among other things, Legislative Decree No. 231/2001 on the administrative liability of companies.

The “Organismo Di Vigilanza” (referring to the Legislative Decree 231/2001) which is responsible for:

- Ensuring the observance of the modalities and procedures provided for by the Compliance Program and identifying any different conduct that might emerge from the analysis of information flows and reports that all heads of functions are committed to provide
- Surveying company activities in order to update the map of Sensitive Processes
- Performing periodic focused audits of specific transactions or acts by FIAT, especially in connection with the Sensitive Processes, whose results must be summarized in a special report to be presented to the delegated Corporate Officers during dedicated meetings
- Liaising with corporate management to assess the adoption of possible disciplinary sanctions, without prejudice to its prerogative of levying sanctions and activating the relative disciplinary procedure
- Liaising with the Head of Human Resources on the elaboration of personnel training programs and the content of periodic communications to Employees and Corporate Officers in order to provide them with adequate awareness and basic knowledge of norms pursuant to the Legislative Decree no. 231/2001
- Collaborating with the Human Resources Department, continuously preparing and updating the Group Intranet site area that contains all information relative to Legislative Decree no. 231/2001 and the Compliance Program
- Monitoring the initiatives taken to diffuse awareness and understanding of the Compliance Program and preparing the internal documents necessary for the implementation of the Compliance Program, containing user instructions, clarifications, and updates
- Gathering, processing, and storing significant information regarding compliance with the Compliance Program, as well as updating the list of information that must be sent to him or kept available for him
- Liaising with corporate functions/departments (at meetings and in other venues) in order to monitor in the best possible manner the activities in relation to the procedures laid down in the Compliance Program.
- Interpreting relevant norms (in coordination with the Legal Function) and assess the adequacy of the Compliance Program with respect to those norms
- Coordinating with corporate functions/departments (at meetings and in other venues) to assess the adequacy of, and need for updates to the Compliance Program
- Launching and conducting internal investigations, interfacing with the affected corporate functions/departments to acquire additional evidence (e.g. with the Legal Function to examine agreements whose form and content do not conform with the standard clauses designed to protect FIAT against the risk of involvement in the commission of Criminal Offenses with the Human Resources Department for application of disciplinary sanctions, etc.)
- Suggesting to management how the financial resource management systems (both collections and disbursements) already in place in the company could be supplemented so as to detect financial flows, characterized by margins of discretion which are higher than those ordinarily adopted.
- Is appointed and removed by the Board of Directors and reports to the CEO, the Internal Control Committee and the Board of Directors
- Is assigned the duty of monitoring the effectiveness, adequacy and compliance with the Compliance Program
- Granting have free access to all corporate documents that are deemed significant and must be constantly informed by management.

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In conclusion the internal Audit is a proactive function within Fiat Group and works to add value to the Company in a win-win system through the improvement of Corporate Governance and Internal Control. It's not by chance, in fact, that the Internal Auditing's motto is "Progress through sharing."

Mr. Di Gennaro joined Price Waterhouse in 1987 as Assistant Auditor and was subsequently promoted to Senior Manager. In 1994, he became Head of Internal Audit at Stet S.p.A. In 1997, 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. On January 1st, 2004 he joined Fiat S.p.A. as Chief Audit Executive and Compliance Officer. He is Vice President of IIA – Italy Chapter and President of European Confederation of Institutes of Internal Auditing. (ECIIA).

Fiat Group is known as one of the automobile industry's founders but, in a century of history, Fiat has also meant more than this. In fact, it has focused its attention on the production of all forms of people and goods mobility: from automobiles to trucks, from agricultural to commercial vehicles, from naval engines to aeronautical and space shuttles. Moreover, the complexity of this Group also arises from the worldwide spread of its offices and Plants located in all continents and entering or gaining "new" and exciting markets like that of the Far East. Such a kind of Group needs a huge number of auditors and a very strong Internal Audit Function. In 1976 Fiat Revi S.c.r.l. was established by Fiat SpA and the leading group companies which selected the Consortium as the appropriate legal status. Fiat Revi's head office is in Turin, since 1997, it has established branches in certain strategic countries (France, Germany, Poland, Brazil - for Latin American Area - and China for the "Far East"). These entities operate with local personnel who are managed and trained by audit managers under the supervision of the Turin Headquarters.